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WASHINGTON ECONOMIC WATCH

A Digest of Development Policy Information

A Project of the Overseas Development Council

A. I. D.
Development Information Center
Room 105 SA-18
Washington, D.C. 20523-1801

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WASHINGTON ECONOMIC WATCH

A Digest of Development Policy Information

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John W. Sewell, President

April 12, 1991

Dear Reader:

With this issue we begin the 1991 series of the Washington Economic Watch. As we enter our second year, we look forward to continuing to provide you with timely and relevant information on U.S. economic policy toward the Third World.

We would like to thank you for the overwhelmingly positive responses we have received from subscribers throughout our first year. A quote from a Latin American research institution illustrates the consensus of your feedback: "The Washington Economic Watch is an excellent compilation of information on current developments in Washington, which we find very interesting as well as very useful."

With this in mind, we would like to thank those of you who have already returned the surveys enclosed in the fourth quarter, 1990 issue of WEW. This information will help us adapt our digest further. If you have not yet completed your questionnaire, please do so and send it to us at your earliest convenience. We value your input and suggestions.

Sincerely,

Richard E. Feinberg
Executive Vice President
and Director of Studies

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TRADE

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I. The 1991 Agenda

In 1990 world trade provided tremendous opportunities for the United States economy and was a major engine of economic growth.

The rate of growth of U.S. exports was twice as fast in 1990 as the rise in imports and generated nearly half of our total growth in GNP.

Expanding these opportunities by aggressively working to increase U.S. access to foreign markets comprises the Administration's trade policy agenda for 1991. To do that, we have set ourselves three broad objectives for the year ahead:

First, to strengthen and expand the international trading system through the conclusion of an ambitious Uruguay Round agreement with 107 nations under the GATT.

Second, to complement Uruguay Round goals and agreements by undertaking regional and bilateral market-opening and market-expanding initiatives such as the historic North American Free Trade Agreement with Mexico and Canada, and the President's Enterprise for the Americas Initiative.

Third, to enforce and implement U.S. trade laws in ways that best advance the goals of open markets and expanded trade.

In order to achieve these goals, however, we must first accomplish a fourth and crucial objective:

The extension of fast-track negotiating authority from Congress for another two years.

Fast track authority provides two guarantees essential to successful negotiation of trade agreements: a vote on implementing legislation within a fixed period of time, and no amendments to that legislation.

Fast track authority expires on May 31 unless the President requests a two-year extension by March 1. Without fast track, the President cannot assure our negotiating partners that the agreement they reach is the agreement that will be voted on by Congress. Without that assurance, foreign governments are reluctant even to negotiate with the United States and will not make the tough concessions necessary to reach agreements the United States would be willing to sign.

Maintaining the fast track will preserve our ability to continue our efforts to liberalize trade and open markets through the GATT, through multilateral agreements, and through bilateral agreements.

1. Successful Completion of the Uruguay Round

The United States remains convinced that the Uruguay Round is the best means of strengthening the multilateral trading system. In the Uruguay Round the United States seeks to:

- Lower tariff and nontariff barriers worldwide and to eliminate these barriers completely in key sectors;
- Establish international rules of fair play in the new areas of services and investment, and to protect intellectual property;
- Fundamentally reform world agricultural trade by opening global markets and reining in costly trade-distorting agricultural subsidies;

- Integrate developing countries into our global trading system; and
- Strengthen international rules on dispute settlement, subsidies, antidumping and import safeguards, to expand access to foreign markets and ensure fair trade in the U.S. market.

If we can bring these negotiations to a successful conclusion, it could add more than $4 trillion to our global economy over the next decade. The U.S. share of this new wealth would be more than $1 trillion in output over the next ten years.

2. Regional and Bilateral Initiatives

This year the United States is undertaking two sweeping regional trade initiatives in this hemisphere:

- Negotiation of a North American Free Trade Agreement (NAFTA) with Mexico and Canada; and
- Advancing the President's Enterprise for the Americas Initiative (EAI) which envisions an hemispheric zone of free trade stretching from Alaska to Tierra del Fuego.

NAFTA: On February 5, 1991 the President announced his intention to negotiate a North American Free Trade Agreement with Mexico and Canada. This announcement followed on from the earlier decision by the United States and Mexico to initiate negotiations of a comprehensive bilateral FTA.

The United States is Mexico's principal trading partner and Mexico is our third largest customer. We already have an FTA with Canada. Linking our complementary economies through free trade will work to strengthen these economic bonds, increase regional political stability, and create new opportunities for U.S. exporters.

Ultimately, a NAFTA will create one of the world's largest and richest markets, with 360 million consumers and $6 trillion in annual output. A progressive lowering of obstacles to the flow of goods, services, and investment, and heightened protection of intellectual property, will provide the three nations with the opportunities they need to grow and succeed in an increasingly competitive global trading system.

A NAFTA also will support our broader aim of open markets and expanded trade globally by giving other countries greater incentive to seek open markets with us.

EAI: On June 27, 1990 the President proposed an historic initiative to join all the nations of the Americas in a new, open economic relationship, which he called the Enterprise for the Americas Initiative. This bold initiative has three elements: trade, investment, and debt reduction. EAI's trade aspects include working together to bring the Uruguay Round to a successful conclusion, a complementary effort to reduce trade barriers in our hemisphere, and ultimately the creation of a zone of free trade extending from Alaska to Tierra del Fuego.

As part of the EAI, the United States is negotiating framework agreements on trade and investment with a number of our Latin American partners. In this context we are pursuing improvements in the protection of intellectual property rights, more open investment regimes, reductions in export subsidy practices, and improvements in market access for goods and services.

Caribbean Basin Initiative (CBI): We are also working to ensure effective implementation of the CBI, including administrative measures that would allow further development of the region's tourism industry.

Andean Trade Initiative: As part of the President's effort to help the Andean nations find economic alternatives to the drug trade, the Administration is working to gain passage in Congress of Andean trade preference legislation. This would result in duty-free imports of a broader variety of goods from the region.

The Administration continues to press ahead with efforts to open key foreign markets through a

number of bilateral initiatives. We are seeking implementation of modern patent laws in the major South American countries and negotiating bilateral investment treaties.

Pacific Rim

Japan: Expanding access to the world's second largest market economy remains a top Administration priority. In pursuing this goal, the Administration is employing a comprehensive four-part plan of action: using the Uruguay Round to negotiate strong and enforceable multilateral rules; lowering structural barriers through our Structural Impediments Initiative, or SII, talks; eliminating barriers in specific sectors using our trade laws and through other means; and, building constituencies in Japan that will support market-opening measures.

In 1991 the Administration will continue to press Japan on commitments made last June under SII to remove an array of structural barriers, to amend laws, change policies, and spend money in ways that will further open the Japanese market.

The Administration also will closely monitor progress achieved under past market-opening agreements with Japan, including satellites, supercomputers, wood products, telecommunications, and amorphous metals.

Finally, we will vigorously pursue ongoing negotiations in areas such as construction, semiconductors, and legal services to ensure that Japan continues to open its markets in key areas of U.S. interest.

Korea: The United States will continue intensive bilateral negotiations with Korea to ensure that its growing market is accompanied by expanded access for imports. The Administration will pay particular attention to any Korean attempts to discourage imports.

Association of Southeast Asian Nations (ASEAN): In December 1990 the United States signed a memorandum of understanding with the six ASEAN governments (Malaysia, Thailand, Indonesia, Philippines, Singapore, and Brunei) to facilitate trade and investment. In 1991 the Administration will regularly consult at both the ministerial and senior staff level with the ASEAN nations to set up mechanisms for enhancing trade and investment relations.

Europe and the Mediterranean

EC 1992: The United States is carefully following the European Community's progress toward a unified market next year. We will continue to intervene with the EC in cases where the process of EC economic integration jeopardizes U.S. interests through restrictive discriminatory practices. Among the areas we are monitoring with special interest are: telecommunications, government procurement, financial services, and testing and certification.

Eastern Europe and the Soviet Union: The Administration seeks to integrate the emerging market economies of Eastern Europe into the open global trading system, in order to foster both political stability and economic growth. As these economies develop and open to world trade, new markets will be created for U.S. exporters. This year the United States will be working to implement trade and investment agreements negotiated last year, to complete ongoing negotiations, and to undertake new discussions.

Sectoral Efforts

Textiles and Apparel: The Administration seeks to negotiate an international arrangement in the context of the Uruguay Round that will replace the Multifiber Arrangement (MFA), allow for the orderly integration of this sector into the GATT, and provide enhanced export opportunities for the industry. The combination of these efforts will ultimately help the textile and apparel industries to adjust to an open trading system. The MFA is due to expire on July 31, 1991. The MFA will need to be extended until a Uruguay Round agreement is implemented; should the Round fail, the MFA will need to be renegotiated.

Steel: In 1989 the President established the Steel Trade Liberalization Program. Its goal has been to ensure that market forces, not

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governments, determine the patterns of trade, and the price and quantity of steel produced. This has been done through the negotiation of bilateral agreements to eliminate unfair practices and the phase out of Voluntary Restraint Agreements. The Administration now is working to incorporate these commitments into a multilateral agreement within the GATT through the Uruguay Round.

Shipbuilding: The Administration is working through the Organization for Economic Cooperation and Development (OECD) to reach an agreement eliminating subsidies and other forms of trade distorting government assistance to shipbuilders. It is expected that this agreement will be successfully concluded this year.

3. Implementation of U.S. Trade Laws

The Administration will use U.S. trade laws to complement its multilateral and bilateral objectives of free markets and fair trade. This includes implementing 1988 Trade Act provisions including initiatives involving intellectual property protection, telecommunications, and government procurement in ways which further U.S. multilateral goals.

The United States also will closely monitor market-opening agreements negotiated under section 301 in the past year, and will continue negotiations on matters that are the subject of current section 301 investigations.

In addition, the Administration's trade agenda supports internationally recognized worker rights around the world.

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

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release March 5, 1991

REMARKS BY THE PRESIDENT
DURING BRIEFING FOR
FAST TRACK AUTHORITY EXTENSION

Room 450
Old Executive Office Building

11:22 A.M. EST

THE PRESIDENT: Thank you all very much. One interrupts Carla at their own risk. (Laughter.) But that gives me a good lead-in to express my confidence in our USTR, in our trade representative. Certainly, also, in our very able Secretary of Commerce, Bob Mosbacher, who is behind me; Michael Boskin, upon whom I rely for so much in the economic field; and Fred McClure without whom we could not operate in terms of working with the Congress. So you have four of our best here, and I hope that you've been able to glean from them how important we feel this Fast Track is.

Obviously, the attention has been focused by the whole country -- indeed, the whole world -- on the Persian Gulf. But I wanted to come over and talk about economic growth because I am optimistic about the economic future of this country. And frankly, one of the things that's going to lead us out of the recovery is this vital export segment of our economy. I'm confindent that we can expand exports, and I'm confident that we can expand economic growth generally, but we've got to do it through opening world markets and not through throwing up barriers, not through protection that we might think, short run, will help somebody here at home; but long run, inevitably, results in a diminishing of the worth of this country.

As these four have told you, our economic growth depends on free markets and our trade agreements have got to open up these markets and provide rules for fair and free trade. I'll readily concede -- and so will Carla and Bob -- that we have further to go in terms of the fairness aspect. And we are going to continue to work on that. For many years, the Fast Track has allowed us to successfully negotiate the very important trade agreements in our history, reducing the barriers to trade and contributing to growth here and abroad.

We are committed -- this administration is committed to America's leadership role in the global economy and to the extension of Fast Track. We want to continue our active partnership with the Congress and with the private sector in expanding trade. Congress has a very special role in international trade. As business and association leaders -- all of you -- you've been tremendously helpful so far, and I want to keep this partnership strong. Fast Track will do this.

It'll also give us the same bargaining power that our counterparts already enjoy: the ability to ensure that the agreement reached at the table is the same one voted on at home. Supporting Fast Track will allow our important initiatives for economic growth to go forward. And if a disapproval resolution is passed by either house, the Fast Track for all purposes is history -- it's gone. As I would say with that is our ability to negotiate in the Uruguay Round, the North American Free Trade Agreement and the Enterprise for the Americas Initiative. All vital -- vital interests of the United States of America.

MORE

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So a vote against Fast Track really is a vote against vibrant international trade. We're doing very, very well with Mexico. Our relations with Mexico have never been better. And I give great credit to the President of Mexico, Carlos Salinas, and to his trade people, just as I do to our Secretary of Commerce and to our very able Trade Representative. They've worked hard and closely with Mexico. And it would be a shame to see special interests in this country gun down the Fast Track and thus stop us from getting the kind of free trade agreement with Mexico that is clearly in the interest of U.S.-Mexico relations, and I think will benefit all Americans as well.

And clearly, the Hispanic American population revels in the newfound improved relations with Mexico. And I think they would have a lot at stake in seeing that we have a good, strong agreement with the Fast Track leading the way.

We are the world's largest trader. And these exports in which many of you have been so active have become a vital source of strength to our economy. Even when the economy is weak and slow, the exports have been profitable and certainly leading the way.

So I know we're facing a tough fight on this in the Congress. I have pledged to you that the White House will do absolutely everything we can to get the message across to the Congress as to how important this is.

But the bottom line is simply this: We have before us the opportunity to expand growth and prosperity for all Americans. We can look at it selfishly. We can look at it -- what's in the best interest of the American people. And I am absolutely convinced that this Fast Track, it will lead to the Uruguay Round's successful conclusion, will lead to the America's Initiative, and also will lead to the bilateral agreement with Mexico are in our fundamental interests.

So I wanted to come over, thank you all for your very, very important work and urge you to redouble your efforts as we get down to what will be critical votes in both Houses of the United States Congress.

Thank you all very very much.

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The Likely Impact of Trade on The United States of a Free Trade Agreement with Mexico

United States International Trade Commission, February 1991.

EXECUTIVE SUMMARY

Introduction

The idea of the United States and Mexico entering into a free trade agreement has evolved from a distant goal to a serious possibility in a relatively short time. Less than 5 years ago, Mexico was mired in debt and committed to a highly interventionist economic policy that discouraged imports and limited foreign participation in the Mexican economy. In recent years, however, Mexico has reduced state intervention in the economy and opened its market to foreign goods, services, and investment. Mexico also entered into a series of trade negotiations with the United States. Largely as a result of these events, two-way trade between the United States and Mexico has grown significantly.

Negotiation of a free trade agreement (FTA) is now the primary mechanism being considered for expanding bilateral trade and investment between the United States and Mexico. On June 10, 1990, President Bush and Mexican President Salinas de Gortari endorsed a comprehensive bilateral FTA as the best means to strengthen economic relations and meet the challenges of international competition. Subsequently, Canada, which already has an FTA with the United States, requested participation in the negotiations. On September 25, 1990, President Bush formally requested Congress to allow the use of the so-called fast-track procedure for negotiating an FTA with Mexico and to explore the possibilities of Canada joining an agreement. It is anticipated that the Congress will have to disapprove the use of the fast-track procedure by spring 1991 or else it will be approved automatically. However, the authority granted the President to use the fast-track procedure expires on June 1, 1991 and would have to be extended to apply to any agreement. A decision on Canadian participation will probably be made soon.

The Commission analysis suggests that an FTA with Mexico will benefit the U.S. economy overall by expanding trade opportunities, lowering prices, increasing competition, and improving the ability of U.S. firms to exploit economies of scale. Since these gains are likely to outweigh the costs, the U.S. economy will probably gain on net. However, there are likely to be some shifts in production so that certain U.S. industries—such as horticultural products—will be disproportionately affected by an FTA.

The relative importance of the bilateral trading relationship between Mexico and the United States and the relative sizes of the two economies imply that the relative magnitude of effects of an FTA would be significantly smaller for the United States than for Mexico. Mexico is the United States' third-largest trading partner, after Canada and Japan, but it accounted for just 6 percent of U.S. imports and 7 percent of U.S. exports in 1989. In contrast, the United States accounted for more than two-thirds of Mexico's exports in 1989. Mexico's gross domestic product (GDP) of $187 billion in 1989 was only 3.6 percent of U.S. GDP.

Likely Impact on the U.S. Economy Overall

An FTA would benefit the U.S. economy overall, but for two major reasons the benefits relative to the size of the U.S. economy are likely to be small in the near to medium term. First, in spite of Mexico's population of some 88 million, as discussed above its economy is much smaller than the U.S. economy. Second, with a few exceptions, both countries already have relatively low tariff and nontariff barriers to trade with each other. A sizable share of U.S. imports from Mexico already enters the United States either free of duty unconditionally, under the Generalized System of Preferences (GSP), or at substantially reduced effective rates under maquiladora production-sharing arrangements. Similarly, many U.S. exports to Mexico are afforded duty-free treatment in Mexico under the maquiladora program. Since 1985, Mexico has significantly reduced tariffs and the number of products subject to import permits. Mexico has also liberalized the administration of its foreign investment regulations. The relatively low barriers already allow most of the benefits of trade between the two countries to be realized and therefore limit the potential benefits to the United States of an FTA.

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Many observers believe that Mexico's economy will grow rapidly in the coming years because of its recent economic reforms, whether or not an FTA is adopted. If Mexican growth is forthcoming, Mexico will become a larger trading partner of the United States and the increased trade will benefit the United States. The United States is likely to be the single largest foreign beneficiary of such growth, since it is by far Mexico's most significant source of imports and investment capital. The United States accounted for over 70 percent of Mexico's imports in 1989, and for some 63 percent of all accumulated direct foreign investment in Mexico.

An FTA would probably increase Mexico's rate of growth and thereby increase the benefits to the United States over time. For example, an FTA is likely to increase both domestic and foreign investment in Mexico. By codifying liberal trade and investment policies in an international agreement, heretofore adopted only as a matter of administrative policy, a United States-Mexico FTA would increase the confidence of investors in Mexico's economy. An increase in investment in Mexico would raise wage incomes and employment in Mexico, increase GDP growth, increase foreign exchange earnings, and facilitate the transfer of technology. In so doing, it would increase Mexico's demand for U.S. exports and benefit the United States. Nevertheless, for many years the effects would probably still be fairly small relative to the size of the U.S. economy.

An FTA with Mexico could have a greater impact on certain U.S. industries and regions than it has on the U.S. economy overall. The strongest effects on U.S. industries would likely be where current barriers to trade and investment are high or where demand for each others' products and services is highly sensitive to price. Regions with a high concentration of such industries or where trade with Mexico accounts for a substantial portion of economic activity are likely to be disproportionately affected.

Likely Impact on U.S. Labor Markets

An FTA is likely to have little or no effect on employment levels in the United States, but it could cause some shifts in employment among occupations and could affect wage rates and the level of immigration from Mexico. An FTA is likely to decrease slightly the gap between real United States wages and Mexican wages of both skilled and unskilled workers combined, but a greater share of the wage adjustment would occur in Mexico than in the United States. As wage differentials between the United States and Mexico narrow, the incentive for migration from Mexico to the United States will decline. Real income for U.S. skilled workers and capital service owners is expected to rise. Preliminary analysis indicates that the real income for unskilled workers in the United States is likely to decline slightly, although some plausible scenarios suggest that it could actually increase. Total real income in the United States would increase because of the trade creating effects of the FTA.

Likely Impact on U.S. Trade with Third Countries

The increase in United States-Mexico trade resulting from the reduction of trade barriers under an FTA would partly displace U.S. trade with other countries, including Canada and those in Central and South America, the Caribbean, and Asia. The fact that some of these countries already benefit from U.S. tariff preference schemes such as the GSP and the Caribbean Basin Economic Recovery Act (CBERA) may limit the amount of displacement. Moreover, only some of this displacement is expected to result in a loss of welfare associated with trade diversion—a shift from a lower cost supplier to a higher cost supplier. Since the displacement itself is expected to be small, it should have only a minor negative effect on the U.S. economy. It should be noted, however, that the U.S. market is vital to many countries and exporters. The relative benefits of tariff preference schemes, such as the GSP and the CBERA, to these third countries are likely to decrease. Some U.S. trading partners are concerned that any loss in sales to the United States as a result of a United States-Mexico FTA could hurt foreign suppliers.

Some U.S. producers have expressed concerns that a United States-Mexico FTA could allow third countries to circumvent U.S. tariffs and other trade barriers by transshipping their goods through Mexico to the United States or by using Mexico as a base for processing and export to the United States. The nature and the enforcement of the rules of origin in the agreement will determine the degree to which third countries will be able to access the U.S. market by these means.

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Likely Impact of Canadian Participation

Following the United States-Mexico decision in June 1990 to actively pursue negotiations toward a bilateral FTA, Canada requested participation with a view to negotiating a North American FTA. Two-way trade between the United States and Canada totaled some $163 billion in 1989, more than 80 times as great as Canada-Mexico trade of $2 billion. Canada hopes that a trilateral FTA would preserve its access to the U.S. market under the United States-Canada FTA. Canada wishes to avoid a loss to Mexico of U.S. trade and investment, which might occur should the United States become the sole North American locus with duty-free access to all three markets. Though small, Mexico has reportedly emerged as a competitor for Canada's share of U.S. markets for some products, such as autos and auto parts. Among other things, Canada would also like FTA negotiations to address tariffs, rules of origin, textiles and apparel, intellectual property rights, standards, dispute settlement procedures, and longer term questions such as future energy flows. In many of these areas the United States and Canadian economies are already closely aligned.

Canada's interest in a trilateral FTA also rests on its desire to participate in any North American dialogue on trade. Canada wants to be a part of any process that may eventually broaden market access to Central and South America. Although Canada hopes to gain from trade with Mexico in the long run, most analysts foresee relatively small short-term benefits because of the size of current Canada-Mexico trade.

Initial analysis suggests that the effects on the United States of free trade with Mexico and with Canada would be similar regardless of whether the United States concludes separate bilateral agreements with Canada and with Mexico or reaches a trilateral agreement. The only major difference would be that under separate bilateral agreements U.S. trade with both countries would be slightly greater than under a trilateral FTA because Mexico and Canada would maintain barriers on trade with each other.

U.S. trade with Canada is likely to decrease as a result of displacement by goods produced in Mexico under either the bilateral or the trilateral scenario. However, this decrease in U.S. trade with Canada would probably be slightly greater under a trilateral FTA.

Likely Impact on U.S. Regions

Southwest Border Region

The Southwest border region of the United States is vitally linked both geographically and economically to Mexico. As United States-Mexico trade increases under an FTA, trade-related activities along the border will also expand. However, an FTA could hurt other segments of the U.S. border economy.

- Mexico's maquiladora industry represents a large part of the region's economic base. An FTA could lead to an expansion of maquiladora production in Mexico, but would reduce the incentive for such firms to locate themselves near the border. However, incentives for investment to move closer to Mexican population centers in the interior and away from border infrastructure bottlenecks could be matched by incentives to remain along the border, such as proximity to existing border suppliers and services. Major maquila industries include electronics, automotive products, and apparel.

- Reportedly, U.S. firms currently supply about 98 percent of the raw materials and components used by maquiladoras. By eliminating U.S. tariffs on the non-U.S. value-added component of maquiladora exports to the United States, an FTA would tend to reduce the incentive to use U.S. raw materials and components.

- Retailing accounts for more than one-fourth of employment in the border region. Over one-third of retail sales in the U.S. border region are made to Mexicans. An FTA would tend to reduce some of the current advantages for U.S. retailers in serving Mexican consumers. However, any short-run losses would probably be offset in the longer term as retailers benefit from overall increased growth in the border region. Smaller U.S. retailers could be more vulnerable to Mexican competition than larger retailers.

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- An FTA will increase United States-Mexican trade and thereby raise demand for trade-related activities along the border, including transport, warehousing, and other services. Additional pressure will likely be placed on already strained border transport systems and entry facilities.

- Agriculture constitutes only a small fraction of the region's economy. Generally speaking, the problems and opportunities created by a United States-Mexico FTA are not centered in the border region. However, there is some concern that an FTA with Mexico will reduce the availability of Mexican migrant labor on U.S. farms in the region and strain already scarce water resources along the Texas border.

U.S. Census Regions

The Commission's sectoral analysis indicates that a United States-Mexico FTA will likely have negligible effects on the domestic operations of 17 of the 19 industries studied. It is expected to have a moderately negative effect on the horticultural products industry and will have an uncertain effect on the auto and auto parts industry. Based on these expected effects, as well as the regional concentration of the horticultural products industry and the expectation that an FTA would probably have a positive but small effect on the economy overall, it is unlikely that an FTA would have a significant positive or negative effect on the economy of any U.S. region.

The Industrial Midwest

The auto and auto parts industry is particularly important to the East North Central region, or "industrial midwest," but uncertainty about the effects of an FTA on this industry leaves uncertainty about the effects on this region. Although it is unlikely that the effects in the auto and auto parts industry would be great enough to affect significantly the economy of the region, the effects in the East North Central region could be slightly different from the national average.

Likely Impact on Major U.S. Industries

Although Mexico has liberalized its trade and investment policies in recent years, barriers to trade and/or foreign investment remain in industries such as agriculture, automotive products, energy products, banking, and transport. The removal of these Mexican trade and investment barriers, as well as U.S. barriers, under an FTA has the potential of creating additional trade between the two nations in affected industries. However, it is possible that U.S. investments and export opportunities in Mexico arising from an FTA will be limited, at least in the short term, given the underdeveloped state of Mexico's infrastructure.

The Commission analyzed the likely impact of an FTA with Mexico that removed United States and Mexican trade and investment barriers, for 19 key manufacturing, services, and agricultural industries.[1] The analysis focused on the likely impact of an FTA on U.S. trade with Mexico, Canada, and other countries and on production and employment levels in U.S. industries. The evaluation was based on (1) a quantitative analysis of relationships between expected changes in import and export prices due to removal of tariffs and NTBs and the resultant changes in U.S. import and export levels of affected industries; (2) interviews with experts in industry, trade, government, and academia; and (3) a qualitative analysis of nonprice factors such as investment restrictions that may influence the development of U.S. trade in particular industries. The analysis estimated the losses under an FTA (the likely increases in U.S. imports and resulting declines in U.S. production) and the gains (the likely increases in U.S. output resulting from increased U.S. exports to Mexico).[2]

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[1] Some of the industries covered in the analysis were identified by the House Ways and Means Committee and the Senate Finance Committee in their joint letter to the Commission requesting the study. Other sectors were added by the Commission staff.

[2] The quantitative analysis was used to assess trade and production impacts at the national level and not at the regional level. To conduct a rigorous and systematic analysis at a regional level would have required a different modeling approach and a different set of data not readily available. A qualitative analysis was conducted on the basis of the geographic concentration of the U.S. industries. It was assumed that the impact would be proportional to the regional distribution of the industry's domestic operations.

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In carrying out the quantitative analysis, the Commission used the effective rate of duty on U.S. imports from Mexico, rather than the nominal rate, to account for the relatively large amount of trade that enters duty free under the GSP or at reduced duties under the maquiladora program. Under this production-sharing program, U.S. components enter Mexico duty free for processing or assembly and the finished or semifinished goods enter the United States on a preferential basis with only the value added in Mexico subject to duty.[3]

The Commission also made two key assumptions in its analysis. First, it assumed that Canada would participate in the negotiation of an FTA, thereby resulting in a North American free trade area. Second, it assumed that the rules of origin adopted under an FTA with Mexico would be similar to those under the United States-Canada FTA.[4] In addition, the Commission was unable to factor into the analysis any changes in tariffs and NTBs that can be expected from the Uruguay Round negotiations, because of the remaining uncertainty over the results of the Round. However, to the extent that the Uruguay Round reduces tariffs and NTBs, the additional effect of an FTA with Mexico will be less pronounced.

The estimated quantitative effects of an FTA on the covered industries are reported in three qualitative categories: negligible, moderate, or significant in either a beneficial or adverse direction. Estimates are provided for adjustments in the short term, defined as adjustments within 1 year, and in the long term (those that would occur within 5 years).

The results of the Commission's analysis show that an FTA with Mexico may have moderate to significant effects on U.S. trade with Mexico in many of the industries covered. However, these trade gains or losses, though considerable in absolute terms for industries such as grains, electronic equipment, machinery and equipment, steel mill products, and textiles and apparel, would likely have a negligible impact on production levels in most of the U.S. industries, both overall and regionally. This is because the expected gains or losses in U.S. trade with Mexico would represent a very small share of these industries' domestic production. The industry that would be most affected by an FTA with Mexico is horticulture. In addition, several subsectors of the covered U.S. industries such as the tuna industry and producers of inexpensive household glassware would likely be affected. The analysis also shows that an FTA with Mexico would likely have a negligible impact on U.S. trade with Canada in almost all the industries. The impact on U.S. trade with other third countries would also be negligible, except for horticultural products and tuna. The results of the Commission's analysis for each industry are briefly discussed below.

Agriculture

An FTA is expected to affect significantly the level of U.S. trade with Mexico in agricultural products. Mexico is the second-largest foreign supplier to the U.S. market for these products after Canada, and the third-largest U.S. export market after Japan and the Soviet Union. About 40 percent of the agricultural imports from Mexico enter free of duty. The remainder are dutiable at a trade-weighted average of 7 percent ad valorem. Mexico's trade-weighted duty on U.S. agricultural goods averages 11 percent. Also affecting U.S. agricultural trade with Mexico are NTBs, such as U.S. marketing orders, Mexican import-licensing requirements, and both countries' phytosanitary rules.

Horticultural Products

Mexico is by far the largest foreign supplier, and the seventh-largest U.S. export market for horticultural products such as fresh and processed fruits and vegetables. Duties imposed by both the United States and Mexico are relatively high. NTBs such as U.S. marketing orders, Mexican import-licensing requirements, and phytosanitary rules in both countries also limit bilateral trade. The elimination of tariffs and NTBs under an FTA would generate a significant increase in U.S. imports from Mexico and a moderate increase in U.S. exports to Mexico. Mexican producers are able to supply the U.S. market with many of the same

[3] U.S. imports from Mexico under the maquiladora arrangement are dutiable under subheadings 9802.00.60 and 9802.00.80 of the Harmonized Tariff Schedule of the United States (HTS), formerly known as the 806.30 and 807.00 provisions.

[4] The rules of origin under the United States-Canada FTA are used to determine whether goods traded between the two nations are eligible for preferential duty treatment under the FTA. In general, to be entitled to such treatment, goods must be made wholly in one or both FTA nations or, if the goods contain third-country materials, the materials must have been transformed in one or both FTA nations in a manner that is physically and commercially significant to effect a change in tariff classification in the HTS.

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products grown or processed in the United States at much lower costs. This is particularly true for citrus crops and winter vegetables that are manually harvested. U.S. growers of these products are expected to experience losses in production, particularly growers in Florida, California, and other warm-climate States who compete directly with products during the same growing seasons in Mexico. U.S. processors of these crops are also expected to experience production losses. An FTA with Mexico would also likely cause a decline in U.S. imports from Latin American nations that tend to export the same type of products as Mexico.

U.S. producers of temperate-climate products and certain processed products such as canned potatoes and dried beans are likely to benefit moderately in the long term from an opening of the Mexican market. In the short term, however, the underdeveloped channels of distribution and the unequal distribution of consumer income in Mexico may limit U.S. export potential.

Grains and Oilseeds

About two-thirds of U.S. agricultural exports to Mexico consist of grains and oilseeds, for which the United States is the world's largest exporter. Both countries maintain import quotas on grains and oilseeds, although the U.S. quotas apply only to peanuts. Tariffs generally average less than 10 percent ad valorem in Mexico and less than 2 percent in the United States. Both countries also maintain extensive government-support programs for farmers that affect trade in these products. An FTA that eliminates these barriers would likely result in a significant increase in U.S. exports, particularly of corn, sorghum, and soybeans. However, the expected export growth would represent a small share of total U.S. production of grains and oilseeds. U.S. imports of these goods from Mexico would only be negligibly affected, because of Mexico's poor endowment of arable farm land suitable for such crops.

Livestock

Mexico is a major U.S. trading partner in livestock (i.e., cattle, swine, sheep, and lambs) and meat derived from such animals. Mexico supplies all but a small part of U.S. imports of feeder cattle and is the second-largest export market for U.S. meats. U.S. tariffs on imports of feeder cattle average about 1.5 percent ad valorem. Mexico also currently charges a fee on its exports of cattle, of 5 percent ad valorem. Mexican tariffs on U.S. meats range from 10 to 20 percent.

Removal of Mexico's relatively high tariffs on meats under an FTA would likely result in a moderate increase in U.S. exports of meats to Mexico. Similarly, the removal of U.S. duties and Mexican export fees on feeder cattle would likely result in a moderate increase in U.S. imports of such cattle. The expected growth in imports might benefit the U.S. cattle feedlot subsector, but could harm the cow-calf subsector, which produces feeder animals. Farmers concentrated in the Southwest and Southcentral States, where most of the imports enter, could be most affected. In addition, U.S. imports of Mexican meats might also increase under an FTA, especially now that U.S. restrictions on such shipments have been lifted for several Mexican meatpacking plants.

Fish and Fish Products

Mexico is the third-leading supplier of U.S. imports of edible fish and fish products. Most of these imports from Mexico enter free of duty, with the exception of canned tuna. U.S. imports of canned tuna packed in oil are subject to a duty of 35 percent ad valorem and imports of tuna packed in water are subject to a tariff-rate quota of 6 percent on those under quota and 12.5 percent for those over quota. In addition, U.S. trade with Mexico in fisheries products, especially tuna, is affected by disputes over territorial rights and the killing of dolphins during tuna harvest.

The overall impact of an FTA on U.S. imports of Mexican fish and fish products would likely be negligible. However, removal of U.S. duties on canned tuna would likely lead to significant growth in U.S. imports of Mexican tuna. The expected import growth would likely result in significant harm to the U.S. tuna industry, particularly to the cannery in California and, to a lesser extent, the canneries in Puerto Rico. However, an FTA that increases U.S. access to Mexico's 200-mile fishery zone would likely lead to a moderate increase in U.S. production of frozen tuna.

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Alcoholic Beverages

An FTA would likely spur U.S. exports of alcoholic beverages to Mexico. These exports have grown rapidly since 1985, in response to Mexico's reduction or elimination of many of its duties and NTBs. This trend is expected to continue under an FTA, as Mexican duties are further reduced and distribution arrangements in Mexico improve. The likely impact of an FTA on U.S. imports from Mexico is expected to be negligible, primarily because U.S. duties on alcoholic beverages are already low.

Automotive Products

Mexico is a small, but rapidly growing supplier of autos to the United States. During 1985-89, U.S. imports of autos from Mexico rose at an average annual rate of 34 percent to almost 143,000 units, valued at $1.3 billion. The auto industry in Mexico is owned by five foreign producers, the Big Three U.S. automakers, Nissan, and Volkswagen, which assembled 641,000 autos there in 1989. U.S. trade with Mexico is also expanding rapidly in auto parts, with U.S. imports rising by 14 percent annually, to $3.6 billion, and U.S. exports advancing by 16 percent annually, to $3.4 billion. The auto parts industry in Mexico comprises several hundred firms, with U.S.-owned auto parts firms playing a major role in the industry. The industry, along with the electronics industry, generates more value-added in Mexico's maquiladora sector than any other industry.

The most significant factors affecting U.S. trade with Mexico in automotive products are Mexican foreign investment restrictions, export performance requirements, local content rules, and import restrictions. Automakers in Mexico must maintain trade surpluses. For each dollar's worth of autos that automakers import into Mexico during 1991, they must earn $2.50 in foreign exchange from auto exports. Mexico currently limits auto imports to 15 percent of total Mexican auto sales and prohibits imports of autos with engines less than 1.8 liters until the 1993 model year. Mexico also limits foreign investment in the auto parts industry to 40-percent equity participation, with some exceptions. In the maquiladora sector, full foreign ownership is permitted provided that at least 80 percent of the output is exported. In addition, Mexico requires at least 36-percent Mexican content in the value added in the country by automakers and auto parts producers.

These trade and investment restrictions in Mexico, coupled with other economic and political factors, have significantly influenced the evolution of the Mexican automotive products industries and, at the same time, currently limited their integration into the greater North American automotive products sector. Because the auto market in Mexico is small and diverse, automakers in Mexico produce a relatively diverse number of models—at low volume levels—to meet consumer preferences. Consequently, the auto plants primarily serving the Mexican market are marked by relatively low operating efficiencies. Their output currently averages less than half the standard output of modern plants around the world.

Thus, the most significant impact of an FTA in automotive products could come from liberalization of the above-referenced Mexican barriers to trade and investment. However, the likely impact of an FTA with Mexico on the United States in automotive products is difficult to determine without knowledge of the Big Three automakers' plans for their Mexican operations. It is also difficult to assess the impact of an FTA with Mexico on U.S. trade in automotive products with Canada, given the highly integrated nature of the Big Three U.S. automakers' operations in the United States and Canada. Other auto producers have not announced their manufacturing strategies in the event of an FTA with Mexico. U.S. auto industry representatives view Mexico as a long-term, high-growth market for autos. They also believe that the potential exists for the Mexican auto industry, with its low labor costs, to become an integral part of the North American auto industry. The pace of integration would likely quicken if an FTA removes Mexico's NTBs. An FTA would likely encourage the Big Three to restructure their Mexican operations to increase their specialization, thereby achieving economies of scale and, in turn, enhancing their competitive position vis-a-vis Asian and European producers.

Cement

Mexico is a major supplier of cement to the United States, especially in the southwestern and southern border and coastal regions where it has captured 11 percent of the market. All but a small part of U.S. imports from Mexico are supplied by CEMEX, the largest cement

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producer in the Western Hemisphere, which also maintains extensive operations in five U.S. border States. U.S. imports from Mexico, totaling $118 million in 1989, already enter free of duty, although they are subject to U.S. antidumping and countervailing duty orders. By contrast, U.S. exports to Mexico, totaling a much smaller $2 million, are dutiable at 10 percent ad valorem.

An FTA with Mexico would have no impact on U.S. imports of cement from Mexico, but would lead to a significant increase in U.S. exports to that nation. The expected export growth would, because of the regional nature of the cement market, benefit U.S. producers located near the United States-Mexican border. However, the expected export growth would represent only a negligible portion of U.S. shipments, both overall and for the regional industry.

Chemicals

U.S. trade with Mexico in chemicals, marked by a surplus of $1.6 billion in 1989, is affected by Mexican restrictions on foreign investment and inadequate protection of intellectual property rights. The Constitution of Mexico prohibits foreign investment in production of basic petrochemicals, for which the United States is the world's largest producer, and of a few secondary petrochemicals. In pharmaceuticals and specialty chemicals, the lack of intellectual property rights protection has discouraged foreign investment in Mexican production.

An FTA that removes Mexican restrictions on foreign investment and protects intellectual property rights would likely spur U.S. investment in Mexico for the manufacture of high-technology products and generate moderate growth in U.S. exports. Such investments would likely stimulate a complementary increase in U.S. exports of chemical intermediates for the production of high-technology products, since such intermediates are not made in Mexico. The long and costly startups associated with the construction of chemical production facilities, however, would delay any investment-related impact on trade in the short term. The removal of Mexico's duties, though averaging a rather high 15 percent ad valorem, would not by itself lead to a noticeable increase in U.S. exports to Mexico, because of the importance of existing supplier-customer relationships in purchasing decisions. An FTA would likely result in a negligible increase in U.S. imports of Mexican chemicals because U.S. duties average a relatively low 4 percent ad valorem.

Electronic Equipment

An FTA with Mexico would likely result in a negligible increase in U.S. imports from Mexico. U.S. trade with Mexico in electronic products, totaling $8 billion in 1989, takes place mostly under the maquiladora program. The nominal U.S. tariff on Mexican electronic goods averages 5 percent ad valorem, although some duty rates are as high as 15 percent. The effective trade-weighted duty averages only 2 percent, given the large portion of the trade that enters at reduced duties under either the maquiladora or GSP programs.

U.S. exports to Mexico, on the other hand, would likely grow moderately in the short run and significantly in the long run. Mexican duties on electronic goods average an estimated 16 percent. The difference between U.S. and Mexican duties partly explains the different growth that can be expected, as does the significant need and demand in Mexico for modern equipment, such as in the telecommunications area. Elimination of Mexican "buy national" policies and local content rules would also serve to expand the market in Mexico for U.S. exports. U.S. producers of telecommunications apparatus, office machines, and other advanced-technology equipment for use in Mexico's infrastructure would likely benefit the most.

Energy

The United States is a major market for Mexico's energy products, such as crude petroleum and refined petroleum products. It is also a major source: almost half of Mexico's demand for refined petroleum products and 90 percent of its total imports of natural gas are supplied by the United States.

United States and Mexican duties on energy products are relatively low and, thus, their removal under an FTA would likely have a negligible effect on bilateral energy trade. The major deterrent is Mexico's constitutional ban on U.S. and other foreign investment in its energy sector, operated solely by the national oil company, PEMEX. Assuming that an FTA does not open the Mexican energy sector to U.S. investment, opportunities for trade expansion would remain limited.

Glass products

Mexico is an important U.S. trading partner in glass products, ranking as the United States' fifth-largest foreign supplier and the third-largest export market. Most U.S. imports of glass products from Mexico enter duty free under the GSP. The major exception is household glassware, for which U.S. duties average 22 percent ad valorem. Mexico's duties average 20 percent for all glass products. The removal of these duties under an FTA would likely result in a significant increase in U.S. imports of household glassware from Mexico. Although the expected import growth would likely have a negligible impact on the overall U.S. industry, it could have an adverse impact on U.S. producers of inexpensive household glassware. In addition, the expected import growth is likely to be greater and more immediate than any potential increase in U.S. exports to Mexico, which are limited because of the dominance in the Mexican market of Mexico's largest producer. The lack of an effective distribution system for U.S. products and the smaller size and purchasing power of the market in Mexico also limit U.S. sales prospects.

Machinery and equipment

The machinery and equipment sector is expected to remain a key element of U.S. trade with Mexico, given that nation's need for capital goods to modernize its production and infrastructure base. An FTA that results in the removal of Mexico's import-licensing requirements and duties of 10 to 20 percent ad valorem, coupled with Mexico's improved prospects for economic growth, would likely lead to a moderate increase in U.S. exports of machinery and equipment to Mexico. The expected export growth would likely benefit U.S. producers of major household appliances and capital goods such as machine tools and general industrial equipment. The potential for U.S. export growth also exists in farm and construction machinery and in food processing, plastics injection molding, and pollution control equipment.

The removal of U.S. duties under an FTA would likely result in a negligible increase in U.S. imports of machinery and equipment from Mexico. The trade-weighted U.S. duty on imports of Mexican machinery and equipment averages only 3.35 percent ad valorem. Moreover, the expected increase in imports from Mexico would likely be concentrated in low-valued, low-technology products such as general components and home appliances. In the long run, and assuming that an FTA does not result in the equalization of wages and health, safety, and environmental standards, U.S. firms may accelerate the process of producing more finished machinery and equipment in Mexico.

Steel Mill Products

Mexico has been one of the largest markets for U.S. exports of steel mill products (steel), accounting for about 17 percent of all such exports in 1988 and 10 percent in 1989. Mexico's steel exports to the United States have been limited to less than 1 percent of apparent U.S. steel consumption since 1985 under a voluntary restraint agreement (VRA) scheduled to expire in March 1992. U.S. tariffs on steel range from 0.5 percent to 11.6 percent ad valorem and Mexico's duties range from 10 to 15 percent.

An FTA that removes tariffs, coupled with the expiration of the VRA, is likely to result in a moderate short-term increase in both U.S. imports from and U.S. exports to Mexico. The long-term impact is likely to be more significant as new market opportunities are pursued and trading relationships develop. The expected export growth is likely to be concentrated in non-flatrolled products for construction applications (e.g., structurals and wire products), certain tubular products for energy applications, and in higher value sheet products for use in autos and appliances. The projected increase in imports from Mexico is likely to consist of products currently subject to relatively high U.S. tariffs, such as high-value specialty steels, and also price-sensitive products such as plate, bar, rod, wire products and certain tubular products. The trade shifts likely to occur under an FTA are small relative to overall U.S. trade and

production. Thus, they are expected to have a negligible effect on the U.S. industry and on U.S. trade with other foreign suppliers.

Textiles and Apparel

U.S. trade with Mexico in textiles and apparel primarily occurs under the maquiladora program. U.S. and Mexican duties in this sector are relatively high and U.S. imports of Mexican products are subject to quantitative limits under the Multifiber Arrangement. U.S. duties average 15 percent ad valorem for textiles and apparel. However, the effective trade-weighted rate is only 6 percent. Mexican duties average from 12 to 18 percent for textiles and 20 percent for apparel.

Elimination of duties and quotas under an FTA would give further impetus to U.S. imports of textiles and apparel from Mexico, which grew at an average annual rate of 19 percent during 1985-89. The expected import growth would likely displace some U.S. production and third-country imports of lower cost apparel and textile products, notably those from the Caribbean Basin. However, the overall impact on the U.S. industries would be negligible, given that the trade with Mexico is small relative to U.S. output. An FTA would also result in a significant short-term increase in U.S. exports of textiles and apparel to Mexico, which rose by 25 percent annually during 1985-89. The projected export growth would likely be concentrated in components for use as inputs in maquiladora operations producing garments and other textile products for export to the United States. In the long term, the growth of U.S. exports to Mexico would likely moderate as the Mexican textile industry becomes more developed.

Services

U.S. trade with Mexico has traditionally been limited primarily because of Mexican limitations on foreign ownership and other restrictive NTBs. An FTA, coupled with recent Mexican efforts aimed at privatizing and liberalizing several services sectors, would likely lead to an increase in investment and export opportunities in Mexico for U.S. firms. However, since trade in services with Mexico is minuscule relative to U.S. output of services, the overall economic impact on U.S. services sector will be negligible.

In banking, U.S. exports of services to Mexico would likely expand at a moderate rate if an FTA removes Mexican restrictions on foreign investment and if Mexico continues to revitalize its financial services industry. Similarly, if the existing NTBs in insurance are removed (especially those limiting non-Mexican companies to 49-percent ownership), the likely impact would be a significant increase in U.S. investment in the Mexican insurance sector, which would likely lead to a moderate increase in U.S. exports.

Construction services currently play a minimal role in United States-Mexico trade. This is mostly due to Mexican regulations restricting foreign participation in construction projects to a minority role in joint ventures and to U.S. immigration laws that restrict the movement of unskilled labor across the border. Under an FTA, U.S. construction firms will continue to benefit from their competitive advantage in projects requiring advanced design techniques and highly skilled construction management teams. Additionally, free movement of labor, if permitted under an FTA, could benefit both U.S. and Mexican firms by lowering labor costs. In the long term, if labor shortages develop in the United States, Mexican firms might then have an advantage in projects in the United States that require large numbers of unskilled workers.

U.S. trade in transportation services (excluding tourism-related transportation) with Mexico is limited because of numerous trade and investment barriers. Changes in the transportation sector resulting from an FTA would largely depend on revisions in U.S. State and Federal regulations and Mexican regulations that restrict participation on both sides. An FTA would likely have the most effect on motor carriers, which haul most of the domestic cargo in Mexico and most of the cargo that moves between the United States and Mexico. Although U.S. imports of trucking services from Mexico are likely to increase significantly, the overall effect on imports of transportation services would probably be small.

While an FTA would probably have little impact on the U.S. telecommunication and information services sector, the recent sale of TELMEX will appreciably change the Mexican telecommunication sector. Development of Mexico's telecommunication services sector has

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been constrained by restrictive regulations and an underdeveloped infrastructure. The change in ownership and subsequent expansion and improvement of the network should result in an increase in telecommunications-based and related services that will lower costs, bring in foreign capital, and lead to an increase in demand for U.S. telecommunications software. An FTA in services would complement these changes in the domestic Mexican telecommunications market and significantly increase exports of U.S. information and data-processing-based services. Since approximately 90 percent of current trade is dominated by basic services i.e., telephone calls, the overall increase in U.S. exports will be negligible.

Three-Way Trade Gains

The following is an excerpt from "Free Trade for North America a Canadian Perspective," a speech given by Edward P. Neufeld before the National Economists Club in Washington on Feb. 5. Mr Neufeld is an executive vice president of the Royal Bank of Canada.

The incentive for Canada to participate in the Mexico-U.S. free trade negotiations has both positive and defensive aspects. This is because there are likely to be negative repercussions from staying out as well as positive benefits of being in.

The positive benefits relate to the expansion of the market for Canadian products in Mexico, particularly as, over time, the wealth of the country and so its imports of investment and consumer goods increases.

Canada has an educated labor force, a reasonable range of international corporations, a highly developed capital market and demonstrated strength in transportation equipmen , telecommunications, civil engineering, real estate development, agriculture, fishing, forestry and financial services. These represent a solid base for developing opportunities opened up by freer trade.

Canada's aging population means inevitable shifts out of labor-intensive industries. The Mexican relationship would give Canadian companies the option of continuing labor-intensive operations there

Consider the consequences for Canada of the United States and Mexico going it alone. Canada would be penalized because it could not expand exports to Mexico, but would face stiffer competition from Mexican producers. Canada would be faced with a competitive challenge on at least four fronts.

• There could be some diversion of U.S. trade away from Canada and toward Mexico. New investment in manufacturing in Mexico combined with low labor costs could give a competitive advantage to Mexican exports over Canadian exports in the U.S. market.

At present, Canada's share of the U.S. market in certain product lines is protected by U.S. policies, primarily in the form of quotas, but also in the form of tariffs against Mexican imports. If the United States were to liberalize access, some of that market share would be lost to expanding Mexican firms.

Mexican exports to the United States are bearing an increasing resemblance to those from Canada, particularly in the case of the automotive industry. Those goods are now the biggest component of merchandise trade between the United States and Canada, and also between the United States and Mexico.

Mexico is, in varying degrees, a competitor in automobile parts, industrial machinery, metal fabrication, textiles, footwear, iron and steel, petrochemicals and paper products. A Mexico-U.S. free trade agreement excluding Canada could negatively affect some Canadian exports to the United States.

• There also could be greater indirect import penetration from Mexico. The duty-free provisions of the Canada-U.S. agreement do not apply to goods purchased in the United States if they are manufactured abroad. But goods with a sufficiently low proportion of intermediate content produced in a third country could qualify as U.S. or Canadian products for purposes of further manufacturing. If a Mexico-U.S. free trade pact is negotiated without Canada's participation, more U.S. finished products with intermediate components made in Mexico may find their way into Canada.

• Greater Mexican import penetration into the United States might force U.S. producers to shift some of their output to Canadian markets.

• Labor costs and locational advantages could divert from Canada to Mexico investment flows of both North American and non-North American companies seeking to develop a production base in North America. The United States also could be a preferred investment location since it would be the only country with free access to markets in all three countries.

The large differences between wages and productivity in U.S. and Canadian manufacturing plants and those in Mexico suggest that there are very substantial efficiency gains to be obtained by freeing up trade. But these differences also suggest larger transitional costs.

A free trade deal that quickly removed tariffs on most of the trade between the United States and Mexico could make it difficult for some U.S. and Canadian producers to compete with cheaper Mexican goods. U.S. producers of electrical equipment, autos and parts, and consumer goods would face greater competition from Mexican exporters. U.S. fruit and vegetable growers would also face greater competition from Mexican growers

Some U.S. unions already are strongly opposed to the establishment of in-bond manufacturing zones in northern Mexico, which have shifted jobs from the Rust Belt to the South. Given that Mexico has already unilaterally lowered its tariffs substantially, the economic adjustment effort might be greater on the part of the United States.

On the Mexican side, a free trade deal promises to be a major issue in this year's mid-term elections. Several union leaders have criticized a possible Mexico-U.S. free trade deal, saying that it would flood the country with imports, create chronic unemployment and lead to the "exploitation" of Mexican workers.

Like Canada, Mexico has a number of sensitive sectors such as energy, banking, rail transportation, and services Mexico may look for a deal that extends only to certain sectors.

In Canada the specter of "cheap labor" already has been raised by certain groups, including the unions. They express concern over the impact on people in low paying jobs and on Canada's social programs, which they fear raise costs more than do those in Mexico. It may be that the non-economic issues — national identity, foreign ownership, culture, resource control — will actually be much easier to manage than they were in the U.S negotiations. This, at least, bodes well for a successful Canadian participation.

The Canada-U.S. Free Trade Agreement in a sense opened the door to the possibility of a Mexico-U.S.-Canada free trade area. It, in turn, could be a force for further trade liberalization in Latin America and the Caribbean. That is an immensely hopeful prospect, for it would constitute a strong foundation for growth and development among a very important group of developed and developing countries, well into the 21st century.

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WASHINGTON POST, March 14, 1991

Free Trade With Mexico

Thomas R. Donahue

Conspiracy for the Rich . . .

There are always a good many schemes floating around to help the rich get richer and the poor get poorer, but the one currently being considered here—the proposed North American free trade agreement—is in a class by itself.

Its scale is vast—Yukon to Yucatan. It would profoundly disrupt the $6 trillion North American economy and throw 90 million Mexicans into cutthroat competition with 270 million Canadians and U.S. citizens. In fact, the list of FTA victims in all three nations would be colossal. In this country and Canada it would include hundreds of thousands of workers whose jobs would be exported to Mexico.

We have a preview of an FTA in the *maquiladoras*, the U.S.-owned plants that operate south of the border and exploit about 500,000 Mexican workers. Plenty of U.S. employees of Electrolux, Zenith, GE, Ford, AT&T, Chrysler and other companies have seen their jobs vanish, then suddenly reappear among the *maquiladoras*. Under an FTA, their numbers would mushroom.

How many people in the United States would be hurt by the upheavals? An International Trade Commission report admits that "unskilled workers" would suffer a "slight decline" in real income, but it happily reports that "skilled workers and owners of capital services" would benefit. For millions, the decline would actually be more than "slight"—but the important point here is that people on the bottom economic rungs would lose and those on the top rungs would win.

The commission mysteriously refuses to say whom it counts as "unskilled workers," but it reportedly includes all workers with four years of high school or less. This would mean that a majority of the working population—52.5 percent—would be hurt by an FTA.

Farther up the ladder, large corporations would hit the jackpot. Mexican plants are already a bonanza for them. They can take advantage of the terrible poverty in Mexico and pay workers a small fraction of average U.S. wages, and they don't have to pay for workmen's compensation, unemployment insurance, health insurance or other essentials of civilized life.

Would Mexican workers benefit from an FTA? Again, the *maquiladoras* are a gruesome preview. They pay employees about 60 to 80 cents an hour, hardly enough for subsistence. Workers in many *maquiladoras* live in shacks made of packing materials. Their drinking water is sometimes in large 50-gallon drums that previously contained toxic materials. The Wall Street Journal noted that the *maquiladoras'* "very success is helping turn much of the border region into a sinkhole of abysmal living conditions and environmental degradation."

When the *maquiladoras* started, they were supposed to help Mexico join Hong Kong, Singapore, South Korea and Taiwan. But years later, northern Mexico remains an environmental, economic and social inferno. Small wonder. The original purpose of *maquiladoras*—their "comparative advantage" in international trade—was providing multinational corporations with a poor, frightened work force. That's never changed.

An FTA would turn much of Mexico into a huge *maquiladora*. Mexico's wealthiest classes would cash in, but most workers would suffer the fate their sisters and brothers along the border have endured for years.

So what keeps the FTA idea going? A glitzy brand name has something to do with it. The "free trade" label has political clout these days, especially with the European Community's 1992 Single Market on the horizon. But using "free trade" to justify an FTA is like using "the sanctity of the family" to justify beating the children.

If the administration wants a continental arrangement to compete with the EC Single Market, it's doing it all wrong. The Single Market includes a Social Charter. It sets out rights to a minimum wage, social assistance, collective bargaining, vocational training and health and safety protection in all of the member countries, partly to discourage runaway plants. Besides, workers have recourse to such institutions as the European Parliament and Court of Justice.

The FTA's worker protections can be summarized in two words: "Tough luck."

The Europeans have a $68 billion Regional Development Fund to narrow the gap between rich areas such as western Germany and poor areas such as Portugal. Here, the per-capita income ratio of the United States and Mexico is a staggering 10 to 1—far larger than anything in Western Europe. In a free-trade area, that would be an economic time bomb, but the FTA wouldn't provide a nickel to defuse it.

No matter. The administration has its FTA scenario all worked out. First, Congress will hand it "fast-track authority." In other words, the House and the Senate will forfeit their right to change anything in the final agreement. The administration will be firmly in control of negotiations. In the end, members of Congress will vote only on the full package. They can take it or leave it—but the administration is confident that they will take it.

All this could happen. If it does, a good many of the working people of North America will find themselves on the "fast track" to being either laid off or exploited.

The writer is secretary-treasurer of the AFL-CIO and chairman of the Labor Advisory Committee for U.S. Trade Policy and Trade Negotiations.

Michael Kinsley

. . . Opportunity for the Poor

Opponents of a free trade zone with Mexico, as proposed by the Bush administration, cannot make the usual protectionist complaint about the absence of a "level playing field." The whole idea of a free trade zone is to level trade barriers on both sides to zero.

Nor can poor Mexico, with one-tenth our per-capita income, be vilified, like Japan, as a monster out to suck our economic life's blood. Instead, the argument is nearly the opposite: Mexico is too primitive and impoverished, with Third World wages and environmental standards. Unrestricted competition with such a country, the case goes, will drag the U.S. economy down to Mexico's level.

The case is wrong. It is impossible for a nation to become poorer by buying the products of cheap foreign labor. Average hourly compensation in 1989 for U.S. workers was $14.31; for Mexicans, $2.32. The difference: $11.99 an hour. But even assuming, incorrectly, that American and Mexican labor are equally productive, there is no national advantage to be gained in barring imports from Mexico. If labor is available for $2.32, paying $14.31 instead doesn't create an extra $11.99 of wealth. It creates nothing. That extra $11.99 is drained from the rest of the economy. The U.S. economy could buy the products in question from Mexico, pay the Americans thereby thrown out of work $10 an hour to do absolutely nothing and still be $1.99 better off.

Of course, President Bush is not proposing to pay anyone $10 an hour not to work. He wants the overall benefit of unrestricted trade with Mexico without worrying about the costs to individuals who lose their jobs or face downward pressure on their wages. These are the same people already suffering from the trend toward greater income inequality.

A trade pact will create jobs as well, by opening up Mexican markets and by giving Mexicans more dollars to spend. Many of the consumers who benefit from access to cheaper Mexican goods will also be poor: buyers of clothes, shoes, food. Nevertheless, some of that $11.99 ought to be spent on training Americans to do jobs that Mexicans can't. Contamination from Mexico will infect us with a Mexican standard of living. What will do so is failure to make sure that our own labor is genuinely more valuable.

And doesn't fairness to Mexicans deserve some consideration as well? The AFL-CIO argues nonsensically that a free-trade pact will destroy jobs and reduce wages in the United States, but will not create jobs or raise wages in Mexico. In fact, every job lost by an American will go to a Mexican who is poorer and more desperate.

Opponents of the pact argue that to import the products of labor at wages no American would tolerate is to implicate the United States in immoral exploitation. And no doubt there is some level of pay or working conditions, approaching slavery, to which this analysis correctly applies. But many Mexicans are glad for work at wages an American wouldn't consider, and you would be too given their alternatives, such as starvation. Piously denying Mexicans such jobs does nothing to improve the alternatives.

The environmental case against free trade with Mexico muddles two questions. One is the effect of Mexican industry on the U.S. environment. Clearly the United States is right to stop Mexican factories from polluting the environment on our side of the border. This is true whether or not the plants in question are making goods for export to the United States.

The second question is whether Mexico's lower environmental standards for itself amount to unfair competition, leading to inevitable erosion of our own standards. The answer is not necessarily. It makes perfect sense for a poorer country to have lower environmental standards than a richer one. Clean air and water are luxury goods; you can afford more of them as you advance. The United States didn't have today's environmental standards when we were as poor as Mexico is, and if we had we wouldn't be as rich as we are. The same is true, to some extent, of worker health and safety standards. If lower standards enable Mexico to, in essence, take on some of our dirty work, it can be a good deal for both societies.

On the other hand, there is a problem in an era of global capital mobility. Government regulation, to work, must be a monopoly. But companies can play governments off against one another, by threatening to move. As a result, two societies can find themselves with lower environmental standards than either might wish to have. It therefore makes sense for countries like Mexico and the United States to negotiate certain minimum shared environmental standards.

Protectionists like to say that free trade ideology is a hangover from the period after World War II. When the giant American economy dwarfed all its competitors, it was easy for Americans to support competition without trade barriers. Life is different now. But compared with Mexico, the United States is still a mighty giant. All the warnings about being dragged down by poverty-level wages, etc., now made about trade with Mexico, could have been made in the 1940s about trade with Europe.

It's not the 1940s anymore, and we all have our private moments of doubt about whether the United States is fit any longer to compete against a rival like Japan. But must we shy away from competition with Mexico? Pathetic, if so.

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STATEMENT OF SENATOR HOLLINGS

FAST TRACK DISAPPROVAL RESOLUTION
Senate Floor March 13, 1991

Mr. President --

Over the past seven weeks, all of us have been precoccupied by events in the Persian Gulf. The swift and decisive victory of the Allied forces has now granted us the luxury to focus on another confrontation that looms just over the horizon -- a conflict whose battlefield is the international market place and whose warriors are the millions of working men and women of this country -- the backbone of our manufacturing base. It is time that the Senate turn its attention to the economic struggle that is already eating away at our standard of living and now threatens our very national security.

If you want to discover why real disposable income is now below 1973 levels, all one has to do is look at what has befallen this nation's position in the international marketplace. The high wage manufacturing jobs that made it possible for millions of Americans to realize the American dream have been gradually shipped overseas. With the assistance of the Marshall Plan and government-directed development policies, the nations of Europe and Asia rebuilt their economies. Now they are girding for the competition in the 21st Century -- not by freeing markets but by banding together to fight for market share through EC92.

Since the end of World War II, we have been on a mission to convert the rest of the world into laissez faire clones of our economic system. Practicing free trade, we set the example by opening our markets at all costs. In order to ensure that the world accepted our vision of free trade we supported GATT and tried to conform the regulation of trade to suit our ideological preferences. But the GATT only benefitted foreign countries with Government led export strategies and American multinationals who moved their manufacturing operations offshore and then sought to import to the U.S. their dumped and low wage products.

Under the auspices of the GATT, trade disputes were cooled by invocations and incantations of "special relationships." In the forty plus years of its existence, six rounds of the GATT have been negotiated, all of which were supposed to exponentially expand world trade. Instead, under the GATT we have watched as our position as the dominant economic power has eroded. Under the auspices of the GATT, manufacturing industry after manufacturing industry in the United States has gone out of business. Our benevolent policy of GATT sponsored free trade at all costs, a policy that ignored the predatory practices of our trading

partners and exacted a terrible toll on our economy. Take consumer electronics, for example. One hundred percent of black-and-white TVs and radios now are imported. For automobiles the figure is 30%, for motorcycles it's 80%. If you want to take a snapshot of an American plant-closing, there is a 90% chance that the camera you're using is imported. Take a look at a list of the major manufacturing industries in this country and the figures will depress you - 60% of apparel, 60% of machine tools, and 67% of ferro alloys, are now imported.

For the past four years, this Administration and its predecessor have been on a mission to sell the Congress and the world on the merits of a successful completion of the GATT Uruguay Round. We are told time and again that a successful completion of the Uruguay Round would result in a four or five trillion dollar expansion of world trade. However, a detailed study released by the Economic Strategy Institute shows how this Administration and previous Administrations have absurdly overstated the benefits to world trade that would result from such an agreement.

According to ESI, the Administration has overestimated the economic benefits of the Uruguay Round by more than 700%. Their analysis shows that USTR figures are based on a set of completely unreasonable economic assumptions, such as increasing U.S. exports to heavily indebted Third World countries by $200 billion over ten years.

A more reasonable economic analysis shows that a successful completion of the Uruguay Round could <u>increase</u> the U.S. trade deficit by as much as $14 billion. Overestimating, overstating, and overselling the benefits of GATT agreements is a time-honored tradition at the office of the U.S. Trade Representative. For example, in 1979, the USTR estimated that a successful completion of the Tokyo Round would benefit U.S. consumers by as much as $10.6 billion per year. In the end, the Michigan Model of World Production and Trade estimated that the total net benefit to the economy from the Tokyo Round was only $700 million -- $700 million in a $5 trillion economy. The Tokyo Round certainly did not benefit our balance of trade. In 1979, when it was completed our trade deficit stood at $15 billion and now it hovers around $100 billion.

Last December Mrs. Hills went to Brussels ready to negotiate away still more of our manufacturing base. In order to get another GATT agreement, she was willing to sacrifice 1.4 million jobs in the textile and apparel industry by agreeing to an end to the textile import program. To appease the demands of our trading partners, the USTR would be willing to weaken our anti-dumping code, the only

real protection American manufacturers have against unfair trade practices.

Mr. President, a funny thing happened on the way to an agreement in Brussels. Our negotiators discovered that the Europeans and the Japanese were not willing to sacrifice substantial sectors of their economies for the sake of ideological purity. They have been too successful in international trade competition to now adopt policies that brought the U.S. triple-digit trade deficits. After four years, the Brussels Ministerial ended in failure because the rest of the world does not accept our concept of free trade. They are not willing to let the magic of the marketplace determine their destiny. Instead, they understand that it is affirmative government policies that create a nation's comparative advantage.

Last month, the Administration declared that there was light at the end of the tunnel because the Europeans merely acquiesced to a statement by GATT Director-General Dunkel declaring a willingness to discuss, again, after four years of negotiations, reforming EC farm policy. As a result of this "breakthrough" the President has come to this body now and requested that Congress abdicate its Constitutional authority and grant an extension of fast-track treatment for legislation implementing bilateral and multilateral trade agreements.

Mr. President, Article I, section 8 of the Constitution gives to Congress alone the right and responsibility to regulate foreign commerce. Fast-track treatment represents an abdication of this Constitutional authority to regulate foreign commerce.

Mr. President, "fast-track" was written into the Trade Act of 1974. It was a response to this body's refusal to accept a portion of the Kennedy Round of the GATT, which would have seriously weakened our anti-dumping laws. The proponents of fast-track argued that our trading partners in the GATT would not negotiate with us in the Tokyo Round if Congress were again allowed to exercise its right to amend or disapprove parts of the agreement. By agreeing to fast-track, Congress took itself out of the trade war. When a trade agreement is concluded, fast-track operates like a gun to our head - no amendments, no reservations, take 30 days and vote up or down. Now, with a wink and a nod, USTR officials have come to the members of this body and told them that any specific concerns they might have with the effects of a trade agreement will be "worked out," just support an extension of fast-track and we'll take care of you. By the way, if you don't, they'll write off the sector of the economy that you are concerned about.

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Mr. President, all we are asking for is time to examine a trade agreement - its merits, its deficiencies. If an agreement were really going to have a four trillion dollar expansionary effect on world trade, then you wouldn't need 30 days. You could pass it in thirty minutes.

During the Cold War, even our Communist adversaries respected our Constitutional processes. When this body considered the nuclear test ban treaty, the ABM treaty, SALT I and SALT II, and the INF treaty, there was no need to impose a 30-day limit on our consideration. To limit our consideration to 30 days would have been unconscionable, even when we did not approve the SALT II treaty, the Soviets still continued to negotiate with us, eventually signing the INF agreement.

After spending billions of dollars and risking our lives to protect our trading partners from totalitarian agression, the least our trading partners can do is to show similar respect for our Constitutional form of government. If we disapprove the extension of fast track, the world as we know it will not come to an end. What may end, however, is our deluded faith in the GATT's ability to protect American jobs. If the Uruguay Round fails, American business will not shut down, but if it succeeds, I can tell you that certain industries will. The fact of the matter is that since GATT covers only 5-7% of world commerce, business will not come to a screeching halt. Instead we will carry on and maybe we will wake up and discover how our competition really operates. Our competitors understand that it is government that creates their comparative advantage - David Ricardo wrote that land, labor, capital and natural resources determined comparative advantage - but in today's international competition it is government guidance that determines comparative advantage - it is not the field and the streams, it is MITI in Japan and their equivalents in Korea, Hong Kong and EC 92 that make market forces operate.

In addition to an extension for the Uruguay Round, the President has also requested fast-track treatment for a free trade agreement with Mexico. Again, Mr. President, we are told that an agreement cannot be negotiated without fast-track treatment assured in advance.

Mr. President, do the Mexicans really have a choice? Since its revolution, Mexico has pursued a statist economic policy, keeping its borders closed and nationalizing its major industries. Thanks to oil wealth generated by the price explosion in the seventies, the Mexicans went on a borrowing binge, loading themselves up with close to $100 billion of commercial debt. When oil prices collapsed, so did the statist Mexican economy. I applaud the efforts of President Salinas to liberalize the political and economic system -- he is selling off the government-owned enterprises

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such as the phone monopoly and the government-controlled banking system.. But the political and economic differences that divide our two nations are wider than the Rio Grande.

Mr. President, politically the Mexicans have never had a free and fair election -- one party has ruled that country for fifty years. Economically, any agreement with Mexico must address the vast difference in wages, environmental standards, and worker protections.

The average wage in Mexico is about $1 an hour. The average Mexican work week is 48 hours. Of course, they have nothing comparable to OSHA or EPA or Social Security or workers compensation. If we are worried about illegal immigration now, if an FTA is negotiated, we will witness a reverse migration as American-based multinational corporations stream across the border to take advantage of low wages and this absence of regulation south of the border. Let's be done with the myth that these are patriotic American companies. Their allegiance is not to the red, white and blue, its to the green, the almighty dollar.

The idea that an FTA would provide a vast new market for American exports is even more optimistic than USTR's estimates of the benefits from the Uruguay Round. How is a nation with a per capita GNP 10% of ours going to buy American exports?

Mr. President, the fact of the matter is that the Mexican economy is being crushed by an onerous debt burden and its own inefficiencies. They need an agreement more than we do. They need our capital, our technology, and with 40% of their export earnings going to finance their debt burden, they need our market. The benefits to our own economy are marginal. If this body reasserts its Constitutional authority, the Mexicans will not walk out of the negotiations, because frankly, they have nowhere else to go.

I want President Salinas to succeed and I want to promote stability in Mexico, but I do not want to pay for it with American jobs. So, today I am introducing legislation that directs the President to negotiate with the MExican and Canadian governments to reach a comprehensive package to address all the serious concerns that have been raised.

I urge my colleagues to support this resolution which disapproves fast track extension for two years. I also would welcome their support of my legislation directing the President to negotiate a comprehensive North American Free Trade Agreement.

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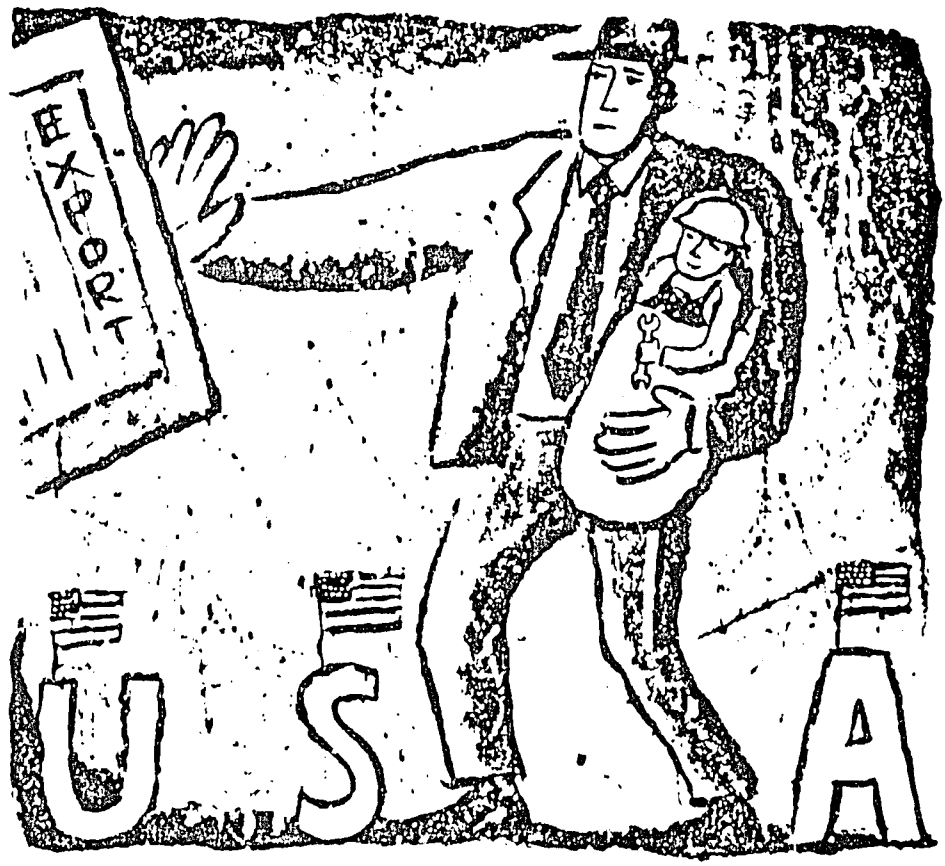
THE NEW YORK TIMES, SUNDAY, FEBRUARY 10, 1991

O.K., O.K., Call Me a Protectionist

By Lee A. Iacocca



Josh Gosfield

DETROIT

There is no use hiding anymore. I'm tired of denying it, and turning my back every time I hear those dirty little whispers. Since some people are cruel enough to say it to my face, it's time to get the truth out.

I'm a protectionist.

In a world dominated by three-word headlines and 20-second sound bites, you're either a free-trader or a protectionist. There's no headline word for somebody standing between the two extremes — the common sense approach of managing trade in the country's self-interest.

So, if I've got to choose, I guess I'm a protectionist. And what's more, I'm proud of it.

What's wrong with being a protectionist, anyway? Somewhere along the line, the word became a synonym for "isolationist." That's not me. I don't want to close the borders. I believe in free and fair trade. I just want to see America protect itself from those, like Japan, who don't.

In any kind of competition, the first thing you do is protect yourself. In baseball, the batter protects the plate, and in basketball you protect the lane. In business, you protect your trade secrets. There is nothing wrong with protecting yourself. It's irresponsible and stupid not to.

Those who say that protectionists have their heads in the sand have it exactly backward. The real ostriches are those who believe that we can survive economically by simply ignoring those who target our market while protecting their own.

America has always been willing to protect liberty, her allies and her economic interests abroad. We're even willing to risk the lives of our young men and women in the deserts of the Middle East. And it's not just to protect our own interests but to protect the oil flow to countries like Japan and Germany who, curiously, seem to be sitting this war out.

Well, tell me, what is so wrong with protecting our interests at home?

I've never understood why those who claim to be the most committed to free trade won't defend it. If you believe in something, you fight for it. Demanding reciprocity from our trade partners, and retaliating if we don't get it, doesn't undermine free trade; it defends free trade.

We're learning a hard lesson in the Middle East right now. We know that peace is impossible if you aren't willing to defend it. So is free trade. If you aren't willing to defend it, to protect yourself against those who won't practice it, then the only one to benefit from free trade is the guy who doesn't believe in it.

Undoubtedly, Japan's success is a tribute to the hard work and ingenuity of its people. But it's also a tribute to protectionism. If we copied Japan's example, we would revitalize our auto industry first by shutting out all foreign cars. That's how they did it. And we'd get back into the consumer electronics business by banning all those VCR's coming in.

But I don't want to keep their cars or VCR's out. I sell some cars built in Japan. I've even got a Japanese partner. I just want to force every country who enjoys the free American market to play by the same rules I have to play by. And I believe we should retaliate if they don't.

Almost as bad as being called a protectionist is being called a "Japan-basher." That makes me two for two, because I get accused of that as well. That one I deny absolutely. I don't bash Tokyo, I bash Washington.

The Japanese Government, working hand in glove with its major industries, has a clear policy of protecting its home market while at the same time providing every incentive to help its companies penetrate foreign markets. They put on both a strong offense and a strong defense. But we're a single platoon team; we don't believe in defense.

Fight to protect free trade.

That's why we're losing. It's not that we can't compete. It's that we're doing it with the old Vietnam strategy: with one hand tied behind our backs.

We're all grateful for the amazing American technology at work in the Persian Gulf — weaponry invented by Americans, built by Americans, and used by Americans. But we developed our military industries the way Japan developed its consumer industries — we protected them.

There's more at stake than the fate of the American auto industry. I'm not a jingoist or a saber-rattler. I don't believe we need to dominate the world, economically, militarily or any other way. I don't believe in rigging the trade rules to make sure American companies win. But I don't believe in being a patsy, either.

And a patsy is somebody who won't protect himself.

When the gulf war is over, we'll still have to deal with some serious problems at home: a shaky banking system, an education system that's already bankrupt, an astronomical Government debt and strategic industries that are threatened by the predatory economic practices of some of our trading partners.

Those problems have to be solved. As events in the Middle East show, the world still needs a strong U.S. And if that means a dose of "protectionism," I'm all for it. □

Lee A. Iacocca is chairman of the Chrysler Corporation.

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THE JOURNAL OF COMMERCE, Wednesday, March 20, 1991

Debunking Free Trade's Critics

By WESLEY SMITH

Congress is on the verge of making its biggest trade blunder in decades by voting against the administration's plan to create a free trade agreement with Mexico. On March 1, President Bush asked Congress to extend the administration's "fast-track" trade negotiating power. Fast-track authority speeds a completed agreement through Congress and reduces the chances of killer amendments. That makes it easier for negotiators to reach agreement.

Congress has until June 1 to decide on Mr. Bush's request. If fast-track authority is approved, the administration will use it to continue the world trade talks in Geneva and to begin U.S.-Mexico-Canada free trade talks in June.

Unfortunately, the protectionist drumbeat over free trade with Mexico is growing louder on Capitol Hill. If Congress blocks fast-track authority, it could undermine a new world trade agreement and exacerbate the recession. Before Congress jumps blindly over the precipice, it should take a harder look at the misconceptions espoused by opponents of a free trade agreement.

The first fallacy is that Americans will lose hundreds of thousands of jobs when U.S. firms move to Mexico in search of low-cost workers. Rep. John LaFalce, D-N.Y., recently predicted that the wage differential for unskilled and semi-skilled labor ($1.90 an hour in Mexico vs. $14.50 an hour in the United States) would dislocate "American industries and workers on a massive scale."

Other free trade critics predict an even worse scenario: a "lose-lose" situation in which low-wage U.S. companies in Mexico exploit Mexican workers, destroy jobs in America but still can't compete internationally.

This zero-sum view of trade overlooks the dynamic effect freer trade with Mexico will have on U.S. export industries that can integrate low-cost Mexican labor with U.S. high technology. Japan is doing just that in Singapore, Malaysia, the Philippines and China. Europe is beginning to do it in Poland, Czechoslovakia, Hungary and the former East Germany. U.S. companies have been doing it to a limited extent in Mexico, even without a free trade agreement.

For example, Rockwell International Corp. opened plants just across the Mexican border in 1969 — so-called maquiladora operations — to assemble U.S.-manufactured electronic components. This allowed Rockwell to maintain its manufacturing base in the United States while increasing its worldwide competitiveness. Rockwell now sells Japan 65% of the modems for its fax machines.

It is easy to think U.S. jobs are being lost to imports from Third World countries, but it is also wrong. The United States buys 63% of its imports from developed countries. U.S. imports from underdeveloped countries have fallen 12% since 1980. In 1991, our choice is clear: integrate cheap labor from Third World countries into U.S. production, like the rest of the industrialized world, or raise barriers against those countries and abandon our position as the world's free trade leader.

A second misconception is that a free trade agreement should not be negotiated while a recession is eliminating jobs. This view is plainly wrong. With barriers to investment and trade in Mexico removed, the U.S. economy would receive an immediate boost in its export industries.

Mexico, for example, needs to buy billions of dollars in equipment for its transportation, computer and telecommunications systems. Since over two-thirds of Mexico's imports already come from the United States, American industries that produce these products and services will be the first beneficiaries of freer trade. Each additional $1 billion in exports, the Commerce Department estimates, creates 22,000 American jobs.

A third fallacy is that Mexico will be used by third countries — Japan and Korea, for example — to dump their cheap products on the United States. Both U.S. and Mexican authorities, however, have clearly said this will not be permitted.

Free trade skeptics also say an agreement with Mexico needs a "social charter" that addresses the "fundamental labor, health, environmental and political policy differences that exist between the two countries." Reps. Don Pease D-Ohio, Terry Bruce D-Ill., and 25 other members made this point in a letter to Mr. Bush on Dec. 3.

Unfortunately, social charter advocates, from labor unions to environmental groups, fail to recognize the bilateral cooperation that already has occurred to combat drug-trafficking, enforce intellectual property rights and standardize commercial laws. Many advocates of a social charter simply haven't done their homework.

For example, several major environmental agreements between the United States and Mexico have been signed since 1983, most connected with the maquiladora industries.

Free trade opponents also claim Mexican workers will flood the United States under a new agreement, displacing millions of Americans. Yet, both countries have stated emphatically that labor will not be a part of any agreement; the trade accord will deal only with goods and services, not people.

Nevertheless, the AFL-CIO continues to raise the specter of millions of Mexicans crossing the border legally once a trade agreement is approved. They fail to realize that a trade pact will provide jobs for Mexicans at home through increased business, reducing immigration from Mexico and freeing up more U.S. jobs for Americans.

The best way to ensure Mexico prospers under a democratic, free-market economy is to link its future inextricably with ours. If we fail to promote prosperity and security on our own border through a free trade agreement with Mexico, we will find it more difficult to protect our interests further from home.

Wesley Smith is a Latin American policy analyst at The Heritage Foundation, a Washington-based public policy research institute.

THE JOURNAL OF COMMERCE, Friday February 8, 1991

No Time for Korea-Bashing

By JOHN T. BENNETT

Trade frictions between the United States and Korea have seesawed wildly during the last decade. They reached a crisis late last year when the Korean government was charged with conducting an anti-import campaign. While the United States has every right to push aggressively for open markets, patience sometimes is the better path.

The Korean government has denied U.S. charges of an anti-import campaign. Officials say their efforts were merely a reaction against luxuries in a society that exalts income equality and condemns conspicuous consumption. But their disavowal looked suspect. Several sources have said the campaign was created by government officials. The National Agricultural Cooperative Federation, originally a government agency, had distributed to government-controlled primary schools a comic book attacking imports.

Moreover, at what was supposed to be the final bargaining session of the Uruguay Round of the General Agreement on Tariffs and Trade, Korea, followed by Japan and the European Community, opposed a compromise on farm trade, jeopardizing the round's success.

U.S. trade officials were outraged that Korea, which has been one of the largest beneficiaries of free trade, should turn its back on the global trading system.

In response, the Korean government issued a long policy statement on imports, encouraging consumers to buy them if quality and price warranted. The government replaced the minister of Trade and Industry and sent a former deputy prime minister to Washington for informal talks. Korean officials also have developed proposals on agriculture and trade services that go some way to meeting U.S. concerns.

What does all of this mean? Four points seem relevant.

First, a boycott of imports, luxuries or not, violates the spirit of free trade. But Korea's imports of finished consumer goods are less than 7% of total imports. Korea cannot truly conduct an anti-import campaign because it relies on them for raw materials and components.

Second, Korea is now a democracy. The old days of authoritarian rule, which allowed the United States to meet with a government official and make a deal, are over. Interest groups have become vocal and sometimes violent in trying to protect their interests. In Korea's multi-party system, even small minorities have great influence.

Third, Korea once again has a trade deficit. The country enjoyed four years of surpluses after 32 years of shortfalls. The government is under attack for jeopardizing the Korean miracle that has given it 9% average annual growth since 1962.

Fourth, the United States has negotiated enormous changes in Korea's trade regime since 1982. U.S. officials should recognize that they have accomplished their most important goals. Korea's current account surplus, which peaked at $14 billion in 1988, fell to a deficit of $1.5 billion by 1990. The bilateral surplus with the United States topped out at $9.6 billion in 1987 but was down to $2 billion for the first ten months of last year. This contrasts sharply with the enormous trade surpluses still being run by Japan and Taiwan.

The United States also has reached agreement with Korea on a long list of important trade issues. Patents, copyrights and trademarks now enjoy legal protection and enforcement is improving. Areas for foreign investment and service trade have been widened steadily. Prohibited imports largely have been eliminated, and the few remaining items are steadily being whittled down. Tariffs have been greatly reduced and further reductions already have been announced. The exchange rate is now determined by market forces.

The United States wants even more, but American officials should consider whether there isn't a better negotiating strategy than overreacting to setbacks as minor as those of recent months.

Consider farm trade. Korea now imports several billion dollars a year in farm goods, mostly from the United States. Significant limits remain on beef and luxury foods and rice imports are prohibited. But the percentage of Koreans employed on farms is down from 70% 40 years ago to about 18% today. Moreover, most young Koreans are leaving the farms for skilled factory and white collar jobs in the city. Farms will consolidate and mechanize to get by with fewer workers. Incomes will have to rise to induce people to farm even as import competition results in lower prices.

The United States should recognize, therefore, that farming in Korea will change, but slowly. If U.S. negotiators insist that Korea completely open its market now, the remaining farmers likely won't be able to find other work. They will continue to farm, prices will fall, and the United States will sell no more than it does now.

The United States has three choices when Korea violates trade laws. It can retaliate, pursue remedies under GATT or be patient.

So far, U.S. officials have threatened to retaliate but have never followed through. U.S. importers and consumers would have been hurt by such actions. Moreover, the United States would have been viewed as a bully, confirming in Korean minds that Americans see free trade as a one-way street.

Pursuing GATT remedies is time-consuming and has not been very successful with other countries. Even the United States has ignored GATT determinations. Resorting to a global authority also removes the argument from a bilateral context.

The United States has done very well at improving the world trading system. U.S. officials should understand and appreciate that success, even as they try to win further improvements. Patience and perspective remain at the core of this diplomatic effort.

John T. Bennett is a consulting economist in Alexandria, Va.

THE JOURNAL OF COMMERCE, Thursday, Mr ch 14, 1991

Learning the Tricks of Trade

By CHARLES STONIER

As kids, we swapped marbles, baseball cards, stamps, and hoped we got the better end of the deal. This gamesmanship carries over into adulthood.

When deals have to be made across national boundaries, however, trading or swapping becomes more of a challenge. It is intriguing to watch the game, especially among petty traders in Southeast Asia, where evading tariffs has become a fine art.

A few weeks ago on a train from Bangkok, Thailand, to Penang, Malaysia, I had the opportunity to witness the prevailing ingenuity and subterfuge firsthand.

It was quite noticeable after crossing into Malaysia that much of the baggage taken off the train was not clothes luggage, but satchels — ostensibly packages of food for personal consumption. They actually contained Thai rice, which can be sold at much higher prices in Malaysia, where a stiff tariff is imposed on this import.

Rice traders manage to evade tariffs by using several modes of transportation. Rickety coastal boats ply the shallow waters between Sathun, Thailand, and Kuala Perlis, Malaysia, stopping over on a small island with numerous lean-tos that store rice.

The rice is transferred to passenger boats and stowed below the luggage and other cargoes before entering Malaysian waters. Much overloaded, these boats frequently are beached along the way. On one of my crossings I had to wait more than three hours (not unusually long) for the tide to lift us from a sandbar.

On rural roads in the Malaysian state of Perlis, bordering Thailand, the "informal" rice trade thrives. Bicycles, carrying up to 260 kilograms of rice each, are pushed laboriously to the border on muddy laterite tracks across difficult hills.

Rice is not the only product that is smuggled across borders. During the three-hour journey between the Thai border and Butterworth in Penang, passengers stuffed upper berth mattresses with small packages.

These contained Japanese candies, which on the return trip would find their way — duty free — into Thai markets. There they are much desired and undersold compared with imported candies, which are subject to full tariffs.

Along the Thai-Cambodian border I hoped to buy "informally" some Khmer handicrafts. After two futile trips on foot to sites where peddlers sell their wares, I was taken to a third place about a mile off the highway.

There were a few motorcycles parked there and a number of food and clothing stalls, right up against the high, roiled barbed wire marking the border. A crowd was milling about and I was puzzled as to why a seemingly ordinary market would be situated here. Later I was told the places I had canvassed were notorious for smuggling motorcycles into Cambodia.

A more sinister trade goes on further south where the Khmer Rouge control large deposits of rubies. Thai prospectors can obtain licenses to mine and take precious stones to Thailand.

This trade is said to amount to $100 million in 1990, enabling the Khmer Rouge to use this foreign exchange to purchase arms in lieu of depending on China for supplies.

Beating the official trade system also is serious sport in the small country of Nepal, situated between Tibet and India.

Nepal must import goods from third countries by way of Calcutta, notorious for its substandard port facilities, poor handling, theft and endless clearing procedures. The goods then are shipped across India. Mercifully, they are transported in containers these days, which has eliminated the traditional pilferage en route.

Still, after Nepal gets its share of import taxes, much of the merchandise finds its way back across the porous 700-mile India-Nepal border into the almost totally protected Indian market. Barefoot porters often are used, so that eventually some Indians can enjoy better quality television sets, cameras and watches.

On balance, this trade's benefits outweigh the costs. Many people gain — the customs staff collecting fees (formal and informal ones), the Nepal treasury, assorted middlemen and, importantly, Indian housewives. The only losers are likely to be a few officious bureaucrats in New Delhi.

Politicians, including U.S. congressmen, typically distrust the forces of trade, just because they are so hard to control.

The urge to trade compels buyers and sellers to overcome the nuisance of international boundaries. Interference with this trade is futile and unwise (stopping Japanese candy?), especially as free trade can improve the lives of so many.

Protectionism protects producers, never consumers. It may be justified in the case of illicit arms and narcotics, when there is environmental damage and labor abuse and occasionally to aid "infant" industries, provided they are made to grow up. Such caveats insure that custom officers need never lose their jobs.

Today, however, the General Agreement on Trade and Tariffs has become endangered. GATT, devoted to taking down trade barriers, estimates that by year 2000 the world community stands to lose $7 trillion to $12 trillion in income if its work cannot proceed.

Let's not lose this income to protectionism. We should start by urging the free trade of rice and candy bars between Thailand and Malaysia.

Charles Stonier, a writer based in Tucson, Ariz., specializes in trade and transport development issues. He travels widely throughout Asia.

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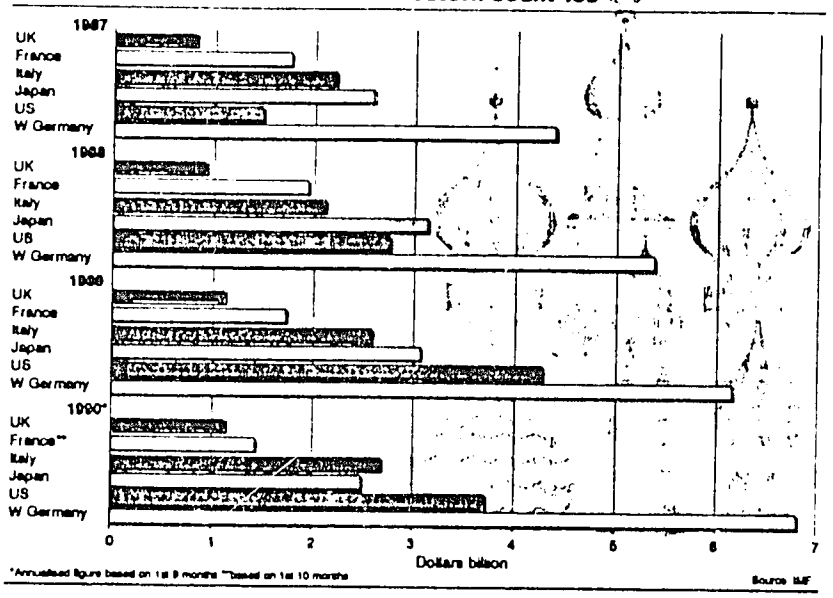
Soviet markets for western exports are tailing off. FT writers analyse what went wrong

The trade bonanza that never was

Exports to the Soviet Union from western countries



*Annualised figure based on 1st 9 months **based on 1st 10 months

Source IMF

It was always too good to be true. Three or four years ago when glasnost and perestroika first entered the western vocabulary, the Soviet Union seemed poised to become a bonanza for western exporters.

Dangled before them as a result of economic and political reform was the prospect of a new market of 288m consumers, rich in natural resources, and one that could replace shrinking western outlets in debt ridden developing countries.

The dream lasted about as long as a brief Siberian summer. Now, in the wake of the crackdown in the Baltics, western business is reassessing its future in the Soviet Union. Only the most stout hearted companies are staying the course; most of these now know they face a long uphill struggle before the dividends start to flow.

Disillusion was rife in the west even before the crackdown. It is not just a matter of chronic payments delays now amounting to some $5bn, or the nightmare of dealing with a disintegrating bureaucracy. The dilapidated infrastructure, foreign debt of more than $500bn, and the remorseless economic decline, which saw national income drop 4 per cent last year on the Soviets' own admission, were enough to deter even the most intrepid entrepreneur.

The latest developments have come to symbolise the failure of attempts at political and economic reform on which, for western business, the whole development of the Soviet market was predicated.

Western governments were already disconcerted by the resignation late last year of the reformist Mr Eduard Shevardnadze as foreign minister. Now they may cut aid pledges leaving Moscow even more isolated financially. They may also withdraw the active political backing for trade deals with the Soviet Union which western business still regards as vital.

Exporters say they view the Soviet market as only suitable for companies committed to a very long haul. The flood of activity in the early days of reform was always more apparent than real. Yet says Mr Andrew Seton of Morgan Grenfell, the merchant bank, deals in areas such as energy – from which the Soviet side profits too – "will grind on steadily, whatever the complexion of government".

Even committed companies need resolution and patience to push deals through. International Business Machines said this week, for example, that it was taking a "cautious, long term" approach to discussions which could lead to the establishment of a wholly owned subsidiary involved in marketing and maintenance.

Plans to supply 60,000 personal computers for Soviet schools and to develop a passenger boarding and cargo system for the Soviet airline Aeroflot, which would have been unthinkable five years ago, were still likely to go ahead.

But the world's largest computer manufacturer said discussions on the subsidiary were at a very early stage. It was continuing the talks with an open mind and with due regard for developments in the Soviet Union.

Business links between Italy and the Soviet Union have meanwhile lost much of the vigour which only 12 months ago was spawning a series of joint venture announcements.

Groups such as Finmeccanica, the state holding company, which has agreements for a number of joint ventures in the Soviet Union are being much more careful in assessing new projects. Group companies are also finding it difficult to get decisions out of Moscow because of frequent changes of personnel in government ministries. Ansaldo, Finmeccanica's power engineering subsidiary, is in the running for a large contract to rehabilitate Soviet power stations. It is still waiting for a decision which was due on December 16. Fiat, which has a 30 per cent stake in a joint venture car plant to be built at Yelabuga, is also experiencing delays in getting decisions out of its Soviet partner. The Turin group says it is "clearly concerned" about political instability but "we are not pessimistic" about the chances of the launch of its joint venture. Fiat says it is not shelving any of its decisions connected with the project and has allocated L600bn (£275m) for the manufacture of the plant and machinery it is required to put into Yelabuga.

Most of the 41 Franco Soviet joint ventures formed over the past three years are still not in operation because of basic bureaucratic problems, like obtaining raw materials, fuel and power, says a Soviet expert at the Banque Française du Commerce Exterieur (BFCE).

One of the few to show signs of life is Iris, a FFr430m (£43m) Moscow eye hospital nearing completion by Bouygues, the construction group. Bouygues, toughened by experiences in some of the most difficult Third World markets, reports no serious problems.

Total, the oil company, last month signed a joint venture with a unit of the Soviet Ministry of Geology, under which the French company will provide technical assistance for oil production north west of the Urals. Executives admit that the venture is encountering bureaucratic difficulties. It is impossible to know who is in charge the republic, the ministry in Moscow or their partner.

For German companies with long experience in dealing with the Soviet Union, the tensions are simply the latest in a century long saga of twists and turns. Nonetheless Mannesmann, the engineering group, has seen its pipeline business shrink to almost nothing in the past two years.

While many industrial plant suppliers report business at a standstill, Metallgesellschaft does about DM300m (£172m) worth of trade with the Soviet Union each year. It said 1990 volumes were up.

Its Lurgi subsidiary, which has built 120 industrial plants in the Soviet Union since 1917, has 5,000 people under contract constructing a DM1.6bn petrochemical plant on the Caspian Sea. The Wintershall subsidiary of BASF, the chemicals group, also reports no problem with its new gas venture – and, with gas as a vital source of foreign exchange, expects no big difficulties in future. Gas imports last year into west Germany rose to DM3.56bn from DM2.72bn in 1989.

By Katherine Campbell, Alan Cane, William Dawkins, Nancy Dunne, Andrew Fisher, Peter Montagnon, Stefan Wagstyl and John Wyles

Still dogging western companies, meanwhile, are payment delays. These have continued even on debts due to Italy, France, Germany and other countries which have extended credits especially for the purpose of mopping up arrears, and are prompting a renewed interest in counter trade. Yet even counter trade is hard to arrange in the bureaucratic chaos.

According to an official from the Ost-Ausschuss, the German industry association co-ordinating German trade with the east, current payment arrears amount to around DM1.5bn, slightly lower than at the worst point last May, when DM1.8bn was owed to German companies.

Hermes, the German export credit agency, reports a sharp rise in demand for cover on credit to the once scrupulously prompt Soviet importers. Like its counterparts in other industrial countries, the agency insists on a counter-guarantee from Vnesheconombank, the Soviet foreign trade bank. Apart from a very few priority projects, this has become almost impossible to obtain.

Rome's political anxiety to be seen to be helping Mr Gorbachev's perestroika sparked internal conflict within the administration when the government decided to overrule the management committee of SACE, Italy's export credits insurance organisation, and give 90 per cent rather than 100 per cent cover on L5,000bn of Soviet credits planned for the next five years.

This was a factor behind Mr Mario Sarcinelli's departure in December as director-general of the Treasury. He believed the government should not cover the full 100 per cent.

Growing signs of political instability and the evident slippage in Mr Gorbachev's personal authority are now, however, inducing the maximum caution in Italy. SACE says that for the moment it, too, is only insuring credits which are guaranteed by Vnesheconombank.

Elsewhere too the watchword is caution.

Relations between Japan and the Soviet Union have been blighted since the Second World War by a dispute over four islands seized by the Soviets in 1945. With the Japanese government pressing companies to keep contacts with the Soviet Union to a minimum, trade and investment have been insignificant. Two-way trade last year totalled US$5.9bn, or less than 5 per cent of Japan's total trade.

Late last year it seemed that the long thaw in east west relations might at last be warming the frozen ties between Tokyo and Moscow. Hopes were rising that President Gorbachev would use his first visit to Japan in April to signal willingness to settle the territorial row in return for substantial pledges of Japanese aid. Japanese companies began to dust off old investment schemes including mega projects for the natural resources of the Soviet far east.

But the optimism was always tinged with caution, not least because the Soviet leader has personally never given the slightest sign that the territorial issue was ripe for settlement. Now, the crackdown in the Baltics is making officials and businessmen even more anxious.

Since Mr Gorbachev began to move to the right, the US business community has found itself "playing defence", according to a Washington lobbyist. "Before they started shooting people in Lithuania we thought we had a decent chance. Bilateral tax and investment treaties are close to conclusion. They probably won't be submitted to the Congress in the current climate."

British businessmen say the government is no longer encouraging small and medium-sized companies to enter the Soviet market unless they have a particular niche. Equally, however, it is urging larger groups to hang on to their presence particularly in energy and food related sectors.

John Brown says its $330m project to modernise a polyethylene project in Buddyenovsk is "unaffected". Negotiations are also proceeding on the financing of a second $400m to $500m venture signed with the Gasprom agency last year. A consortium of companies in the food industry, including APV, Allied Lyons, Booker Tate and Taylor Woodrow, and United Biscuits, is looking at possible projects in the Ukraine.

Elsewhere, there are still some hopefuls eyeing the market, especially in the services sector where the initial capital outlay is not that great.

Allianz of Germany, Europe's largest insurer, has just announced a joint venture with Moscow which it has been negotiating for a year. Like other companies, it says it will be patient and is there for the long haul. Just DM1m capital has been committed and initial emphasis will be on training. "Despite the political turmoil, it is still possible to do various things in the business world," says Allianz which also believes it is not too early to start advising Soviet companies on how to obtain insurance in the west.

Mr Charles Hugel, former chairman of Combustion Engineering, which was acquired last year by the Swedish Swiss ABB concern, negotiated a joint venture agreement to build the $2bn Tobolsk petrochemical complex in western Siberia.

He finds the situation "disquieting" but not surprising. "I've never been under any illusion that prospects for business were good in the short term. But we should be there now working to get started," he says.

US companies are as unlikely to flee the Soviet Union now as they were to rush in at the height of glasnost. They are searching for a balance. They take to heart the warnings of Professor Herman Diligensky, editor of the Soviet journal Memo.

"Bush cannot close his eye to the repression," he said in Washington recently. "But don't return to the Evil Empire accusations. This will strengthen the hardliners and bring a return of the Cold War."

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International Agreements to Protect the Environment and Wildlife

United States International Trade Commission, January 1991

EXECUTIVE SUMMARY

The Commission identified 170 multilateral (global and regional) and bilateral agreements that are of significance to U.S. interests. About two-thirds of these agreements have been signed since 1972, the year in which the Conference on the Human Environment was held in Stockholm, Sweden. The conference marked the first time that high-level officials of a large number of nations had gathered for the purpose of fostering world-wide cooperation on matters relating to the environment.

Most international organizations that address environment and wildlife issues were established during the past 20 years. Probably the best known and most influential of these organizations is the United Nations Environmental Program (UNEP), headquartered in Nairobi, Kenya. There are several other U.N. organizations active in environmental and wildlife matters.

The present U.S. environmental program and organization dates back to the National Environmental Policy Act of 1969 (NEPA), which established the President's Council on Environmental Quality. The Environmental Protection Agency (EPA) and the National Oceanic and Atmospheric Administration (NOAA) were established in 1970. Currently there are at least a dozen Federal agencies with environment or wildlife programs designed to meet the requirements of U.S. environmental law.

The General Agreement on Tariffs and Trade (GATT), which was drafted long before worldwide attention was focused on environment and wildlife issues, only indirectly provides for such issues. Several GATT articles can be considered relevant to environmental measures adopted at the national level. For example, article XX of the GATT allows a member country to take certain measures "necessary to protect human, animal or plant life" and measures "relating to the conservation of exhaustible natural resources," provided that they are not applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries. Several GATT dispute panels have addressed country measures related to environmental and wildlife protection matters. In addition, the GATT Standards Code, negotiated in 1979, makes reference to measures taken to protect the environment and wildlife.

In response to the Senate Finance Committee's request that the Commission suggest a method for the U.S. Government to periodically evaluate present and future agreements, the Commission suggests the establishment of an "environmental practices report." Such report would be compiled by a single designated Federal agency, with information collected on individual agreements from the various agencies responsible for implementing and monitoring their provisions in the United States. A base report, in loose-leaf form, would contain (1) basic information on each agreement's objectives and mechanisms for information exchange, enforcement, and dispute settlement; (2) summary of or reference to scientific and statistical reports published by recognized environmental experts; (3) a statement of the agreement's effectiveness, in terms of participation, compliance, disputes, and important issues; and (4) when it is considered necessary, individual country assessments. The basic report could be supplemented and updated on annual basis.

The Commission solicited public comment in connection with this study. Oral hearing testimony and written submissions by the Competitive Enterprise Institute (CEI) and the American Association of Exporters and Importers (AAEI) argue that the United States should not unilaterally attempt to encourage other countries, by threatened or actual trade sanctions, to cooperate in international environment and wildlife agreements. CEI claims that U.S. environmental policies do not export well to third-world nations; that "globalized" environmental policies would be unsuccessful in practice; that trade policy with trade sanctions would be subject to distortion by special interest groups; and that environmental priorities would conflict with other political pressures. AAEI opines that unilateral trade sanctions would harm U.S. trade interests far more than they would contribute to environmental protection. Instead, AAEI advocates multinational discussions in the GATT, Organization for Economic Cooperation and Development (OECD), or other appropriate organizations to establish international environmental standards.

The 170 agreements identified by Commission staff as being of significance to U.S. interests have been categorized into eight separate, but necessarily overlapping, groups, as follows:

Marine fishing and whaling

Land animals (including birds) and plant species

Marine pollution

Pollution of air, land, and inland waters

Boundary waters between the United States and the countries of Mexico and Canada

Archaeological, cultural, historical, or natural heritage

Maritime and coastal waters matters

Nuclear pollution

Other general agreements

Nineteen agreements were identified as employing trade restrictions, which are designed to protect natural resources, wildlife, and cultural/historical property. Summary information on all these agreements (when available) includes objectives and obligations, dates signed, literature citations, enforcement and dispute-settlement provisions, information-exchange provisions, current issues, and a listing of parties. When applicable, there are discussions of significant nonsignatory countries (including the United States) and reasons for their unwillingness to become party to a given agreement.

Executive Summary

Purpose

The controversy in 1989 over Alar, a growth regulator primarily used on apples, heightened public concern about the presence of pesticides and other chemicals on U.S. food. This controversy has also led to concerns overseas and to losses in U.S. agricultural exports.

The Ranking Minority Member, Subcommittee on Agricultural Research and General Legislation, Senate Committee on Agriculture, Nutrition, and Forestry, asked GAO to provide information on (1) U.S. government efforts to prevent or resolve trade disputes that may arise over pesticide use; (2) the specific procedures used by foreign governments in selected Pacific Rim countries and Australia to set tolerances and test for pesticides on U. S. exported produce; and (3) the technical capabilities of these foreign governments to conduct pesticide testing. To evaluate pesticide testing and technical capabilities, GAO visited Australia, Japan, South Korea, Taiwan, and Thailand.

Background

In June 1989 the news media in South Korea and Taiwan reported that Alar had been detected on U.S. grapefruit. As a result the market for U.S. grapefruit in both countries was adversely affected. The markets for other U.S. perishable commodities in several Pacific Rim countries were also threatened. Since the Alar incident, concern over the presence in food of other chemicals, primarily pesticides, has surfaced as well.

The Pesticide Monitoring Improvements Act of 1988 calls for foreign countries to identify pesticides used on food imported into the United States, but does not address the issue of pesticides used on U.S. exported food.

Results in Brief

The United States is attempting to respond to pesticide residue concerns through multilateral, bilateral, and administrative efforts. U.S. approaches to deal with pesticide concerns include taking a lead position on strengthening health-related standards in the current Uruguay Round of the General Agreement on Tariffs and Trade negotiations, forming ad hoc technical working groups with several countries, and creating an International Food Safety Task Force. However, governments in the five countries GAO visited have lacked information about which pesticides and other chemicals were being used on U.S. exported produce. Hence, the risk of exposure to a problem like the South Korean grapefruit scare remains.

The governments of Australia, Japan, South Korea, Taiwan, and Thailand have laws, regulations, and government agencies for ensuring the safety of the food supply. They have established import inspection and sampling procedures which include monitoring for pesticides. Each country was at a different stage of registering pesticides, establishing pesticide tolerances, and developing testing standards.

Government laboratories in the five countries GAO visited also had the necessary technical capabilities, including equipment and personnel, to conduct pesticide testing. However, a variety of standards were used in these countries, and the United States and these countries have not agreed on and have not used common standards and testing methods.

Principal Findings

U.S. Government Efforts to Address Pesticide Disputes

Multilaterally, the United States has taken a leading position in the General Agreement on Tariffs and Trade's negotiating groups on health-related measures that can serve as trade barriers. These negotiations are directed toward making sound scientific evidence and the United Nations' Codex Alimentarius Commission's standards central to resolving trade disputes over food safety.

Bilaterally, the United States and several countries, such as South Korea and Taiwan, have established certain ad hoc technical working groups to assist in setting standards and sharing information on pesticide tolerances, sampling, and testing methods.

Administratively, the U.S. Department of Agriculture has created an interagency International Food Safety Task Force in response to the 1989 South Korean grapefruit scare. The Foreign Agricultural Service chairs this group. The task force promulgates a single U.S. government position on and provides a quick technical response to disputes over food safety concerns. The Department also participates in food safety seminars to share information on international negotiations and on bilateral and administrative actions.

The governments in the five countries GAO visited had little information on the type and amount of pesticides and other chemicals used and tolerance levels actually allowed on specific U.S. exported produce. Regular information-sharing between the United States and its trading

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partners would help reduce the likelihood of future disruptions of U.S. agricultural exports caused by foreign concerns over the use of pesticides and other chemicals.

Varying Standards and Procedures for Monitoring

The governments of the five countries GAO visited have set tolerances for a number of pesticides. As of May 1990, Australia had established tolerance levels for 395 pesticides, Japan for 25 pesticides, South Korea for 17 pesticides, Taiwan for 127 pesticides, and Thailand for 10 pesticides.

These countries have conducted pesticide testing less routinely than the United States. Australia and Thailand have not systematically conducted pesticide testing on imported produce. Japan has conducted tests on certain products when deemed necessary. And in South Korea and Taiwan, tests have been conducted on selected commodities to detect residues on those pesticides for which tolerance levels have been established.

In addition, Australia has deferred to Codex standards or applied a zero tolerance level in evaluating imported produce when established tolerances did not exist. Japan, Taiwan, and Thailand have allowed flexibility in such circumstances and generally have deferred to Codex standards or have accepted the standards of the exporting country when deciding whether to allow the commodity to enter the market. South Korea normally did not have such flexibility.

Testing Is Conducted at Capable Labs

Based on the Federal Drug Administration's laboratory standards, the five countries GAO visited had government laboratories with adequate pesticide testing equipment. The equipment included gas chromatographs for multiresidue testing and mass spectrometers for conducting pesticide residue confirmation tests. According to laboratory officials, the laboratories were generally well stocked with the solvents and chemicals needed to conduct accurate tests. However, in Thailand, the government was unable to use a U.S. Food and Drug Administration standard method to test for Alar on apples because the laboratory did not have the required solvents.

The laboratories employed trained personnel to conduct pesticide residue testing and analysis. Scientists and technicians GAO interviewed were familiar with international and U.S. recommended guidelines for pesticide testing. Laboratory technicians were aware of the procedures

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for cleaning and handling equipment and samples and with other standard scientific practices to ensure the accuracy of the results.

However, the five countries have used a variety of testing methods which could contribute to variations in test results. For example, in Japan they were developing and using their own methods, while South Korea has used analytical methods similar to those used in the United States. Thus, technical capability alone has not eliminated the potential for obtaining conflicting test results.

Recommendations

To help reduce the likelihood and impact of future disruptions of U.S. agricultural exports caused by foreign concerns over pesticides, GAO recommends that the Secretary of Agriculture, in cooperation with other federal and state agencies

- develop mechanisms for routinely providing foreign trading partners with information on pesticides used on U.S. exported produce and
- establish ad hoc technical working groups with more U.S. trading partners to address technical problems related to agricultural trade, such as U.S. pesticide use patterns and tolerances and sampling and testing methods.

Agency Comments

As requested, GAO did not obtain official agency comments on this report. However, GAO discussed the information contained in a draft of this report with officials at the Environmental Protection Agency, the Food and Drug Administration, and the Departments of Agriculture and State. Their comments have been incorporated in the report where appropriate.

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Global Trade Turns 'Green'

By PATTI PETESCH
And STUART K. TUCKER

Environmental concerns are permeating one more corner of international diplomacy — the powerful arena of global trade policy. Unfortunately, the new nexus is simplistically being cast as "trade vs. green." Yet, applying an environmental test to trade policies may contribute to a more efficient and fair trading system. Sensitizing the global marketplace to environmental objectives also offers an unprecedented opportunity to promote more sustainable development.

Environmentalists fear that current multilateral and regional proposals for a more open international trading system will seriously erode their hard-won national environmental regulations. Indeed, 17 members of the House just sent a letter to President Bush warning that they will oppose an extension of trade negotiating authority unless such environmental protection concerns are included in the upcoming negotiations for a North America free trade agreement with Mexico and Canada.

The general counsel for the Office of the U.S. Trade Representative, Joshua Bolten, already conceded at a Washington workshop on trade and the environment that environmental factors would have to be considered in the U.S.-Mexico-Canada free trade talks. Mr. Bolten further attempted to allay environmentalists' worries by stating that, "We are not prepared in this agreement to see in any respect the U.S. environmental standards relaxed."

Trade officials preferred in the past to keep their agendas more narrowly focused on knocking down the barriers to trade. They often suggested that separate bargains be crafted for managing related problems such as labor standards, pollution controls or migration flows. In fact, environmental issues never made it onto the substantive agenda for the current round of talks on the General Agreement on Tariffs and Trade, the global organization that sets trade rules. Environmentalists only began making noises about the current Uruguay Round of GATT talks after nearly four years of painstaking negotiations were drawing to a close.

Nevertheless, GATT Secretary General Arthur Dunkel has announced that the next round of negotiations among its 101 member governments will have to contend with the rising number of environment-related trade frictions. These involve national environmental policies such as import quality standards, anti-pollution subsidies, recycling laws and export bans that many believe are being used with rising frequency to serve protectionist objectives.

Trade doctrine calls for a "level playing field," where producers from all nations compete on equal terms. The United States spearheaded efforts in the Uruguay Round to foster greater harmony among countries, especially in the abused area of agricultural subsidies but also on trade issues such as intellectual property and food safety.

When examined through an environmental lens, aspects of these proposals, which are seen as possibly leading to an erosion of environmental standards, seem troubling and merit much closer scrutiny by public officials. Still, the anti-trade posture that some environmentalists are adopting will do little to serve their objectives.

The food safety debate illustrates this dilemma. The U.S. proposal has two goals: to reduce the gray area between genuine food safety standards and not-so-genuine safety regulations that nations are using simply to block competitors' food imports; and to set up a more viable process for dispute resolution. Accordingly, the minimum standards for such things as pesticide residues on fruits and vegetables would be set by an existing scientific U.N. body known as the Codex Alimentarius Commission, and all nations would be encouraged to raise standards where necessary.

Environmentalists worry that if these rules go into effect, international pesticide standards — often lower than U.S. or state laws — would be reduced to the least common denominator. The United States, for example, could be challenged in GATT to change its import standards (or California's) and accept foods with higher levels of pesticides, such as DDT, than are currently allowed under national law.

U.S. agricultural exporters contributed directly to efforts to standardize the regulations internationally. On the one hand, they want more reliable access to foreign markets; on the other hand, lower standards in other markets puts them at a competitive disadvantage. The developing countries signed on to these objectives, too. They are betting that the benefits of more predictable markets will outweigh their added production costs when their standards must rise.

More generally, developing countries argue that massive poverty, rather than trade, is exacting the highest environmental toll.

The challenge for environmentalists lies not in resisting efforts to harmonize trade. Rather, it is to ensure that trade policies do not weaken U.S. domestic standards but instead exercise a salutary effect on international standards. First, the skilled input of environmentalists will be needed to develop criteria for adopting appropriately vigorous standards on environmental grounds rather than on protectionist grounds. Second, their continued vigilance will be required to prevent efforts to roll back the standards.

Environmentalists began sounding alarms over the potentially harmful impact of some of the Uruguay Round proposals much too late to affect the course of negotiations. Yet, other opportunities exist. Most immediately, the upcoming North American trade talks present an historic opportunity to deepen the environmental agenda. Now that environmentalists have captured the attention of trade officials, it is to their advantage to support legitimate trade liberalization efforts and to work within those negotiations toward the adoption of sound environmental standards.

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Strengthening Protection of Intellectual Property in Developing Countries

by Wolfgang E. Siebeck, editor with
Robert E. Evenson, William Lesser, and Carlos A. Primo Braga

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I. INTRODUCTION

Wolfgang E. Siebeck

Should developing countries step up their protection of intellectual property and strengthen laws and institutions necessary to enforce such protection? By doing so, would they gain better access to technology from industrial countries, develop more indigenous research and development, and attract more foreign investment?

Economic science has probed many of the effects that protecting intellectual property has on welfare gains and losses. But little concern has been shown for the interests of developing countries. And, one should add, until recently little interest has been shown by developing countries in these issues.

There are several reasons for this neglect. First, strong intellectual property protection is widely seen as a prerogative of advanced countries, something not required until relatively late in the development process. Second, the issue has not generally received the serious attention it deserves: Suggestions that developing countries could be better off protecting intellectual property are often interpreted as attempts to deprive the developing world of the benefits of technological advances.

The current Uruguay Round of multilateral trade negotiations includes intellectual property among its fifteen negotiating subjects. This step was taken at the instigation of the United States and over long and strong resistance from developing countries. During the first phase of the negotiations, until the mid-term review in Montreal in December 1988, developing countries effectively refused to negotiate on the subject of intellectual property. In Montreal, however, a compromise stipulating that rules and principles of intellectual property protection should be worked out without prejudging who would later administer such rules and principles (the GATT or the World Intellectual Property Organisation) has since allowed substantive discussions to take place in the Negotiating Group on Trade-Related Aspects of Intellectual Property (TRIPs). Agreement in this group is widely seen as critical for a positive outcome of the Uruguay Round.

The purpose of this report is to provide an overview of the economic literature on intellectual property. Our main interest in preparing it was to determine whether the literature provides answers to the questions developing-country policy makers are likely to raise when faced with the need to decide on the introduction of stricter intellectual property rules.

The report is organized into seven chapters. To help the casual reader, chapter 2 provides a primer on the major instruments of intellectual property protection and the international conventions governing them. It also sketches the current scope of protection in individual countries. Unfortunately, a systematic appraisal of the scope and effectiveness of the protection offered by individual developing countries is lacking.

Chapter 3 reviews the economic literature on intellectual property. Although substantial, this literature is overwhelmingly devoted to the impact of intellectual property protection in industrial economies. The chapter recounts the traditional analyses of 19th century economists, the major reviews undertaken in the 1950s, and the more recent attempts to capture the welfare effects of and the trade-offs between encouraging research through the grant of a temporary monopoly and the diffusion of new knowledge and technology. Some analyses raise doubts about the welfare gains from intellectual property protection. Others conclude that optimal protection would have to provide for differential terms of protection instead of the standard fixed term offered in most countries. More recent analyses have been concerned with the use or misuse of intellectual property instruments to gain and control market share.

Only recently have the effects of differential protection of intellectual property by industrial and developing countries received attention. Studies have tried to gauge whether developing countries will be better off free-riding on knowledge appropriated from industrial countries, or protecting it along with their own knowledge production.

Chapter 4 reviews the limited empirical literature and published evidence on the effects of intellectual property protection. While the literature shows that developing countries widely underinvest in research, it does not provide conclusive evidence that higher returns and investments occur in those developing countries which offer stronger protection of intellectual property.

Chapters 5 and 6 deal with the specialized literature in four sectors in which intellectual property appears to matter most. These are (a) pharmaceuticals and chemicals, where patents are generally considered critical for protecting inventions and recouping high research and development expenditures; (b) information technology, where advances have given rise to calls for better protection than patents and copyrights can provide; (c) the audio, video, and publishing industries, where developing countries have a strong interest both as producers and consumers; and (d) seeds and plants, long excluded from intellectual property protection, where a stronger role for private-sector breeding in developing countries may require some form of protection of breeders' rights.

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Chapter 7 examines the costs and benefits that strengthened intellectual property protection could entail for a developing country. The costs of introducing and enforcing intellectual property systems, of higher royalty payments, and of losses from closing down "pirating" activities, as well as the opportunity costs of higher research investment, have to be weighed against the potential benefits deriving from higher domestic research efforts and more access to foreign technology and foreign investment. The threat of trade retaliation, once introduced into the cost/benefit analysis, will affect the trade-off faced by countries with significant trade links with industrial countries.

The current state of economic analysis provides few of the answers a developing country policy maker would need in order to make an informed decision on whether to strengthen intellectual property and enforce its protection. Chapter 8 summarizes the findings of this survey and suggests that research resources be shifted to a number of tasks of priority interest to developing countries.

To quote one of the first scholars who addressed the concerns of the developing countries (Vernon, 1957: 24): "These nations can hardly be expected to see the extensive grant of patent monopoly rights to foreigners as being unqualifiedly consistent with their own national aspirations. A bridge between our conceptions and theirs in this regard will need a kind of understanding which we have so far rarely displayed in international patent negotiations." We hope that this survey will serve as a block in the building of this bridge.

Two cautionary remarks are required. First, the survey does not claim to be exhaustive. Its authors have attempted to reflect the broadly accessible literature on the subject. By necessity, they have left out important contributions that have appeared in other than economic publications, as well as many publications written in languages other than English. For a subject as international in its ramifications as intellectual property, we only reluctantly agreed to this shortcut. Secondly, while it has been our intention to review the effects of all instruments of intellectual property protection, patents have assumed a predominant position in the discussion. To a large extent this reflects the prevailing focus in the literature, but also the fact that patents as the prime tool for protecting inventions dominate the discussion on knowledge transfer between industrial and developing countries.

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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
UNITED STATES HOUSE OF REPRESENTATIVES
FEBRUARY 20, 1991

Introduction

Madam Chair and Members of the Committee, it is a great pleasure to testify before you today. In the coming months, this Committee will consider a wide range of issues, including a number of legislative proposals that are critical to the international economic policies of the United States. Many of these issues and much of the legislation will involve issues for which the Treasury has the primary responsibility in the U.S. government.

The full plate which you will have before you reflects the growing importance of the interrelationship between the world economy and our well-being at home. A few vital statistics highlight this essential reality.

- U.S. trade, which equaled roughly 8 percent of GNP in 1970, now accounts for over 16 percent of our national income.
- The external sector accounted for more than 40 percent of our growth in 1990.
- Roughly one out of every four new jobs in the United States is related to merchandise exports.

Let me review with you a number of areas in which the Treasury is engaged that bear on our ability to foster a sound world economy and stable international monetary system that promotes U.S. political and economic interests. I will also inform the Committee of other areas in which Treasury is involved, including the Persian Gulf crisis, efforts to open markets overseas, and the operations of the Exchange Stabilization Fund (ESF).

Before proceeding with this review, however, let me note that during the seven years which I have been Assistant Secretary and Under Secretary of the Treasury I have consulted extensively with this Committee on a number of major policy issues. This has enabled me to learn from you as well as to take account of your views. We have made some important progress on macroeconomic

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policy issues and international debt. For my part, I certainly hope that this close consultative arrangement that we have established will continue. I am confident that you share this hope.

Economic Policy Coordination

Our economic relations with the major industrialized G-7 nations -- Canada, France, Germany, Italy, Japan, and the United Kingdom -- comprise one pillar in our efforts to maintain growth and stability in the world economy.

In the 1970s through the mid-1980s, the world saw firsthand the consequences of uncoordinated economic policies in the major countries.

- Divergent economic conditions, coupled with wide fluctuations in currency values, including the sharp appreciation of the dollar, resulted in large trade imbalances.

- For example, the dollar rose around 100 percent against many major European currencies in the early 1980's and the U.S. trade position moved from near balance to a deficit of some $160 billion, 3-1/2 percent of our GNP.

- These developments led to unemployment in many important sectors of our economy and a rapid build-up in the external indebtedness of the United States.

Since 1985, however, the G-7 countries have created a mechanism -- the economic policy coordination process -- to establish the consistent policies necessary for sustained growth with low inflation, reduced trade imbalances, and greater stability of exchange markets. As part of this process, the G-7 have intensified their cooperation on exchange markets. The G-7's record of success has been impressive.

- The major countries have achieved the longest postwar expansion on record -- eight consecutive years of sustained growth.

- Exchange rates better reflecting underlying competitiveness are now in place, contributing to greater stability of exchange markets. For example, the annual range in the movement of the deutschemark against the dollar was 25 pfennigs in 1990 (15.5 percent), down from 100 pfennigs in 1985 (35 percent) and 35 pfennigs in 1987 (19.5 percent).

- As a result, trade imbalances have been reduced sharply in the United States and Japan. Also, the long-awaited reduction in Germany's surplus is now occurring, influenced importantly by reunification.

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At the same time, we are now in a period where economic conditions in the major industrial countries are diverging. This situation is posing important new challenges to the coordination process. In the months ahead, there will be a need to intensify efforts to develop consistent mutually supportive policies that will sustain global growth with low-inflation, continue the adjustment of trade imbalances and maintain stable international financial and currency markets.

International Monetary Fund (IMF)

The IMF is another critical pillar of our efforts to promote a sound world economy. The Fund's chief mandate in recent years has been to extend its limited resources in support of comprehensive economic reforms in a large number of member countries. In effect, the IMF provides countries with policy advice and seed money, which helps them put in place the appropriate policies to put their economic house in order.

In so doing, the IMF is supporting U.S. foreign economic policy interests throughout the world.

- In Eastern Europe, the IMF is playing the lead role in restructuring Eastern European economies away from central planning towards private markets. Over the past year, IMF support has been critical to the reform efforts of Poland, Czechoslovakia and Hungary, and to unlocking substantial additional resources for them from other contributors. Estimates suggest the IMF may commit up to $10 billion in 1991 in Eastern Europe.

- In response to the Gulf crisis, the IMF quickly adapted its procedures and policies in order to provide timely support to countries adversely affected by Iraq's brutal aggression. To date, the IMF has disbursed $2.2 billion in increased financing to help countries address higher oil import costs.

- In Latin America, in particular, the IMF is providing essential support for economic policy reforms, and for debt and debt service reduction under the U.S.-led international debt strategy.

- In Africa, the IMF is extending concessional resources to help the poorest countries of the world achieve sustained growth and alleviate widespread poverty.

The resource needs of the IMF are periodically reviewed to ensure that the Fund has adequate resources at hand to fulfill its important systemic responsibilities. Last year, the IMF membership concluded negotiations to increase Fund resources from $130 billion to about $195 billion, a 50 percent increase -- the first such increase since 1983. The U.S. share of the increase is

some $12 billion, for which we will be seeking Congressional authorization and appropriation as part of the FY 1992 budget.

The IMF is an extremely cost-effective organization. First, no net budgetary outlays are associated with the use of the IMF quota. Each time the IMF uses dollars, we get in return a liquid, interest bearing reserve claim which we can automatically draw. Second, the IMF leverages our resources, which is especially important at this time of budgetary restraint. For every dollar we put in, others put in four. Third, the United States has effective veto power over key IMF decisions, which uniquely positions the United States to influence the policy direction of the IMF in a manner consistent with our interests. Finally, as part of the recent quota negotiations, we secured agreement on a strengthening of the IMF's arrears strategy, in order to ensure that our increased contribution is used wisely.

Madam Chair and Members of the Subcommittee, we look forward to working with you on the IMF quota increase in the months ahead.

The Multilateral Development Banks (MDBS)

U.S. participation in the World Bank Group and the regional MDB groupings is based on the same premise as our participation in the IMF -- to promote a sound world economy and increased prosperity for all countries. In an interdependent world this means furthering an international economic framework that is open and market-oriented to promote the efficiencies in production that trade fosters. These gains from trade make for a world-wide improvement in living standards.

MDB lending supports this general objective by mobilizing private sector and government resources to finance the basic infrastructure and service projects that improve productivity and living standards in developing countries. Loans from the World Bank and the regional MDBs have financed rural electricity, basic health care, agricultural extension, education, water and sewerage, environmental and resource management, telecommunications, private sector investment, and public sector reform projects.

Project viability, however, is determined not only by the rate of return on a specific project, but also is dependent upon the environment in which a particular project exists. Therefore, the MDBs also engage in adjustment lending to support sectoral and macro economic reforms to improve the domestic policy and institutional environment with the goal of moving a national economy toward self-sustaining economic growth.

Stronger, more stable, growing developing country economies directly help the U.S. economy: they contribute to an expansion of employment in the United States through increased exports.

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In addition, the business contracts resulting from MDB projects are a direct and tangible benefit of U.S. participation in the MDBs.

These contracts are composed of three related elements. First, there is the procurement stemming directly from MDB provided finance. U.S. businesses secured roughly $2.0 billion in contracts from the MDBs last year. This compares with U.S. budget expenditures for the MDBs averaging about $1.6 billion annually. Secondly, since the MDBs only provide a portion of the finance needed for a project, there are other procurement possibilities generated by non-MDB finance for a project. Finally, the business contacts established through U.S. business participation in bidding on MDB projects lead to follow on business. In sum, MDB projects are an important nexus for the development of U.S. exports and jobs in the export sector, the value of which far exceeds our financial support for these institutions.

Financing the operations of these institutions is shared by all member countries. Consequently, U.S. interests in developing countries can be pursued through these institutions without the United States bearing the full burden. This is particularly important during periods of severe budgetary constraint.

For their market-related lending operations the MDBs leverage the callable capital guarantees of member countries to borrow funds on private capital markets. Hence, the majority of MDB loans are financed with relatively small cash outlays from MDB members, and are cost effective when compared with U.S. bilateral economic assistance.

Periodically we need to increase the capital base of the market-related "hard-loan windows" and replenish the resources of the concessional "soft-loan windows" of these institutions. This year we will be seeking Congressional approval for U.S. participation in a Special Capital Increase (SCI) of the Asian Development Bank (ADB). Depending on the outcome of negotiations, we may also be seeking Congressional authorization to participate in the sixth replenishment of resources for the African Development Fund (AFDF). There have also been serious discussions between the management and executive directors of the International Finance Corporation (IFC) regarding substantive justifications for an IFC capital increase.

The International Debt Strategy

Our work to promote strong developing country economies through the international financial institutions has been profoundly affected over the last decade by external debt problems. The United States has assumed a leadership role in crafting an international strategy for addressing these debt problems. This evolving strategy has produced results. We have protected the international financial system from risks of insolvency while

focusing increasingly on supporting economic reform and sustained growth in debtor countries. Most recently, the Brady Plan has proven effective in facilitating financing agreements that recognize the need to reduce debt burdens.

Seven countries have reached agreements with their commercial banks on packages that include debt/debt service reduction. These countries account for almost half of the total commercial bank debt of the major debtor countries. The benefits are substantial.

- The Mexican agreement reduced annual interest payments by 33 percent ($1.5 billion); commercial bank debt was reduced by 32 percent; and the burden of $42 billion in principal payments was removed.

- The Costa Rican agreement reduced that country's commercial bank debt by 62% and cut annual debt service payments by 74%.

Chile, Venezuela, Morocco, and Uruguay have also reached agreements involving significant reductions in debt burdens, and several other countries are continuing discussions with their banks.

These Brady Plan agreements enable debtor countries and commercial banks to address their disparate needs. Furthermore, these agreements are producing results for debtor economies by helping restore investor confidence and stimulate new investment flows.

Enterprise for the Americas Initiative

In a further effort to strengthen the economies of our neighbors in Latin America and the Caribbean and to improve trade opportunities in the hemisphere, President Bush announced last June the new Enterprise for the Americas Initiative.

This region is of vital interest to the United States. Ten years of slow growth and debt overhang have plagued the economies of Latin America and the Caribbean and thwarted opportunities for the hemisphere as a whole.

The Enterprise for the Americas Initiative aims to address these problems through action in three areas -- trade, investment, and debt. It thereby joins in a single endeavor the three economic issues of greatest importance to the region. It also seizes, in terms of timing and concept, on important developments already underway in the region -- including the spread of democracy and a clear commitment on the part of leaders in the region to pursue reforms that will improve their economic prospects and make them more competitive in attracting capital.

We are making real progress in implementing the vision laid out in the Initiative. To increase trade and move toward the goal of a hemispheric free trade system, we are pursuing a Free Trade Agreement with Mexico, with Canada as a party. The goal of this agreement is to foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. This FTA should expand and lock in recent trade and investment liberalizations achieved by the Salinas Administration.

We are also negotiating framework agreements on trade and investment to establish the basis for progress with other countries in the region. These agreements establish fora for addressing technical issues and beginning to remove barriers to trade and investment. Such framework agreements have been signed since June with five countries -- Colombia, Ecuador, Chile, Honduras, and Costa Rica -- adding to those already in place with Mexico and Bolivia. Negotiations are underway with a number of additional countries, including Jamaica, Venezuela, Peru, Nicaragua, Panama, El Salvador, Guatemala, and a group of countries composed of Argentina, Brazil, Uruguay, and Paraguay.

The dramatic progress we are seeking on trade will take time to develop. The potential for action on investment is more immediate. Latin American and Caribbean countries are competing for scarce capital with other dynamic economies. They need to attract private investment both from abroad and at home, and to reverse capital flight, which in many cases is believed to be as large as their total external debt. The Inter-American Development Bank is developing an investment sector lending program to help countries to open and liberalize their investment regimes. The IDB has begun evaluating the necessary changes to achieve meaningful reform in individual countries, and we hope that the first investment sector loans will be moving forward over the next several months.

The debt reduction proposed under the Initiative will be an important incentive for countries to carry out investment reforms. The IDB has taken action to join the IMF and World Bank in providing support for commercial bank debt reduction. We expect Uruguay to be the first beneficiary. On bilateral debt, we gained authority from Congress during the last session to undertake reduction of concessional PL-480 debt for countries pursuing strong economic reform programs, including liberalization of their investment regimes. We will be discussing such debt reduction with individual countries as they become eligible. We will be seeking comparable legislation permitting the reduction of AID debt this year.

Our initiative will also provide significant benefits for the environment within the Hemisphere. Interest payments on the reduced PL-480 and AID debts will be dedicated by debtor

governments to support a broad range of local environmental projects or programs. We expect local non-governmental organizations with expertise in the environment and conservation to play a strong role in determining the use of these environmental funds.

To implement fully the investment and debt elements of the Initiative, we will be seeking additional authority from Congress as a matter of priority.

- Congress must also act to authorize the reduction of concessional AID debt and the sale of a portion of Eximbank and CCC loans. I want to ask for the support of this Committee for action on Eximbank debt. These sales would facilitate debt-for-equity, debt-for-development, and debt-for-nature swaps in eligible countries.

- I want to highlight for this Committee our request that Congress authorize U.S. contributions of $500 million over five years to the Enterprise for the Americas Investment Fund that the President proposed be established in the IDB. We are working with the IDB and other creditor governments to identify productive uses for this Fund. We are also seeking contributions from other countries to meet the goal of a $1.5 billion fund over five years. In sum, we envision that the Fund would make available grants and loans for: technical assistance to help build the expertise needed to undertake privatization and other investment related reforms; worker retraining and relocation necessary due to investment reforms; and enterprise development to assist very small firms in building equity and attracting investors.

I hope we can count on your support for this important Initiative.

Environmental Considerations

The environment has been an extremely important element in our overall approach to economic issues in recent years. Economic progress will be sustainable only in the context of sound environmental practices. Hence, environmental considerations must be integrated more effectively into the on-going operations of the international financial institutions.

This concern led us to negotiate an environmental framework for the IDA 9 Replenishment Agreement in 1990. It is the reason we are now taking such a strong stance on these issues in negotiating replenishments of the Asian Development Fund and the African Development Fund and the establishment of the European Bank for Reconstruction and Development. It underlies the great weight we have given to three key issues: environmental impact assessment, protection of tropical forests, and promotion of energy efficiency and conservation measures.

As a result of our efforts, we believe the World Bank and the Inter-American Development Bank are ready to implement new environmental impact assessment procedures in line with legislation introduced in this sub-committee in the last Congress. The World Bank is reassessing its forest policy and taking a new look at energy efficiency and conservation alternatives. It has created a special unit for energy efficiency and conservation for its operations in Eastern Europe and is restructuring its Energy Sector Management Assistance Program.

These reforms represent a significant strengthening of environmental capability in the MDBs. However, additional effort is still needed to assure their effective implementation. This year we will look for new opportunities to influence energy policy and promote more energy efficiency and conservation projects. We will seek more rapid progress on environmental impact assessment in the Asian and African Development Banks and further improvements and refinements, if they are needed, in the procedures already being adopted by the World Bank and the Inter-American Development Bank. We will continue our efforts to secure greater protection for tropical forests, including reform of the Tropical Forestry Action Plan.

We also want to encourage innovative programs that can be a catalyst for more rapid environmental progress within developing countries. That is why we have encouraged debt-for-nature swaps and put so much emphasis on the environmental element of the Enterprise for the Americas Initiative. In addition, we have offered to provide up to $150 million in parallel financing to the World Bank's Global Environmental Facility over its three life. Our objective in the facility is to foster greater interest in pilot projects that can become part of regular lending programs in future years.

The United States is also at the forefront in encouraging the IMF to enhance its environmental focus. Widespread recognition has emerged that IMF macroeconomic policy advice and prescriptions can have at times an important, though indirect, impact on environmental protection. In particular, the IMF is now discussing the establishment of a group of economists that will serve as a liaison with other organizations on environmental research and advise the Fund on addressing environmental concerns. Also, most IMF country documents now discuss environmental concerns. The IMF has also strengthened its collaboration with the World Bank with respect to taking into account structural measures for environmental protection into its work.

<u>Treasury Department Role in the Gulf Crisis</u>

The Treasury Department is playing an important role in the efforts of the United States and the international coalition of its allies to enforce the U.N. Security Council's resolutions

aimed at obtaining Iraq's unconditional and complete withdrawal from Kuwait.

A key aspect of our contribution is our chairmanship of the Gulf Crisis Financial Coordination Group. This Group was established in September by President Bush to complement the diplomatic and military efforts of the international coalition against Iraq.

The purpose of the Group is to mobilize and channel extraordinary assistance to the front line states, namely Egypt, Turkey, and Jordan. By offsetting the effects of the crisis on their economies, this assistance enables the front line states to continue their effective enforcement of the U.N.-mandated economic sanctions against Iraq.

The Group has met four times, most recently in Washington on February 5. Another meeting is tentatively planned for early March. It now brings together under Treasury Department leadership 26 countries, the European Commission, and the Gulf Cooperation Council. Representatives of the International Monetary Fund and World Bank provide technical and analytical support.

Through this successful initiative, the United States has obtained from other creditors commitments of $14.7 billion for the front line states and other countries whose economies are seriously affected by the crisis. Of this amount, $6.7 billion has already been disbursed, with substantial additional disbursements expected in the coming weeks.

Within the framework of the Gulf Crisis Financial Coordination Group, the Treasury Department is keeping economic developments in the front line states under continuous review to ensure that the economic effects of the crisis are offset to the maximum extent possible. This should help maintain effective enforcement of the economic sanctions against Iraq and facilitate the task of economic recovery and reconstruction in the post war period.

Negotiations to Open Markets Overseas

Treasury is engaged in a number of comprehensive negotiations to open markets overseas for U.S. exports, investment and financial services. Let me briefly discuss our negotiations with Japan, Korea and Taiwan.

With respect to Japan, we are addressing market access problems in the Working Group on Financial Markets (the so-called "Yen/Dollar" talks) and the Structural Impediments Initiative (or "SII"). There has significant progress in liberalizing Japan's financial markets since our talks in this area began in 1984. However, the pace of change has been relatively slow -- particularly compared to liberalization in London and New York -- and U.S. firms

continue to face numerous access problems. We will continue to press the Japanese to accelerate their efforts towards true liberalization in order to create a level playing field for U.S. firms in Japan.

We are also in the critical first year of the follow-up process of the SII, which is aimed at addressing the underlying causes of our persistent external imbalances, with the objective of reducing these imbalances further and opening markets. This initiative, which was patterned after the "Yen/Dollar" formula, resulted in a Joint Report last summer, containing commitments by both countries. Japan's commitments include increasing spending on public infrastructure, making the keiretsu system more open and transparent, and increasing the availability of land. If fully implemented, the SII commitments will result in a more open, fair and transparent Japanese economic system. Although there has been progress on implementing these commitments, much more needs to be done.

With respect to Korea and Taiwan, we have made substantial progress on financial policy issues. Negotiations on exchange rates had the desired effect of prompting appreciation in both the Korean won and the Taiwanese dollar to reflect more fully the strength of the two economies. This contributed to substantial declines in the large external surpluses of both countries, and particularly in their bilateral surpluses with the United States. More recently, we have been engaged in discussions with both Korea and Taiwan on a broader range of financial issues. Our objectives are twofold: to encourage liberalization of the Korean and Taiwanese banking, securities, and exchange markets; and to obtain full equality of competitive opportunity for U.S. financial institutions in those markets. We have had some success in these talks -- for example in easing the criteria on bank branching and beginning to open the Korean and Taiwanese capital markets -- but much work remains to be done.

There are clearly limits to what we can achieve bilaterally without additional leverage or a stronger set of international rules than currently exist. Our efforts within the Uruguay Round to negotiate a financial services agreement could complement our bilateral efforts, but only if certain basic conditions are met. Essentially we must be careful not to lock ourselves into a commitment to maintain our open markets without adequate commitments from other countries to open their markets. These arrangements should provide real liberalization, deal effectively with the problem of free riders, and assure that financial experts oversee the operations of the financial services agreement, including dispute settlement. If these fundamental conditions are not met, a financial services agreement would not be in U.S. interests.

Exchange Stabilization Fund

The Treasury Department has a mechanism which enables the Secretary to undertake foreign exchange operations in order to support certain aspects of the international financial policy of the United States outlined above. That entity is the Exchange Stabilization Fund (ESF). It is the only instrument within the U.S. Government which is constituted and empowered to respond rapidly and flexibly to international financial disruptions.

The primary uses of the ESF have been to finance intervention in the foreign exchange market and to extend, under exacting standards, short-term "bridge loans" to assist countries in dealing with problems of indebtedness. In recent years there have been bridge loans to a number of Eastern European countries, including Poland. The Polish arrangement served to support a reform program that incorporated a novel stabilization fund and has led to current efforts to reduce Poland's debt, as provided by Congress.

Secretaries of the Treasury are sensitive to the need to employ judiciously the broad authority provided by statute for use of the resources of the ESF. They are equally sensitive to the need to keep Congress informed of their exercise of this authority and of the financial condition of the ESF, which is extremely sound. I would note in this regard that I provide regular reports to appropriate Congressional bodies, including this Subcommittee.

Conclusion

By now Madam Chair, it should be clear that Treasury is indeed engaged in a number of areas that bear significantly on the ability of the United States to promote a sound, environmentally safe, world economy and stable international monetary system. Treasury relies heavily on the international financial institutions (IFIs) to carry out these objectives, as well as U.S. humanitarian interests. The successful operation of IFI activities makes one additional contribution: the promotion of peace and democracy among nations.

These are important matters, as I am sure you will agree Madam Chair. It is critical that the Executive and Legislative Branches of our government coordinate their activities closely on these issues. That is why I put considerable effort into strengthening the consultation process between this Committee and Treasury. I believe it is essential that this relationship continue.

Congressional Staff Forum
on
International Development

Hearings on the Role of the International Financial Institutions

Rapporteur's Report
By Robin Dunnigan

House Appropriations Subcommittee on Foreign Operations
March 5, 1991

Members in Attendance: Chairman Obey (D-Wi), McHugh (D-NY), Gray (D-Il), Coleman (D-Tx), Smith (D-Fa), Porter (R-Il)

Testimony: Secretary of the Treasury Nicholas Brady

Hearing: **Brady** stressed the critical role of the international financial institutions (IFIs) as instruments of U.S. economic and foreign policy. As Eastern Europe, Latin America, Africa, and Asia turn increasingly to free market systems, and the world's economies become increasingly interdependent, these institutions will play a central leadership role in implementing U.S. policy objectives. He emphasized that we must meet our economic "obligations" to the IMF and the Multilateral Development Banks (MDBs) in order to retain our influence and effectiveness within these institutions. Brady highlighted the objectives and achievements of the IMF and the MDBs, emphasizing their efforts in international debt strategy and environmental protection. He also stressed the pivotal role the Enterprise for the Americas Initiative (EAI) will play in strengthening the economies of Latin American and the Caribbean.

In praising the achievements of the IFIs, **Brady** pointed to the Mexican debt relief agreement, which reduced Mexico's annual payments by 33% ($1.5 billion), cut commercial bank debt by 38%, and removed $42 billion in principal payments. He praised the EAI and said the Administration will be seeking $500 million over a 5-year period for an EAI investment reform fund at the Inter-American Development Bank (IDB). He also praised the proposed North American Free Trade Agreement (NAFTA), adding that Bush needed fast track authority to effectively negotiate the NAFTA.

According to Brady, it has been a major U.S. objective to improve the environmental performance of the IFIs and to make them "effective agents of environmental reform." He added that, "we are at the point of institutionalizing fundamental changes in the way the MDBs address environmental issues."

Questions: The discussion focused on EAI, debt relief, and the environment. **Obey, Coleman** and **McHugh** each asked why it was necessary to establish a separate entity in the Treasury

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Department for the EAI. Why not channel the program through the Inter-American Development Bank? **Brady** answered that this program is very important to the Administration and that making it a separate entity will give it added momentum and support. It also allows for more regional input while at the same time branding it a U.S.-initiated project.

There was particular concern over Mexico's debt. In response to **Coleman**, Brady said that he felt the NAFTA would help alleviate Mexico's debt problem. **Coleman** expressed reservations about granting the Administration fast track authority, adding that many members are dubious that fast track authority will be granted to Bush for the NAFTA.

Several members expressed concern that the United States is not pursuing environmental objectives aggressively enough. **Brady** said that this is not at all the case--we are the leaders in the IFIs in pressing for environmental protection. **Obey** responded that our retreat on emissions control does not portray an Administration concerned with the environment. **Porter** requested more information on our "debt-for-nature" swaps with Latin America and urged Brady to place environmental protection higher on his list of objectives.

Several members questioned the delay in getting the European Bank for Reconstruction and Development (EBRD) organized. It is still in its beginning stages and should have been off the ground by now. There was also concern about debt relief for Poland. The United States has been a strong advocate of relieving Poland's debt, but Japan and Germany are dragging their feet. **Obey** suggested that Germany be asked to repay its WWI debt to the U.S. if it did not "shape up" and help Poland.

Obey asked what is happening with the Soviet Union and the World Bank (Bush has suggested that the USSR be given special associate status). **Brady** answered that changes regarding the Soviet Union are on hold given recent events in the Baltic states.

Obey brought up the issue of Egypt's debt forgiveness. He pointed out that last year the committee agreed to forgive $6.7 million of Egypt's debt. Since then, Egypt has made no real progress toward economic reform. Now the Administration has asked Congress to approve a substantial military aircraft "sale" to Egypt. First of all, with Iraq's current military capability, Egypt does not need more military aircraft. Furthermore, this will not be a "sale" since they won't be able to pay us back, and it will only further hurt their ability to pay off existing debts.

Obey closed by addressing the Administration's proposal that "human capital grants" be made to the LDCs. This money would go for trade adjustment assistance, such as job retraining. He asked how Congress can (and why they should) sell this idea to their constituents? While it is a worthwhile objective, it is an objective that should be pursued at home first. The new budget proposes a 16% cut in trade displacement assistance--why is Congress being asked to facilitate structural change abroad while ingoring the painful side of change at home?

STATEMENT OF CHAIRMAN LEAHY

FOREIGN OPERATIONS SUBCOMMITTEE

MULTILATERAL ASSISTANCE: COPING WITH ENVIRONMENT, POPULATION AND DEBT CHALLENGES

MARCH 5. 1991

Welcome Mr. Secretary.

I just reread my statement at the hearing with you almost exactly a year ago. It is sometimes useful to do that. You realize how little some things change.

Last year I raised concerns about the Brady Plan. The debt agreement with Mexico was just being signed. I asked whether your plan would make any real dent in Third World debt. Three or four more countries have since followed Mexico's lead. But as far as I can tell, the real effect on debt is tiny. I still wonder whether this amounts to just a band-aid on this huge sore of commercial debt.

Dealing with this massive Third World Debt is not just a bankers' exercise. Our own exports in the developing countries are being hurt by their inability to buy from us. This costs jobs right here at home.

So, what are the Brady Plan and the multilateral development banks doing to solve this problem?

I also spoke about the World Bank's record on the environment, something this subcommittee has raised time and time again. I said the Bank got a below passing grade for its efforts to fight global warming.

There has been some progress at the Bank, but far, far too little. It makes me angry that with all the public concern about the environment the World Bank still routinely approves projects that destroy tropical forests, uproot tens of thousands of poor people, and promote wasteful energy use.

Frankly, I am at the point where I am ready to start doing some tough things that will get their attention--like cut back on our contribution.

I also mentioned the Bank's abysmal record on family planning. The Bank acts like it believes economic growth alone will solve the population problem. I know President Conable has called for more support for family planning. But I do not see that he is having much impact on the Bank's lending. I think the Bank's bureaucracy ignores him.

What do we hava to do to get the Bank to share our own sense of urgency about the population problem?

These are questions that are as relevant today as they were a year ago.

THE JOURNAL OF COMMERCE, Friday, February 22, 1991

Winning the Economic Peace

By JOE O. ROGERS

The idea for a new international development bank should set off alarms for U.S. companies bidding for contracts in the post-war Middle East. Multilateral financial institutions have been a long-term disappointment for American companies. In this case such an institution would move American interests from a position of dominance to one of subservience, while relieving non-combatant nations of their international responsibilities.

Kuwait already has signed contracts totaling $800 million for post-war supplies, 70% of which have gone to U.S. companies. They are known to have contracted with Bechtel for the rebuilding of the petroleum sector. An Army Corps of Engineers group has departed for Saudi Arabia to prepare for rebuilding other infrastructure.

The creation of an international body to fund the rebuilding process could only reduce American influence and business. Following the form of existing institutions, it would have an international board of directors that would select projects and allocate contracts. Votes traditionally have been weighted by contributions.

Since the United States will have made its contribution militarily and has announced that it will not contribute to such an institution, we virtually would guarantee ceding billions of dollars of contracts to Japan and Germany. These non-combatants would be able to make loans (to be repaid through future oil revenues) to an internationally sanctioned development institution they would control. They then likely would count those funds as part of their contribution to the war effort on an equal basis with genuine U.S. expenditures of cash and lives. This is a clear and inexpensive win for countries like Germany and Japan.

The idea of setting up some international operation is enticing, especially if you are in the position of State Department officials who have been unable to persuade Japan and Germany to produce promised hard cash. But to accept the proposition that Japan and Germany could fulfill their commitments in this way one must presuppose that there is a U.S. responsibility to finance the rebuilding and that, therefore, Japan and Germany will be lifting the load No such responsibility exists or should be accepted.

The responsibilities to which America has committed itself are freeing Kuwait and providing the people of Iraq the opportunity of freedom. The Japanese and German commitment is to provide direct financial support to the United States.

A quick review of the 1990 procurement statistics for multilateral development banks shows what we should expect if a formal Middle East development bank is created to finance reconstruction. These are institutions in which we are the largest shareholder or, in the Asian Development Bank, co-equal in votes with Japan.

In the World Bank, to which the United States has contributed just under 20% of its capital, we received just 16.7% of the procurement. In the International Development Association, the World Bank's interest-free lending arm for the poorest of the poor, we received only 5.3% of the procurement in exchange for our traditional contribution of 25% of the capital. In both cases, our procurement percentage has fallen over the past five years.

For the Inter-American Development Bank, where we supply 31% of the capital, we received only 17.8% of the procurement. In the Asian Development Bank we supply 15% of the capital and received 5.3% of the procurement. Our record is not good. We pay and the jobs go to others.

What is called for in the post-war Middle East is a fair and equitable sharing of procurement based on contributions to the war effort. If you met your commitment to the war effort, you should be eligible to bid. If you sent your sons and daughters to the front, you should receive a preference in bid pricing.

For Japan, Germany and others who have promised to underwrite allied war expenses, this should mean that their eligibility for procurement depends on meeting those obligations in cash. If they don't meet their obligations, they should not be allowed to win the economic benefits of the peace.

The United States, Britain, Egypt, Pakistan and others who have provided troops should receive a 15% bidding advantage on all construction and equipment contracts. The only exception to these restrictions should be for contract labor from countries that have supplied workers to the Middle East. These nations — notably the Philippines and India — have borne heavy costs. Construction firms from all nations depend on their excellent work forces.

Before anyone becomes alarmed at the protectionist aspects of a 15% bonus, it should be recalled that the World Bank and its sister organizations sanction such an advantage for certain members. These so-called "loadings" are made because the international community has determined that special circumstances merit a politically determined economic advantage.

I am prepared to argue that the circumstances of having sons and daughters, wives and husbands, mothers and fathers standing in the way of a common enemy is as special and deserving a circumstance as one could find. This provides clear definition of the concept of burden-sharing with which many nations approach international economic issues. The international community that has come together behind the war effort should not lightly decide otherwise.

Joe O. Rogers, U.S. ambassador to the Asian Development Bank from 1984 to 1986, is president of his own international business consulting firm. His clients include both foreign and U.S. trading firms. His business does not involve trade in the Middle East.

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EXECUTIVE SUMMARY

Over the last several years, members of the Institute of International Finance have expressed their belief that a viable way must be found to reengage banks in medium- and long-term trade and project finance for middle-income countries. Otherwise, such financing will have to be provided, to an ever-increasing degree, by creditor governments and multilateral institutions, at a time when public sector resources are already constrained.

Early in 1990, the Institute surveyed its bank members in order to clarify the incentives banks consider necessary to increase their trade and investment financing. The survey was followed by discussions with a working party of banks, private insurance companies, and export credit agencies. These discussions centered on ways to expand the overall financing capacity for borrowers in middle-income countries.

Within the group of middle-income countries that restructured commercial bank debt during the 1980s are those that have improved economic performance and those that have not. The recommendations in this report apply only to the former group.

Two major incentives would encourage greater bank participation in trade and investment finance:

- A return to creditworthiness by middle-income countries that have restructured bank debt; and

- Increased financial support by the export credit agencies and international financial institutions.

Full market access can only be achieved over time and, given the constraints on official resources, preference must be given to countries that consistently meet targets under IMF and World Bank programs.

There are a number of other incentives which can have a more immediate effect on bank decision making. They center around two structural problems that impede trade-related finance today: risk sharing and profitability. Specific recommendations therefore focus on:

- Improving risk sharing, including expanded use of reinsurance and cofinancing between export credit agencies, private insurance companies and multilateral institutions; enhancements to downpayment financing for ECA-covered transactions; and limited recourse and other nontraditional financing structures by export credit agencies.

- Improving profitability, including loan features that facilitate securitization; regulatory changes to provisioning and capital requirements that have increased banks' costs; changes in tax policy, particularly withholding; and simplification of administrative requirements.

There is strong agreement among banks that, in order to create a workable framework for trade-related finance, improved cooperation and coordination among export credit agencies, multilateral organizations, private insurance companies and banks is required.

INTRODUCTION

The payments problems of many middle-income countries in the 1980s have had a profound effect on the outlook for future international investment and lending to non-OECD countries. The willingness of banks to finance trade and investment needs of these economies is critical for economic growth and is a precursor to capital inflows from other private, nonbank sources. Reasonable growth aspirations cannot be adequately financed by domestic savings and official transfers alone.

This report addresses the question of whether a viable way can be found for commercial banks to reengage in medium- and long-term trade and project finance.It deals only with middle-income countries (defined by the World Bank as those whose 1989 GNP per capita was between $581 and $6000) that have restructured their debt in the 1980s. Generally, banks have been responsive to middle-income countries that did not reschedule debt during the decade, leaving open a wide range of bank and nonbank financing options. For those countries that have restructured debt, however, a sustained improvement in economic performance and timely debt servicing are key to regaining access to bank financing and, in the longer run, to other sources of private capital. This entails a step-by-step process of providing evidence to lenders and investors that bank relations have been restored and that countries have strong support from the international financial institutions and creditor governments.

To expedite this process, a satisfactory framework for trade and investment finance must be created. This can only be achieved under two conditions. First, borrowing countries must demonstrate improved economic performance, carry through wide-ranging structural reforms under agreed programs with the IMF and World Bank, and maintain flawless debt servicing records. Second, increased official support of trade and project finance must be made available for countries achieving these criteria until such time as full market access is reestablished.

In 1990, the Institute of International Finance conducted a survey of its member banks to clarify the incentives banks need to increase their trade- and investment-related activities. From the survey and subsequent discussions with banks, private insurance companies and export credit agencies (ECAs) the following observations and recommendations emerge.

THE NEW YORK TIMES, SUNDAY, MARCH 24, 1991

As the Dust Settles, Attention Turns to New Arms Sales

By PATRICK E. TYLER

WASHINGTON

At war's end, and with a potentially chaotic peace ahead in the Middle East, the Bush Administration made clear last week that it was preparing to arm its friends in the region against a sea of trouble.

After forceful pledges this month by both President Bush and Secretary of State James A. Baker 3d to work toward reducing the flow of conventional arms and defense technology to the region, Defense Secretary Dick Cheney last week seemed to adjust the Administration's course. He gave the most detailed explanation to date of the emerging policy on arms and security, which can be boiled down to this: arms for America's friends and arms control for its potential foes.

In laying out the rationale, Mr. Cheney said the first order of business in the Persian Gulf must be the security of Saudi Arabia, Kuwait and the other gulf Arab states to make the region safe for an American withdrawal. Then, the United States must cooperate with other industrialized nations to stem the flow of critical technologies that advance the spread of chemical, biological and nuclear weapons, along with the long-range missiles to deliver them.

That is the security imperative Mr. Cheney described.

The political imperative, articulated by other senior officials, was that America's allies, those who stood up against Saddam Hussein, must be seen as the clear winners in a region that respects power and performance. Therefore, the winners must receive tangible rewards. But there was also an economic imperative, which left the Administration with a scarcity of funds or other economic benefits to offer.

What Mr. Bush could offer, however, was something devoutly wished by many developing nations: access to America's arms and technology bazaar. And for those who couldn't afford to shop, the Administration was asking Congress to guarantee credits for cash-strapped allies at the Export-Import Bank. In that way, American defense contractors would not lose business to European nations that subsidize weapons sales abroad.

Many members of Congress, who had hoped that Mr. Bush's new world order was going to make a new and stronger effort to restrain the Middle East arms race alongside the new peace process that Mr. Bush and Mr. Baker say they want, were disappointed.

To some members, it seemed a cynical exercise that on the plains of victory, the Administration would sow the seeds of future militarism, arming to the teeth the lightly populated desert kingdoms and emirates along with some of their newfound protectors, whose blossoming arsenals would only spur Israel to outdistance them further and perhaps incite Iran to rearm more quickly and send Syria on a new arms spree in Moscow.

For their part, the Soviets seemed to recognize — then shrink from — the old instincts of the superpower rivalry that has fueled the arms race in the Middle East for four decades. Moscow's Foreign Minister and its delegate to the United Nations both called on Washington to agree to a period of restraint in the Middle East, but Mr. Cheney argued this would effectively serve as a disloyal arms "embargo" against America's friends.

With the State Department forging ahead with a sale of 46 General Dynamics F-16 jets to Cairo, part of a package long in the pipeline, the resumption of arms transfers was a reminder of the resource drain they would have on some of Washington's economically strained allies, notably Egypt and Israel, at a time when major challenges of population, immigration, water resources and economic restructuring lie ahead.

Mr. Bush has already forgiven Egypt's $7.1 billion military debt, and the new signals of a return to business as usual come as Egypt's unreformed economy continues to collapse. If Egypt, at peace with Israel, cannot rechannel its resources away from arms, who can?

Outfitting a Policeman

The United States has been trying to find and outfit a policeman in the Persian Gulf since the Nixon Administration, when the Shah of Iran was given the keys to the American arsenal. The newest policeman is a collective: Saudi Arabia, Kuwait leading the Gulf Cooperation Council states (Bahrain, Qatar, Oman and the United Arab Emirates), plus Egypt and Syria.

Pool photo via Associated Press

American soldiers preparing to blow up a mass of captured weapons inside Iraq early this month.

The Bush Administration has political, military and economic interests at stake.

The Bush Administration is seeking a postwar security arrangement built on a presence for the United States Central Command, according to Gen. Colin L. Powell, chairman of the Joint Chiefs of Staff. With Arab ground forces armed mostly by the United States, the Central Command will be able to take part in, if not supervise, an alliance built around the Arab allies who fought Iraq. They will be backed by an expanded United States naval presence with greater access to Arab ports, and by regular deployments of American fighter wings and ground troops for visits and exercises.

In a matter of weeks, Gen. H. Norman Schwarzkopf, head of the Central Command, will submit a blueprint for the new alliance, including a forecast of the level of armaments it will need.

Part of the pressure on the Administration to back away from controlling arms sales in the region may be simply that Saudi Arabia and Kuwait are clinging to the presence of 440,000 American troops, whose departure would require the Arab leaders to come to grips with their future relations with Saddam Hussein, still armed and increasingly desperate in Baghdad. Senator Joseph Biden, Democrat of Delaware, said a "top national security council official" told him Americans should "not be overambitious" in seeking Middle East arms control, and that "defense cooperation will provide far more security than arms control."

But the window for arms control in the Middle East may remain open for some time. The Saudis, while not eager for the American army to leave, are also not in any hurry to plow billions into new arms purchases. Neither are the Kuwaitis, who face a daunting rebuilding task. The gulf Arabs certainly are hoping that a peace process, both on the Arab-Israeli front and in the Persian Gulf, will relieve them of some of the defense burdens ahead.

One Less Worry

In an interview Friday, General Powell almost begged the question of whether there is a future military threat in the area that requires large forces. "There will not be a fourth largest army headed by Mr. Saddam Hussein in 1995," he said. "Perhaps one of the fortunate aspects of this entire unfortunate war is that it came at this time when we did have the capability to deal rather handily with the fourth largest army in the world."

Some pressure for new arms sales can be expected from defense contractors, who face a big contraction in United States spending for the rest of the decade. Without foreign orders for the M1-A1 tank, General Dynamics might have to shut down its production lines in Michigan and Ohio before the Army finds the money in the late 1990's to design a new main battle tank. And if McDonnell-Douglas, Lockheed, Northrop, Grumman and General Dynamics don't win their share of warplane sales to the Pentagon in this decade, foreign sales may be the only thing that can keep their production lines open.

These are big commercial interests that mean tens of thousands of jobs in the United States, and any arms control movement in Congress will run into countervailing pressures to sell. Advocates of arms control also will be hard pressed to oppose what appear to be legitimate security needs for defensive systems, such as air defense, anti-missile protection and interceptor aircraft.

In the final analysis, however, the arms race in the Middle East has never been more than a symptom of the intractible political and diplomatic problems that plague the region. There can be no farewell to arms while strong currents of Shiite fundamentalism seek to violently carve their channels across the Muslim world and while Palestinian nationalists fight to win a homeland against Israel's struggle for recognition and security.

The greatest stimulus to arms control, therefore, will be an active peace process between Israel and the Arabs and, in the Persian Gulf, among Iraq, Iran and the Arabian potentates.

were aggravated by the increase in world oil prices that occurred in the second half of the year.

The basic objectives of the updated program for 1991–93 are to achieve a real economic growth rate of about 5 percent, reduce the average rate of inflation from about 37 percent in 1990 to 5 percent in 1993, and to generate sizable surpluses in the overall balance of payments.

To achieve these aims, budgetary and monetary policies will be tightened, with special emphasis being placed on quickly restoring and maintaining positive real interest rates; major tax reforms have been introduced; and flexible pricing policies will be maintained. Among structural policies, state enterprise reform will be accelerated, particularly the privatization program; efforts to improve the monitoring and control of government expenditure will be intensified; and public sector management will be strengthened.

These policies will be complemented by appropriate sectoral strategies in agriculture, industry, health, education, and by efforts to protect the environment.

Within this framework, the program for 1991, which is supported by the third annual arrangement under the ESAF, aims at achieving a real rate of economic growth of at least 4 percent, sharply lowering inflation (to 10 percent); and generating a sizable overall balance of payments surplus.

Ghana joined the IMF on September 25, 1957, and its quota is SDR 204.5 million (about $290 million). [A member's quota in the IMF determines the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs.] Ghana's outstanding financial obligations to the IMF currently total SDR 523 million (about $743 million).

Press Release No. 91/12, March 6

Soviet Study Now Available

The complete three-volume set, *A Study of the Soviet Economy*, (see *IMF Survey*, January 7, 1991, page 1) is now available for US$100.00 from Publication Services, Box S-317, International Monetary Fund, Washington, D.C. 20431, U.S.A.

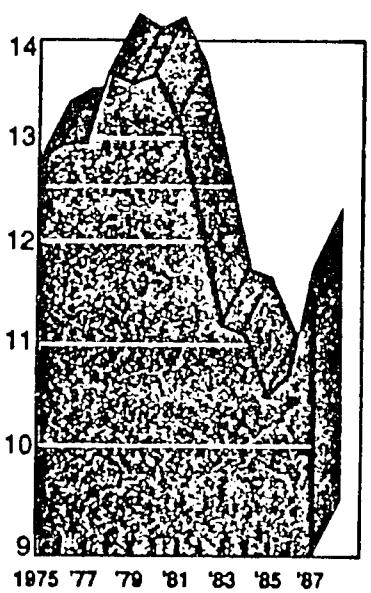
SELECTED TOPICS

Why Some Developing Nations Lure More Private Investment

Developing countries with high growth rates and income levels, low inflation and debt, and substantial public investment have higher levels of private investment relative to GDP. This is the view of IMF staff members Joshua Greene and Delano Villanueva in an article in the March 1991 issue of *Staff Papers*, the IMF's scholarly journal.

The March issue also features articles on the effect of monetary policy in developing countries; the fiscal impact of government contingent liabilities; the implications of opinion surveys of exchange rate expectations; the properties of long-run money demand in large industrial countries; aspects of currency bands and target zones; lessons from economic restructuring in Singapore; and the effect of high inflation on Israel's tax system.

Developing Countries: Private Investment Fell In Early 1980s[1]
(percent of GDP)



[1]Average for 23 developing countries.
Data: IMF, *Staff Papers*, March 1991

Lures for Investors

In their analysis of private investment in developing countries, Greene and Villanueva first look at the trends in such investment during 1975–87. These trends reveal that

- there was a wide discrepancy in private investment rates, ranging from more than 20 percent of GDP in fast-growing Asian countries to less than 10 percent of GDP in slower growing, less affluent, countries such as Bolivia and Peru;
- average private investment during 1975–81 was significantly higher than during 1982–87;
- the variability of public sector investment was lower than that of private sector investment; and
- there was no obvious correlation between high rates of private and public sector investment.

The authors then examine econometrically the determinants of private investment in a sample of 23 developing countries during 1975–87. They focus on the relationship between private investment and

- economic growth and per capita income levels;
- macroeconomic stability (as represented by low inflation rates);
- the level of real interest rates;
- the size of external debt levels and debt-service burdens; and

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• the rate of public sector investment.

Greene and Villanueva find that domestic inflation, high real interest rates, and external debt burdens have had a negative impact on private investment, while economic growth, public investment rates, and (especially for 1975–81) per capita income levels have had a positive impact. They also find that several variables—especially real interest rates, domestic inflation, per capita income, and public investment—had a greater impact on private investment during 1975–81, before the onset of the world debt crisis, than in subsequent years.

In addition, the way in which external debt burdens reduced private investment changed between 1975–81 and 1982–87. During the first period, when most countries remained current in their external debt-service payments, the debt-service ratio was a more significant determinant of private investment. By contrast, in the second period, when rescheduling and external arrears became more common, the ratio of the stock of external debt to GDP became more important.

Monetary Policy

Peter Montiel of the IMF's Research Department analyzes how changes in monetary policy influence aggregate demand in a financially repressed economy—that is, in an economy characterized by the absence of organized markets for securities and equities, by capital controls, and by interest rate ceilings.

In such a setting, open market operations "are out of the question," according to Montiel. The tools of monetary policy consist of central bank credit to the banking system, the setting of administered interest rates and required reserve ratios, and intervention in the free exchange market.

How do changes in these instruments affect aggregate demand? Montiel's analysis, based on a model of developing country financial markets, suggests that they do so in two broad ways: via "autonomous" or "partial equilibrium" effects and via "induced" or "general equilibrium" effects. The former include:

• conventional interest rate effects on interest-sensitive components of aggregate demand—that is, increases in bank interest rates depress demand;

• wealth effects, which arise from the recognition that financial repression entails an implicit system of taxes and subsidies on households as creditors and debtors of the banking system; changes in monetary policy instruments affect the relative degree of these taxes and subsidies; and

• effects on the profits of the central bank, which have fiscal, and therefore demand, consequences.

General equilibrium effects emerge through the impact of monetary policy changes on the exchange rate premium on the parallel market, the expected rate of inflation, and the economy's stock of foreign assets. Since all these variables affect domestic demand, induced changes in their values represent important additional channels through which monetary policy may affect aggregate demand.

Villanueva (left) and Greene: high levels of inflation, real interest rates, and external debt have inhibited private investment.

Government Liabilities

Christopher M. Towe, an assistant in the office of the Executive Director for Canada, examines how fiscal accounting can be modified to accommodate the impact of governments' contingent liabilities, such as deposit insurance, social security and health insurance, and loan guarantees. He argues that by accounting for such contingencies only when a cash outlay is actually made, a conventionally measured fiscal deficit "may misrepresent the government's fiscal impact . . . ." Moreover, since the issuance of contingencies may have severe cash flow implications, budgetary authorities relying on conventional accounting methods may not be in a position to adequately monitor and control the government's overall fiscal position.

Towe reviews the various types of contingent liabilities governments issue, examines their accounting in conventional budget methodologies, discusses their impact on private sector behavior, and suggests how they could be accounted for in measures of the fiscal deficit.

According to Towe, many governments' contingent liabilities relate to social security programs, such as state pension schemes and medical insurance programs. However, governments also provide many non-social-security-related programs that are mainly designed to stimulate particular economic activities by reducing risk. These include deposit insurance, loan and mortgage guarantees, and trade and exchange rate guarantees. In addition, a large share of governments' contingent liabilities may be associated

with the implicit guarantee of public sector agencies.

Towe notes that the treatment of contingencies in conventional fiscal accounting suggests that their macroeconomic impact occurs at the future date when the contingent claim is realized and the cash flow is generated, rather than when the liability is issued. An implicit assumption supporting this view is that consumers are myopic with regard to the future benefits that

Towe: a conventionally measured deficit may misrepresent fiscal impact.

such schemes imply, or face liquidity constraints. These are extreme assumptions, he points out, and if they are relaxed, economic activity may be affected in advance of any cash outlay, thus limiting the usefulness of the deficit as an indicator of fiscal impact. A further drawback of conventional deficit measures is that they may not provide an adequate device to control government agencies' issue of contingent liabilities.

Towe argues that although it would be impractical to abandon conventional deficit measures in favor of comprehensive indexes of fiscal impact that encompass contingent liabilities, such liabilities are important and some measure of them is desirable. He suggests two indexes:

• *Actuarial balance*, which offers a useful gauge of the future tax liability or the required reduction in government consumption implied by a given program. This can be calculated by comparing the net present value of a program's assets to its liabilities.

• *Actuarial fairness*, or a contingency's subsidy value, which measures the transfer implied by a program from future participants to current participants (as in, say, a pension program). This is calculated by comparing the expected present value of contributions and benefits from the perspective of current participants.

These measures can be used as the basis for budgetary control over the government's provision of contingencies as well as for gauging the impact of these contingencies.

Exchange Rate Expectations

Shinji Takagi, formerly of the IMF's Research Department, reviews the empirical literature on exchange rate expectations that are based on surveys of financial market opinions. He reviews the main qualitative characteristics of the exchange rate expectations generated by such surveys. He also examines what opinion surveys imply for the presence or absence of forward discounts and risk premia, for the rationality of expectations, for the mechanisms of expectations formation, and for the differences between short- and long-run expectations.

Takagi draws three broad conclusions from his analysis:

• Changes in the forward discount rate fully reflect changes in the expected exchange rate, so that assets denominated in different currencies can be considered perfect substitutes.

• Expectations based on market opinion surveys tend to be biased predictors of future exchange rates, and the forecast errors are related to variables that were known about when the expectations were formed.

• There is a consistently observed difference between short-run (generally shorter than one month) and long-run (generally longer than three months) expectations. Short-run expectations tend to be in the same direction as actual recent exchange rate movements; a depreciation tends to be followed by expectations of further depreciation. In the long run, expectations tend to move in the opposite direction, toward long-run "normal" values; a depreciation tends to be followed by moderate reversals or appreciations.

According to Takagi, the last finding "suggests that the foreign exchange market in the short run reflects an element of 'noise trading,' trading that is based on factors other than 'fundamentals.'" He points out that chartism—that is, the use of past price patterns as a guide to future price patterns—is the predominant method used for short-term forecasting.

Takagi suggests that if indeed a major portion of the short-run volatility of exchange rate movements is attributable to the chartist nature of short-run exchange rate expectations, there may be a case for policy measures to intervene in the foreign exchange market in the short run. One such measure might be a fixed transactions tax, which would increase the cost of short-run trading relative to long-run trading. He adds, however, that most economists would probably be skeptical of such a policy recommendation until they could be convinced of a firm theoretical link between individuals' expectations and actual exchange rates.

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THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release March 20, 1991

FACT SHEET

The Reduction of Poland's Debt

Today, President Bush warmly endorsed the historic agreement between the Government of Poland and its government creditors in the Paris Club to reduce Poland's debt obligations to official creditors. This package represents a strong signal of creditor support for Polish economic and democratic reforms. Together with a new 3-year program with the International Monetary Fund (IMF) and continued reforms, it should help encourage new private investment and capital flows to Poland and provide a sound basis for sustained economic growth. The agreement is the successful culmination of vigorous U.S. efforts to achieve a multilateral agreement offering substantial benefits to Poland.

Specifically, the agreement provides for the reduction of Polish debt by a minimum of 50 percent in real terms. The debt reduction will be formally adopted by the Paris Club once Poland's IMF program has been approved (expected in April). The restructuring will occur in two stages:

-- The first stage involves 30 percent relief on a net present value basis and includes cash flow relief of 80 percent for the crucial first three years of the agreement.

-- The second stage consists of 20 percent relief on a net present value basis after 3 years, upon successful completion by Poland of the IMF program.

In each stage, creditor governments will have the option of pursuing equivalent relief through debt reduction, interest reduction, or capitalization of interest on concessional terms.

Governments will also have the option of further reducing Polish obligations beyond the consensus level of 50 percent reduction through (a) additional bilateral relief and (b) the voluntary conversion of up to 10 percent of outstanding claims via debt/equity, debt-for-nature, or other debt swaps.

To lead this effort, the President announced that the United States was prepared to increase U.S. debt relief for Poland beyond the 50 percent level agreed in the Paris Club. We propose to do this in the following two ways:

-- Additional bilateral debt reduction within the two stage operation.

- more -

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-- A write-off of 10 percent of Poland's stock of debt to the United States. This action will enable the Government of Poland to provide local currency resources to fund a foundation for the environment.

As a result of these additional steps, Polish debt to the United States would be reduced by a total of 70 percent in real terms.

The unilateral actions by the United States would raise the total debt reduction under the multilateral Paris Club agreement from the agreed minimum consensus level of 50 percent to 52 percent. The President strongly encourages other creditor governments to take similar additional actions and provide bilateral relief beyond the 50 percent level.

# # #

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Linking Debt and Investment

Bert Hofman and Helmut Reisen

Debt Overhang, Liquidity Constraints and Adjustment Incentives

OECD Development Centre, Technical Paper No. 52, 94 rue Chardon-Lagache, 75016 Paris, France.

Investment in most heavily indebted countries has been weak since 1982. There are two competing theories why this is so. One blames the debt overhang: in a country that meets its scheduled debt service only in part, depending on the development of its export surplus, there is little incentive to raise output by investing more and consuming less; much of the net benefits of such action might well accrue to the foreign creditors. The other theory blames the lack of investment on a scarcity of financial resources as a country's savings are drained off by a net transfer (interest payments in excess of net capital inflows).

This paper presents the results of empirical tests of these two hypotheses. It concludes that the evidence seems to reject the debt overhang hypothesis but is in line with the credit constraint hypothesis.

The finding is important from a policy point of view and it is bad news for the Brady debt strategy, which relies on "voluntary, market-based" debt reduction. That approach would constitute an effective lever to raise investment if the debt overhang were to blame for the low level of investment. But if the constraining factor is liquidity, the need is for an infusion of new funds or a reduction in interest payments, and cutting the size of the debt will not by itself be of much help

Hofman is Assistant to the President at the Kiel Institute of World Economics. Reisen is Senior Economist at the OECD Development Centre.

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TESTIMONY OF
RONALD W. ROSKENS,
ADMINISTRATOR, U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT
TO HOUSE FOREIGN AFFAIRS COMMITTEE
THURSDAY, FEBRUARY 7, 1991

I. INTRODUCTION

Mr. Chairman and members of the Committee, thank you for this opportunity to present the Administration's FY 1992 Foreign Assistance request and to discuss how we can work together to refocus the role, purpose, and management of American foreign aid in the 1990s.

Let me start by saying that few could have forecast what a propitious moment February 1991 would be for the executive and legislative branches to be discoursing about the scope and substance of America's role in the developing world. The drama and pace of global change have opened unprecedented opportunities for development partnerships -- a theme to which I will return throughout today's testimony.

II. A.I.D. AND NEW INTERNATIONAL PARTNERSHIPS

Recent changes in the international arena have been breathtaking. And these changes impact our mission and our mandate.

Beyond the oft-cited geopolitical and human revolutions

in Eastern Europe and Central America, the environments in which A.I.D. operates today require a new mandate for the U.S. foreign assistance program. The internationalization of commerce, especially the altered ratio between foreign aid and international trade and capital flows; increased human and organizational capacity in developing nations; the important new opportunities for a close partnership with the World Bank and other large bilateral donors; heightened awareness of transnational threats like environmental degradation, terrorism, drug trafficking, and AIDS; communications and other technological breakthroughs; and, not least, our tight budget, all require a sharpened focus in the post-Cold War era.

To be effective in this rapidly changing world, I believe we must move from the concept of "foreign aid" to one of "international partnership." Although the heart of the U.S. economic assistance program remain unchanged, we must seize the fresh opportunities before us -- particularly the chance to establish a new international partnership for development.

I really believe the need for this can be seen most clearly in Eastern Europe, but the need for partnership is equally evident in other parts of the world.

I am suggesting that in the future, we will not be working with <u>recipient</u> countries, but with <u>partner</u> countries; we will not be <u>using</u> various private sector entities as agents, but <u>enrolling</u> the energies of private voluntary agencies, universities, and businesses in the development challenge; we

will not be asking other U.S. government agencies to bend their activities to A.I.D. purposes, but to do what they do best in cooperation with us.

What I am suggesting here is not simply a change in terminology. It represents a very fundamental shift in the way America approaches international development. These partnerships are essential in terms of creating a democratic base that gives people a stake in their political future; in terms of protecting the environment against destruction and neglect; in terms of enhancing food security and agricultural productivity; in terms of giving all people, especially the poor, children, and women, a stake in the prospects of economic development.

III. NEW A.I.D. INITIATIVES

Our own experience with development over the past several decades, and that of other donors, strongly suggests that our traditional goals -- improving the quality of human life, expanding individual opportunity, reducing poverty, ignorance and malnutrition -- cannot be attacked effectively by relying on traditional approaches.

To meet our continuing objectives of reducing poverty and misery in the developing world, we are placing greater emphasis on sound economic policies and improved governance in developing countries as a critical basis for sustained, broad-based growth.

We are strengthening our efforts to establish a partnership with the U.S. and developing country private sectors in advancing trade investment and economic growth in developing countries. Moreover, we are giving greater attention to establishing mutually beneficial trade linkages between the U.S. and developing countries in an increasingly integrated world economy. A developing country is not only a place in need of humanitarian assistance. It's also a potentially active market for U.S. goods and services.

That's why we have advanced five initiatives...Democracy, Business and Development, the Family, the Environment, and our own Strategic Management.

Perhaps most important is the Democracy Initiative, which has as its inspiration the idea that America's most valuable export is not miles of irrigation pipe, or tons of wheat, but universal principles. Under this initiative, we will concentrate on supporting the peoples of the developing world in their efforts to build democratic institutions, while also helping these countries make the transition to market-oriented economies.

I would argue that a democracy is not merely a concept you explain to someone and then proclaim, as the advertising slogan goes, "Just do it."

In fact, building a free and open democratic society requires patience, patience...and more patience. History has demonstrated repeatedly that sustained economic growth

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generally -- if not always -- takes place within an open society. So, while the direct focus of A.I.D. is and will remain economic development, political and economic advancement are inextricably linked thereto.

You might recall the saying, "A hungry child knows no politics." That is still true. But it is also true that in many cases, politics -- bad economic policies, poor governance, and repulsive political systems -- may have caused that child's hunger. And so, our focus must be on supporting local initiatives to reform the political structures in developing nations so as to provide for long-term growth and expanded opportunity...which will ultimately ensure that no child goes hungry.

A.I.D.'s Business and Development Partnership Initiative seeks to engage the U.S. private sector in a new and more dynamic way to foster economic growth within a free-market system. Building upon our **microenterprise** programs in developing nations, and drawing upon the example of our partnership with the American labor movement in institution building, this initiative brings a critical ingredient -- American business savvy -- more forcefully into the picture.

Our Family and Development Initiative reaffirms the fundamental role of the family as the bsic unit within each society. Allow me to note, as an aside, how easy it is for governments to lose sight of the central role of families. What is so obvious in our personal lives becomes somehow obscured when

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governments overlook the role of the family in planning, implementing and monitoring development programs. The purpose of our family initiative is to make the family a starting point for analysis of what people need and how they use the resources they have. In short, the initiative establishes the family as an organizing principle for mobilizing the energies of ordinary people to shape their own destinies.

Protecting and restoring the environment, in ways consistent with sustainable economic growth and democracy, is a central concern of A.I.D. Our Environmental Initiative builds a private and public sector partnership to define and achieve environmentally sound development goals. We are especially concerned with transnational issues -- climate change, bio-diversity and tropical rain forests for example. We will commit expert staff and substantial levels of monetary resources to assist our partner nations in tackling the hard issues of integrating economic growth and prudent natural resource management.

Our environmental initiative is premised upon partnerships with American business, PVOs, multilateral organizations, and other agencies of the U.S. Government. As a nation we have much to share in the realm of environment and natural resources.

Finally, our Strategic Management Initiative. The goal here is to do fewer things, and do them very well. We want to achieve a high-quality program and demonstrate excellence in the

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stewardship of our resources. We will undertake major evaluations of current programs; develop human resources within A.I.D. and improve incentives for excellent performance. Over the long term, we will develop a management system emphasizing quality programs and services.

Closely related to this is our commitment to what I call "Programming for Results." In these tight budgetary times...when the American public and others ask that U.S. foreign policy organizations justify spending amidst domestic demands...A.I.D is going to be looking for results from host countries. We have decided therefore to direct an increasing amount of funds to those nations that are moving toward economic and political liberalization. This is not a question of rewarding or punishing a developing nation for political behavior. Rather, it is simply a recognition that economic growth cannot be realized without political and policy reform. If nations are not serious about reform, then we at A.I.D. must be prudent in the level of commitments we make to those regimes.

Let me be very clear about one thing: These initiatives do not mean that the humanitarian dimension of our work will be neglected. The Agency for International Development will never lose sight of its traditional role as a vehicle for America to express its concern for the plight of the world's poor.

In fact, during a visit to Africa with the Secretary of Health and Human Services, Dr. Louis Sullivan. We were

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particularly interested in the issues of **child survival**, **population growth**, and **AIDS**, issues of extreme importance to me and others at the Agency, and we are providing a report on that visit to the President very soon.

IV. A NEW FOREIGN ASSISTANCE ACT

Mr. Chairman, President Bush eloquently speaks of a "New World Order;" Secretary Baker's testimony yesterday focused on this subject as well. From a development perspective, I can tell you that building a New World Order is going to be a tough assignment. Arduous...but essential.

This leads to my final point. Mr. Chairman and members of the Committee, as you recognized more than two years ago, it is hard to escape the conclusion that the present Foreign Assistance Act no longer serves the best interests of the United States. Conceived three decades ago in the global chill and urgency of the Cold War, the Act simply does not address the development climate in this post-Cold War era.

It does not provide the flexibility needed to respond rapidly to these dynamic times. It does not contain the elements necessary for binding together a strong domestic constituency, without which any foreign assistance program will flounder.

In December, 1990, Mr. Chairman, you invited the Executive Branch to join your Committee in drafting a new legislative mandate for foreign assistance programs and

activities. We very much welcome this overture and expect to transmit draft legislation to you once Administration deliberations are completed. I look forward to discussing the specifics with you at that time.

Mr. Chairman, one final note. In Africa and on other visits to developing countries, I saw again the real dedication of our A.I.D. staffs, struggling to do a good job under adverse and sometimes dangerous conditions. Often putting themselves and their families at risk, they persevere, gaining the respect and admiration of their colleagues in host governments, other donors and -- I know -- Members of the Congress. I am proud to have as colleagues these women and men who serve America so well.

And now, I would be happy to respond to your questions.

Congressional Research Service
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Foreign Aid: Budget, Policy, and Reform

by Larry Q. Knowels
Foreign Affairs and National Defense Division

SUMMARY

The foreign assistance program is widely regarded by policymakers as a significant tool promoting key U.S. foreign policy interests. With the continuing dramatic upheavals occurring around the world, including events in the Soviet Union and Eastern Europe and the conflict in the Persian Gulf, there is renewed focus on U.S. foreign aid and whether its current structure adequately supports American objectives overseas.

In light of important international change and concern for other threats to U.S. security interests -- such as drugs, terrorism, and environmental degradation -- many believe that U.S. foreign assistance should undergo a critical reassessment, the results of which may argue for a substantial shift in resource allocation among major programs and aid recipients. To some, this means a reallocation of foreign aid resources, primarily through the shift of security assistance funds to programs focused on economic growth, poverty alleviation, and sustainable development. Concern over what some perceive as a declining U.S. competitive edge in the international economy has led to suggestions that foreign assistance should focus more on ways to advance American exports and trade interests. Others, however, take a more cautious approach to changes on the international landscape and the extent to which U.S. foreign aid should be altered in the short term. They argue that it is premature to abandon longstanding U.S. security interests and point out that the United States and its friends will continue to confront security challenges in the Third World apart from those associated previously in an East-West context.

The foreign assistance proposal for FY1992 seeks $15.9 billion in discretionary appropriations, an increase of 5.8%, or $867 million, over the $15.05 billion enacted for this year. The implementation in FY1992 of new budget rules (referred to as "credit reform") for appropriating U.S. Government loan and guarantee programs, however, makes a straightforward comparison between FY1991 and FY1992 somewhat misleading. After adjusting for the effects of credit reform on the FY1992 request, the proposed foreign aid budget is about $475 million higher than FY1991, representing an increase of about 3% or slightly less than the rate of inflation. In terms of spending allocations, the request, with few exceptions, appears largely the same as for the current year. Lacking are any dramatic shifts in budget priorities that many have argued are necessary to realign foreign aid spending patterns with post-Cold War U.S. interests and needs. Also absent are significant modifications in assistance provided to countries most directly affected by the Gulf war. The President and congressional leaders, however, did agree in early March to support an additional $650 million in aid for Israel as part of an "emergency" supplemental appropriation.

Beyond the size and composition of the FY1992 foreign aid budget, debate may also focus around three policy issues, portions of which represent key initiatives being advanced by the Agency for International Development. These issues include flexibility in foreign aid management and congressional oversight, promoting U.S. economic interests with foreign aid, and democracy programs as a component of U.S. foreign aid.

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OPINION

The First Post-Cold-War Budget

By Larry Minear

■ *Washington is a one-crisis town. Yet policymakers should be pressed to look beyond the Gulf war to the reshaping of longer-term US defense and foreign aid policies for a new age.*

NOT far behind the guns of January in the Gulf lie the annual routines of February in Washington. The budget the president has just sent to Congress for review and enactment, however, is anything but routine. It represents the nation's first since the end of the cold war.

Some observers, viewing the occasion as the best chance in 40 years for a fundamental reorientation of national security policies look for the first real fruits of the passing of the cold-war world in budget savings and creative opportunities. Most, however, believe war in the Gulf and backsliding in the Soviet Union will postpone major changes for at least a year.

For the moment, the skeptics have the edge. The Gulf war seems to underscore the importance of heavy defense expenditures and of military and economic aid deployed in the service of strategic objectives. The resurgence of conservative forces in the Soviet Union seems to suggest that while progressive changes in Eastern Europe may be irreversible, it is too soon to count out the Soviet Union itself as a potential threat to the United States.

The financial, human, and political costs of Operation Desert Storm may indeed work against the overdue reordering of US defense and foreign aid priorities and against a domestic peace dividend as well. Incurring costs conservatively estimated at $500 million a day in this so-called "off budget war," the US is spending the equivalent of a year's American foreign aid every month. Five days of war represent a year's expenditures on the WIC program, which provides 4.5 million American women, infants, and children supplemental food and social-service referrals.

BUT to argue that Saddam Hussein and Mikhail Gorbachev have wolfed down the peace dividend is unfair. Some defense experts, allowing for a temporary interruption in a downward trend of military expenditures, still anticipate a cumulative trillion dollar dividend by decade's end. Desert Storm is itself evidence of a changed geopolitical climate in which the two superpowers are charting a fairly common course.

Congress has already set the stage for scrutinizing cold-war defense and foreign aid policies. In recent years it has requested the administration to "review the extent to which the objectives and makeup of future US foreign assistance might be recast in the light of the changing geopolitical situation." The following issues will be key:

First, does the president's first post-cold-war budget acknowledge that the Warsaw Pact countries, if not the Soviet Union itself, are no longer threats to US security? Will traditional expenditures on US defense, regional military alliances, military assistance to developing countries, and international intelligence-gathering be trimmed accordingly?

Second, does the budget reflect the now clearer threats to US security represented by unmet basic human needs, abroad and at home? Will more resources go toward alleviating hunger and poverty and safeguarding human rights? Will other efforts to address problems in developing countries that affect the quality of life in the US be better funded: protecting the environment, assisting refugees and displaced persons, pressing ahead against AIDS and other diseases?

Third, does the budget affirm the newfound importance of the United Nations? Will the US embrace a more principled multilateralism, accelerating payment of the more than $500 million that make this nation the UN system's most egregious delinquent? On the bilateral side, will hitherto sacrosanct country allocations be reviewed on their merits? Will the straitjacketing of aid with "buy American" obligations be relaxed? Will democratic reforms in the Soviet Union and Eastern Europe be encouraged without reducing resources available for developing countries?

Finally, is the president articulating a new vision of cooperative and mutually beneficial post-cold-war relationships with developing countries? Will that vision capture the imagination of Americans who, for good reason, have tired of an aid program out of step with their values and instincts? Will "foreign" aid become instead an investment in a more just world for all its people?

The skeptics are right in cautioning that Washington is a one-crisis town. Yet policymakers should be pressed to look beyond the Gulf war to the reshaping of longer-term US defense and foreign aid policies for a new age. Despite this year's constraints, the broad outlines of policies suited to a more just world order need to be sketched out and resources redirected accordingly.

■ *Larry Minear is a visiting fellow at the Overseas Development Council and Brown University.*

Boston Sunday Globe

SUNDAY, MARCH 10, 1991

A PEACE AGENDA

The 'new world order' and the Third World

There's a world of opportunity in the slogan

By Delia M. Boylan and Richard E. Feinberg

President Bush has targeted the Persian Gulf crisis as the defining event in the creation of his "New World Order." Forged in the midst of war in the Middle East, this slogan also suggests a historic opportunity for rethinking US policy toward the entire developing world. And the unprecedented coalition of Northern industrial and Southern developing nations solidified to restore Kuwait's sovereignty – if astutely managed – could serve as a springboard to overcome previous disagreements on a broad range of critical issues.

Throughout the gulf crisis, the developing nations applauded the US strategy of working through the United Nations. The UN offers the smaller countries, mostly in the Southern hemisphere, a vehicle for articulating their demands in a world where the balance of power is tilted against them. Furthermore, the issue at stake – the universally honored principle of territorial integrity – was ideal for triggering the broad-based North-South consensus condemning the Iraqi annexation of Kuwait. A columnist in the Honduran journal El Heraldo nicely summed up Southern opinion: "It is imperative to set a precedent of this nature for all oppressors and tyrants, as a sign of hope for weak nations and as an act of faith in the principles of law."

But this North-South accord does not come out of the blue. Rather, it reflects deep, structural shifts in international relations and is symptomatic of a long-gestating realignment in attitudes on both ends of the North-South axis.

A 'liberalization tide'

Throughout Africa, Asia, Latin America and Eastern Europe, the "liberalization tide" is in full swing. Even before the Gorbachevian revolution in the Kremlin, many Third World economists had come around to view Western trade and finance as essential, and market mechanisms as the most efficient allocator of resources. At the same time, previously dictatorial states are giving way to more pluralistic practice.

For their part, most industrial-country leaders now recognize the importance of working with Southern nations to solve global problems. On many issues, the United States is no longer strong enough to impose our wishes unilaterally. The diffusion of power around the world makes dialogue, not *diktat*, the only way to build consensus.

The Gulf crisis provided the context for converting this cooperative spirit into decisive action. Yet the consolidation of these new friendships with Southern nations is far from guaranteed. Many in the Third World have been alarmed at the massive US projection of force into one of their own regions. And the eager advance of US troops into Iraq and Kuwait has aroused all the old suspicions about our ultimate "imperialist" designs.

As early as last December, several convinced Pakistani students asserted to one of us that the United States had purposely lured Saddam Hussein into Kuwait, to create a pretext for a US invasion of the gulf. The administration's rebuff of the last-ditch Soviet peace initiative lent weight to such "conspiracy" arguments.

Fears of a resurgent US interventionism are not limited to the Middle East. The South in general stands in awe – but also in trepidation – of our efficient, willful utilization of high-tech warfare. In the absence of the "Soviet threat," many imagine that our real objective in the gulf has been to set a precedent for "rebellious" Third World states who dare step out of line. In Latin America – frequent host to US paratroopers and Marines – the Mexican novelist Carlos Fuentes has commented, "What interests the United States above all is to demonstrate that after the Cold War there will no longer be two superpowers but only one."

Broad-scale reconstruction

The severity and exactitude of allied use of force has left the Third World feeling naked, just as it runs the risk of making the United States feel invincible in the face of future challenges. But the victorious United States should be a "gracious winner." We must demonstrate to our new Southern allies that we turned to the United Nations *not* just out of momentary opportunism, but because we accept that the diffusion of global power makes multilateralism necessary. The Bush administration must also show that, having energetically repulsed a military threat to global security, it is now willing to tackle the world's pressing social and economic issues.

Already the refrain "We must not only win the war, but the peace" has become conventional wisdom. The president has already proposed a post-war agenda that calls for shared security arrangements in the Middle East, a settlement of the Israeli-Palestinian dispute and the reallocation of resources from military to economic purposes among Middle Eastern states.

While these are all important steps toward the concrete realization of a "New World Order," they do not take adequate advantage of the impressive UN coalition for launching an entire array of "New World Order" initiatives. These initiatives could involve multinational decision making, and should be presented not merely because they will pacify our disgruntled Third World friends – but because they are of direct benefit to the United States.

For example, the United States could urge the establishment of a "Global Reconstruction Fund." The fund could bring money and expertise to war-torn regions as governments go about reshaping their societies and economies. While such a fund would have immediate application in the Middle East, it might also be used to foster political democratization and economic liberalization in other conflictive areas of the Third World such as Indochina, southern Africa and Central America.

Or the United States could address the sharp fluctuations in oil prices. The oil price hikes that followed Saddam's invasion of Kuwait cost oil-importing developing nations about $10 billion. The International Monetary Fund lends money to hard-hit oil importers but in amounts that often offset only a fraction of their inflated oil bills. This financing mechanism should be given the resources it needs to fulfill its mandate.

Fears of a resurgent US interventionism are not limited to the Mideast. The developing world, in general, stands in awe – but also in trepidation – of America's efficient, willful utilization of high-tech warfare in the Persian Gulf War.

Some possible initiatives

Among the more wide-ranging initiatives that might be pursued are the following:

- The United States could join with other lending nations to pledge to stem massive and persistent transfer of financial resources from the South to the North by implementing and expanding existing debt-reduction proposals in a more energetic and coherent fashion. Freed of the monstrous debt burden, these countries would be better able to pursue successful development strategies, providing in turn more buoyant markets for US exports.
- Similarly, the free-trade forces in the North could make a more determined effort to overcome protectionist forces in Europe and Japan, in order to reinvigorate the stalled international negotiations taking place under the General Agreements for Tariffs and Trade. More open markets would allow for a freer flow of goods and capital, benefiting countries North and South alike.
- The United States could also pursue cooperation at a regional level, by strengthening the new multilateral mechanism created with the Asian-Pacific countries and Latin America to enhance trade investment ties.
- To further improve bilateral relations between the two great nuclear powers, the United States and the Soviet Union could agree to cooperate on select foreign-assistance projects in developing nations, in such areas as disaster relief, reforestation, technical education and health care.
- International agreements could be structured around critical environmental issues such as acid rain, deforestation and global warming, taking into account the legitimate concerns of countries North and South.

Tackling these economic issues will not necessarily require large amounts of public US monies. Frugal solutions can be found by internalizing costs to private producers, or by expecting those nations that currently enjoy surplus capital to bear most charges. But solutions will sometimes require tough political decisions that incur short-term costs to the White House or particular congressional representatives, even if, in the end, the nation and the world will benefit.

The Bush administration should seize the historic opportunity to define a "new agenda for a new world order." Otherwise, the inherent promise embedded in its most ambitious foreign-policy slogan to date may end simply being full of sound and fury.

Delia M. Boylan and Richard E. Feinberg are at the Overseas Development Council, a public-policy institute in Washington, D.C., specializing in US relations with developing countries.

Statement of Princeton N. Lyman
Director, Bureau for Refugee Programs Department of State
before the Subcommittee on Foreign Operations,
Export Financing and Related Programs
March 19, 1991

Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I look forward to this opportunity, as always, to discuss with you the Department's FY 92 budget request for Migration and Refugee Assistance (MRA) and for the Emergency Refugee and Migration Assistance (ERMA) Fund. This request, as you know, seeks to enable the United States to continue to play a major role in helping the world's refugees and victims of conflict.

BUREAU FOR REFUGEE PROGRAMS
BUDGET SUMMARY
FY 1991 - FY 1992
($ in thousands)

	FY 91 BUDGET	DIFFERENCE +/(-)	FY 92 REQUEST
REFUGEE ASSISTANCE			
East Asia.....	$39,000	$10,900	$49,900
Africa.....	75,200	11,900	87,100
Near East/South Asia	88,300	4,100	92,400
Western Hemisphere...	9,830	(5,830)	4,000
Sub-total.....	212,330	21,070	233,400
OTHER ACTIVITIES.....	59,570	(5,037)	54,533
REFUGEE ADMISSIONS.....	205,220	(12,890)	192,330
ADMINISTRATIVE EXPENSES..	8,528	1,766	10,294
TOTAL.....	$485,648	$4,909	$490,557

FY 92 Budget Request

The Administration's FY 92 request for Migration and Refugee Assistance is $490.6 million. These funds are divided broadly between international assistance and protection programs and the admission of refugees to this country for permanent resettlement. Although this total request is only $5 million over the FY 91 MRA appropriated level, it represents a significant effort to channel increased funds in support of international assistance and protection programs.

The number of refugees worldwide is now estimated to be 15 million. Much of the recent increase is the result of conflict situations which have forced people to seek safe haven across international boundaries. As the numbers of refugees and conflict victims have increased, so too have their accompanying needs and requirement for funds to address those needs.

Within the total MRA FY 92 budget request we include $233.4 million for international assistance. This assistance level represents the continuation of a significant effort by the Administration to channel increased funds in support of these programs. Funding for international assistance and protection programs increased by nearly $44 million in FY 91 and this request for FY 92 seeks a further increase of $21 million.

I would like to point out that this $21 million increase in FY 92 has been partly offset by a decrease in the funds requested for the Western Hemisphere. Therefore, the net increase in the remaining three regions -- East Asia, Africa and the Near East/South Asia -- is nearly $27 million.

The largest portion of this increase, $11.9 million, will support program efforts in Africa. The next largest portion, $10.9 million, will be used to continue progress on solving the problems of Indochinese refugees and asylum seekers. As the third component of this increase we are requesting an additional $4.1 million for the Near East/South Asia region to provide increased support for UNHCR, UNRWA, and ICRC programs.

In administering these assistance funds, emphasis will be placed on the response by international organizations and their implementing partners to the specific needs of women, children, and other vulnerable groups. As a donor government and member of the UNHCR Executive Committee, the U.S. Government will oversee UNHCR implementation of program guidelines for refugee women resulting from policy adopted by the Executive Committee last fall. We are also monitoring and evaluating implementation of guidelines for refugee children which were accepted in 1988.

The U.S. Government continues to encourage other international and non-governmental organizations to establish policies and implementation guidelines to integrate refugee and displaced women and children as equal participants and beneficiaries in assistance and protection activities.

Most of our assistance funds are used to support the programs of international organizations providing assistance to refugees and conflict victims overseas, including the United Nations High Commissioner for Refugees (UNHCR), the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA), the International Committee of the Red Cross (ICRC), the UN Border Relief Operation (UNBRO), and the International Organization for Migration (IOM). As the largest single donor to each of these organizations, the United States is directly involved in the review of these agencies' budgets -- with the exception of the ICRC which is a Swiss organization -- as well as in monitoring the implementation of

their programs. We also assume additional responsibilities to ensure that appropriated funds used to support these organizations are used as effectively and efficiently as possible. The Department has dedicated 29 positions overseas for program oversight, and program officers from the Bureau for Refugee Programs regularly monitor firsthand the effectiveness of programs supported by U.S. funds.

Last year, when I came before this Committee, we were very concerned about UNHCR's financial situation. I am pleased to report that it has improved considerably. In 1990, UNHCR fully funded its approved General Program of $340 million, absorbed a $38 million carry-over of 1989 obligations, and carried over $10 million into 1991. To date, UNHCR has received $230 million in contributions from the international donor community to the approved 1991 General Program of $356 million -- nearly 65% of the current requirement.

Through contributions to international organizations and private voluntary agencies, our assistance funds are used to support life-sustaining relief efforts, and, where opportunities exist and resources permit, durable solutions to long-term refugee problems. I should note a distinction between the Bureau's activities and those of A.I.D.: MRA funds are generally used to aid refugees or other persons displaced outside their country of origin; A.I.D., through its own programs or other organizations, is generally responsible for assisting individuals displaced within their home country.

In 1992 we hope that, where conditions are suitable, UNHCR will be able to support those non-life threatening activities which had to be cancelled or reduced during the financial crisis. Opportunities for literacy and numeracy for more refugees will be a prime objective, especially for children, including on an equal basis refugee girls. Improved agricultural extension for those refugees on the road to food self-sufficiency will be equally important. We will insure that refugee women share equally in opportunities for employment in agricultural extension, access to resources and decision-making concerning the fruits of their agricultural labors. In addition, other community development activities need attention, especially those serving refugees who have languished in camps for years.

Limited funding has been included in the FY 92 assistance request to encourage initial or pilot repatriation efforts, if political conditions permit. We have not, however, included funds to support full-scale repatriation to Afghanistan and Cambodia.

The Administration is also requesting $40 million to assist resettlement to Israel. While this is $5 million less than the

amount appropriated last year, it is a $10 million increase over the amount requested by the Administration in FY 91.

Within the total FY 92 MRA request of $490.6 million we will be able to maintain our current FY 91 level of refugee admissions -- an estimated 120,000 -- in FY 92 with a reduced admissions request of $192 million. (We anticipate a regional breakdown similar to FY 91, but as you know this will be the subject of the consultation process between the Administration and the Congress which takes place in June.) This reduced request reflects a savings of almost $13 million. This savings in costs has been achieved through greater efficiencies in our refugee processing programs and certain initiatives taken in our transportation programs, in particular, an emphasis on prepaid and self-paid transportation.

Over the past four years the Bureau's administrative expenses have been maintained in the range of $8.0 to $8.5 million -- less than two percent of the total MRA appropriation. For FY 92 we are requesting an increase of just over $1.7 million to bring the amount up to $10.3 million million. This increase includes funds for increased monitoring activities, as recommended by the Office of the Inspector General in its inspection of the Bureau, and for sorely-needed computer system improvements, which have been put off for several years, to permit the Bureau to interface with the Department's computer networks. We seek no increase in the current total domestic and overseas staff level of 107 positions.

Statement by Richard T. Crowder
Under Secretary for International Affairs and Commodity Programs
U.S. Department of Agriculture
Before the House Committee on Foreign Affairs
February 26, 1991

Mr. Chairman, members of the Committee, I appreciate the opportunity to address the Committee. Today I will discuss with you the world food situation, U.S. government programs to combat hunger and malnutrition abroad, changes in these programs brought about by the passage of the Food, Agriculture, Conservation, and Trade Act of 1990, our programming plans for this fiscal year, and new programs created by the 1990 Farm Bill.

As the leader in agricultural production, the United States has long recognized its responsibility to help end world hunger. The United States is the world's largest supplier of foreign food aid, providing over one-half of the world food assistance. U.S. food assistance programs provide about 6 to 8 million metric tons of food aid on an annual basis, substantially exceeding the 4.47 million metric ton commitment to the Food Aid Convention.

While U.S. food aid is provided through both long-term credit and donations, it is our food aid donations that focus on emergency needs. For example, food donations under P.L. 480 Title II and Section 416(b) are helping to alleviate critical food needs in Africa resulting from severe adverse climatic and economic conditions. In fiscal year 1990 alone, 34 African countries received a total of about 1 million tons of food commodities. By far the largest amounts were provided to Ethiopia, Mozambique, Sudan, Liberia, and Malawi.

World Food Availabilities and Needs

The 1990 world's cereal crop supply was a record--even the output of developing economies rose nearly 3 percent. However, food needs on a country or regional basis are dictated by resource availability, market dislocations, drought, and even politically motivated limitations.

In the Global Food Assessment report, published by USDA's Economic Research Service, cereal aid needs for 55 low-income countries in 1990/91 are substantial, despite the favorable over-all supply situation. East Africa and South Asia will require the most assistance, followed by Latin America and southern Africa. Total cereal food aid needs for 1990/91 for the 55 low-income countries are estimated at 16 to 17 million tons. This is the level needed to maintain per capita cereal use in these countries at the 1980-89 average level.

In Eastern Africa, cereal production in 1990/91 is estimated at about 18 million tons, down about 7 percent from last year. Commercial imports by the region are expected to reach about 850,000 tons. In order to maintain current consumption levels, total food aid needs in East Africa are estimated at 4.6 to 5.4 million tons. Approximately 45 percent of assessed needs are in Sudan and about 30 percent in Ethiopia. While communication and cooperation with the Government of Ethiopia has improved recently, the relationship with the Government of Sudan remains difficult and an estimated 9 million people are now at risk of starvation, with 1 million critically affected.

West Africa's cereal aid needs are projected to increase in 1990/91 as production falls short of population increase. To maintain the status quo, the region is projected to require about 850,000 to 900,000 metric tons of food assistance. Senegal, Liberia, Sierra Leone, and Mauritania account for most of the deficit, with the most critical needs in Liberia.

Cereal output in southern Africa in 1990/91 is estimated at 8 million tons, 6 percent below last year's record harvest. The total cereal food aid needs to maintain the status quo are forecast at about 2 million tons. Mozambique accounts for about one-fifth of that total.

Total cereal production in North Africa (including Egypt, Morocco, and Tunisia) was a record-high 18.2 million tons in 1989/90 and is estimated to have reached another record of 20 million tons in 1990/91. This increase is due mainly to larger harvests in Egypt. Even with this increase and with cereal stocks at comfortable levels in all three of these countries, food security in the region still depends on the ability to import cereals. In addition, all three countries are faced with tradeoffs between production of cereal crops for domestic consumption and promotion of high-value export crops that earn foreign exchange and enhance their grain import capacity.

The food needs in Eastern Europe and the USSR reflect market dislocations and resource problems. USDA has responded to these needs with direct donations, long-term concessional credit, and commercial export credit guarantee programs.

Corn donations to Bulgaria and Romania under the Section 416(b) and Food for Progress programs will total 500,000 metric tons in fiscal year 1991. Poland has received donated commodities as well as long-term credit under P.L. 480 Title I in the past and may participate in both programs this year. At present, only Hungary has plans to sign a Title I program in 1991. Commercial export credit guarantees have been announced this year for Hungary, Yugoslavia, and the USSR to help meet their commodity needs.

The ability of Middle Eastern countries, other than Iraq, to provide for their food requirements appears to be little affected by the war. GNP levels in most countries in this region are at the middle- to upper-income levels and should remain that way during and after the war.

Overall, food grain production in the 10 Latin American countries included in USDA's food needs study is expected to increase modestly in 1990/91. However, the balance of payments position of nearly all these countries has weakened because of sluggish export earnings and rising debt. As a result, the ability to import food on commercial terms has declined, leading to an increase share of cereal imports being met by food aid.

Changes Effected by 1990 Farm Bill

The 1990 Farm Bill amended all of USDA's food aid programs and specified significant changes in how the programs are to be carried out. I will comment briefly on these new provisions.

The revised P.L. 480 legislation simplifies administration of the program. It separates the agricultural market development and economic development objectives by assigning Title I concessional sales agreements to the Secretary

of Agriculture, and Title III Food for Development grant agreements to the Administrator of the Agency for International Development (AID). It strengthens the roles of both USDA and AID in operating their respective authorities.

While both titles remain aimed at meeting food aid needs, Title I financing is generally aimed at those countries that offer the best promise of becoming commercial markets. The fiscal year 1992 budget request for bilateral government-to-government aid is $772.5 million--$463.5 million for Title I and $309 million for Title III. potential.

The revised P.L. 480 legislation supports market development efforts in two ways: First, keep use of local currency from repayment of loans for in-country activities such as market and trade promotion and limited support for facilities improvement; and second, through direct use of commodity sales financing to cement trade relationships and acquaint recipients with U.S. commodity standards.

The new local currency programming authority is broader than did the old section 108 program. Section 108 was aimed solely at providing resources to indigenous financial institutions.

Programming in Fiscal 1991

In spite of the programming uncertainties introduced by consideration of changes to PL 480 by the 1990 Farm Bill effective January 1, 1991, the affected U.S. agencies made a strong effort to conclude Title I agreements early and did sign agreements worth $97.4 million with six countries. Combined with amounts sold for first quarter delivery from late fiscal year 1990 agreements, total funds committed in that quarter were $130.3 million. Those figures compare with fiscal 1990 first-quarter agreements of $85.4 million with five countries, and total funds committed of $110.6 million.

We now anticipate an even more effective early programming effort for fiscal year 1992. We see substantial benefits from having maximum lead time to arrange commodity sales and shipments, make more effective use of available budget, and have more time for planning to meet cargo preference requirements and reduce ocean freight differential costs. In that regard we welcome the new law's requirement that, "to the extent practicable," agreements be signed by November 30 each year or within 60 days within enactment of appropriations, whichever is later.

In the fiscal year 1992 budget, USDA is requesting $463.8 million for the new Title I program; this will provide funds for commodities and ocean-freight differential costs. This will provide approximately 2.5 million metric tons of commodities.

The P.L. 480 Title II program provides U.S. food assistance to as many as 80 million people in foreign countries each year by channeling donated food largely through the organizational structure provided by private voluntary agencies and the World Food Program. Only minor changes were made in this program by the 1990 Farm Bill. The most significant change was the deletion of the authority for non-emergency government-to-government aid. The mandated minimum tonnage of 1,925,000 metric tons for fiscal 1991 will be increased by 25,000 metric tons during each year of the legislation which runs through 1995.

The fiscal year 1992 budget request for $627 million (for commodities and transportation costs) is less than fiscal year 1990, yet the program will achieve the mandated minimum tonnage because commodity prices are lower.

P.L. 480, Title III is a new bilateral grant authority for least developed countries; AID will implement this new program. The fiscal year 1992 budget request seeks authority for a program of $309 million to cover both commodities and full transportation costs for these countries.

Transportation Regulations

The 1990 Farm Bill contained new provisions placing stricter controls on the activities of country shipping agents under the P.L. 480, Title I program as well as under Section 416(b). USDA published an interim rule applicable to the Title I program in the Federal Register on February 1, 1991, which became effective on that date, to implement these requirements. A policy statement on Section 416 requirements in this area will be published shortly.

Regional Distribution by Commodity

The allocation of P.L. 480 resources by region of the world varied according to the objectives of the program in fiscal year 1990. Asia and the Near East received about 56 percent of total resources, with $500 million from Title I and $180 million from Title II. Latin America and Africa received 23 percent and 21 percent, respectively, of the commodity value. However, Africa received the highest percentage of Title II commodity resources and the least amount of Title I concessional financing

P.L. 480 Titles I and II, 1990, by Region

	Title I *		Title II		Total (Titles I & II)	
	$Mil.	%	$Mil.	%	$Mil.	%
Asia/Near East	500.5	66	181.4	40	681.9	56
Latin America	188.7	25	85.9	19	274.6	23
Africa	67.0	9	187.0	41	254.0	21
Total	756.2	100	454.3	100	1210.5	100

*Prior to December 31, 1990, Title III programs were included in Title I.

Operational Authority

The 1990 Farm Bill provided for significant changes in the operational authority of Executive Department agencies to implement the P.L. 480 program. Under the new procedures the Department of Agriculture and the Agency for International Development will have clearly defined responsibilities to implement Title I, Title II, and Title III. An Executive Order will specify agency responsibilities for implementing the P.L. 480 provisions of the 1990 Farm Bill.

Section 416(b)

The Section 416(b) grant food aid program uses surplus Commodity Credit Corporation (CCC) stocks to help needy people overseas. CCC stocks are

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generally whole grains or dairy products and the quantities available are subject to the ebbs and flows of CCC inventories. During fiscal year 1990 regular Section 416(b) agreements were signed with seven countries, commodities were provided to 11 countries through the World Food Program, and one Food For Progress Program was supported with Section 416(b) commodities. In fiscal year 1990, agreements were signed to provide about 1.7 million metric tons of corn, sorghum, and butter with an export value of about $165 million. This fiscal year we expect to program 2 million tons of commodities to 10 or more countries.

Food for Progress

The third food aid program authorized by Congress is Food for Progress. This program may be carried out using money from Title I, commodities from Section 416(b), as well as CCC funds. We signed an agreement with Nicaragua (uses Title I funds) and an agreement with Ecuador (using Section 416 commodities). The agreement with Nicaragua includes $29.7 million in commodities (wheat, corn, soybean meal, vegetable oil, tallow, and dry edible beans) plus funding for transportation. The agreement with Ecuador provides 36,000 tons of U.S. sorghum, with an estimated value of $4 million.

We expect to enter into agreements soon under this authority with Bulgaria and Romania. Each agreement will provide for the donation of 200,000 tons of corn.

Enterprise for The Americas Initiative

Last June 27, President Bush announced the Enterprise for the Americas Initiative (EAI), a major new initiative to improve the prospects for economic growth and prosperity for developing countries in Latin America and the Caribbean. An EAI bill authorizing the debt components of EAI was submitted to Congress in mid-September, and portions were incorporated into a new Title VI in P.L. 480, to authorize the restructuring and reduction of P.L. 480 debt. However, the 1990 Farm Bill does not authorize the sale of CCC rescheduled export credit guarantees as requested by the President. The Administration is r submitting to Congress this month those components of the EAI debt provisions pertaining to development assistance debt. These include authority to restructure and reduce U.S. development assistance loans and the sale of Ex-Im Bank debt and CCC rescheduled export credit guarantees.

Sharing Agricultural Expertise With Emerging Democracies

The 1990 Farm Bill mandates the sharing of U.S. agricultural expertise on food and rural business systems with emerging democracies. The overall goal is to develop, maintain, or expand markets for U.S. agricultural exports. To do so, the United States is required to share its expertise in three ways: (1) assess food and rural business systems in emerging democracies; (2) recommend measures necessary to enhance these systems' effectiveness; and (3) identify specific opportunities and projects for improving these systems.

The program requires exchanges of experts with at least three emerging democracies per year, an annual report to the Secretary of Agriculture of results, and establishment of an advisory committee. We are hard at work on the program's implementation, which will actively involve the private sector. Our current thinking would give priority to emerging democracies in Eastern Europe

and Central America.

Conclusion

In summary, the world production outlook is good in all regions of the world, except for possibly Africa. And with good weather, the situation in Africa may improve as well. With this year's record production, supplies are adequate to meet food needs. In light of the current supply situation, we anticipate that our budget request will enable us to make the appropriate contribution to world food aid needs.

This Administration is committed to promoting greater food security around the world. We stand ready to provide short-term food relief when emergencies occur, to the best of our resources. However, we recognize that increased food security for the world in the long run depends not only on the food assistance the United States provides, but rather on economic development, both within and across nations. We seek to support economic growth in developing countries through both food and dollar assistance programs and expanded world trade.

That is also one of the reasons why we are putting so much emphasis on agricultural trade reform in the Uruguay Round. If developing countries are to grow, other nations must lift the protectionist barriers that discriminate against these countries and prevent them from producing for export. The developing world must have access to markets, and producers in these countries must get fair prices for their products. They cannot compete with the national treasuries of industrialized countries that pay their farmers to produce surpluses, release those surpluses onto the world market at subsidized prices, and depress world market prices.

That concludes my statement, Mr. Chairman. I will be glad to respond to questions.

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Confidential Memorandum – Limited Distribution

WASHINGTON POPULATION UPDATE

NEWS AND ANALYSIS OF U.S. POPULATION ASSISTANCE POLICY

February 1991

To: Overseas Family Planning Colleagues

From: Sharon Camp and Shanti Conly
Population Crisis Committee
1120 19th Street N.W., Suite 550
Washington D.C. 20036, USA

HIGHLIGHTS

- Congress has increased its budget allocation for international population assistance to $250 million for fiscal year 1991. Two-thirds of these funds are designated for centrally-funded programs managed by the Office of Population of the Agency for International Development (AID). Funding from the Development Fund for Africa for bilateral population programs in sub-Saharan Africa is also expected to increase sharply in FY 1991.
- The November 1990 Congressional elections have increased the number of supporters of international population assistance in both the U.S. House of Representatives and the Senate. Population supporters also remain in a clear majority on the powerful Senate Appropriations Committee.
- On October 31, AID ended its long-standing support to Family Planning International Assistance (FPIA). FPIA was unsuccessful in a last-minute effort to get the U.S. Supreme Court to prevent AID from cutting off funds.
- AID's review of the implementation and impact of the Mexico City Policy found no violations of the policy, but found that in a few countries abortion-related activities permitted under the policy have been negatively affected by excessive cautiousness on the part of AID's grantees.
- AID has also released a highly critical evaluation of the natural family planning project implemented by the right-wing Family of the Americas' Foundation (FAF), hopefully precluding any further AID support for FAF.
- A panel of key Congressional staffers, addressing the annual meeting of AID Cooperating Agencies in population, sent a strong message of support for population programs and mistrust of AID's political leadership on population issues.
- The U.S. Food and Drug Administration (FDA) has approved NORPLANT, paving the way for AID to provide the contraceptive implant through its population assistance programs. As national programs gear up for expanded use of NORPLANT, access to removal services, the potential for coercive use, and high initial cost are emerging as controversies. Opposition to NORPLANT is building among some feminist and anti-birth control groups.

SPECIAL REPORT: CONGRESS INCREASES U.S. POPULATION AID

Population Assistance Account Approved at $250 Million for FY 1991

On October 28, Congress adjourned after passing a $14.7 billion foreign aid bill for fiscal year (FY) 1991, including $250 million for the population assistance account – an increase of

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$34 million over the level approved in FY 1990. Total U.S. funding for overseas population programs in FY 1991 may reach $300 million, when allocations for population activities under the Development Fund for Africa (DFA) and Economic Support Funds (ESF) are included. (The DFA is designated for "bilateral" or government-to-government programs in Africa and the ESF for countries where the United States has special security interests.) Comparable levels have not been reached since FY 1985 when the Agency for International Development (AID), which implements the U.S. foreign aid program, spent $304 million on population activities.

The increase in funding is a clear indication of the high priority Congress assigns to population assistance. It is especially noteworthy given pressures on Congress to cut government spending to reduce the overall U.S. budget deficit and the growing cost of U.S. military operations in the Persian Gulf.

Population supporters had pressed for an "earmark" of the population assistance account as a guarantee that these funds would only be spent on population activities. (Since 1985, AID's political leadership has diverted over $80 million in population funds to non-population activities, such as aid to Afghanistan, disaster relief, and the Private Enterprise Revolving Fund.) A $250 million "earmark" for population was successfully incorporated in the Senate version of the foreign aid bill. However, the final budget conference between the House of Representatives and the Senate adopted weaker language, which merely prohibits AID from reducing family planning funds by a greater proportion than any other sectoral assistance account.

Mistrust of AID's leadership by population advocacy groups appears to have been justified. Soon after the foreign aid budget process was completed in Congress, top AID officials shifted between $18 and $20 million of FY 1991 family planning funds to non-population activities, including AID's administrative reserve, development policy reform programs, and selected country programs. (Funds designated for the administrative reserve may eventually be returned to the population account.)

AID's Central Office of Population gets Major Increase in Budget

Final budget language also includes a provision earmarking 65 percent of total population funds for the central Office of Population in AID's Science and Technology Bureau (ST/POP). This earmark substantially increases the budget for centrally-funded population programs implemented by those private organizations known as the AID Cooperating Agencies in population. The earmark establishes the FY 1991 budget level for ST/POP at $162.5 million. This is a significant increase compared with prior year ST/POP budget levels of $111 million in FY 1989 and $142 million in FY 1990.

The increase in the ST/POP budget will almost certainly result in higher levels of support for most ongoing centrally-funded activities. ST/POP is also initiating some new activities, including a Cooperative Agreement in family planning service delivery with CARE (the U.S. private voluntary organization involved in food relief and community development activities), and a contract in population program evaluation. It will also support the large-scale introduction of the new contraceptive implant, NORPLANT.

Legislative language introduced this year permits AID to use up to five percent of population program funds to meet the program's operating expenses (OE), including travel and training of population staff and technical personnel. This flexibility is badly needed; shortfalls in AID's OE budget in recent years have made it virtually impossible for ST/POP staff to travel to the field to monitor centrally-funded projects on any regular basis. However, there are already indications that the Administration plans to reduce the level of OE funding that Congress approved for population activities.

Africa Bureau Shows Largest Increase in Regional Population Activity

AID's government-to-government or "bilateral" population programs in Africa will continue to be funded from the Development Fund for Africa (DFA) rather than from the

population assistance account. The final foreign aid bill includes a significant increase in overall funding for the DFA; the FY 1991 DFA budget is $800 million, compared with $565 million in FY 1990. The DFA does not include any specific earmark or functional allocation for population activities. However, Congress has suggested a target of 10 percent of the DFA for population activities in Africa. It is estimated that the Africa Bureau will allocate $52 million from the DFA for population programs in FY 1991.

AID population programs in Africa have been expanding very rapidly. In 1985, the total allocation for bilateral population programs in Africa was only $15 million. The number of countries with bilateral population projects has increased from only 6 in 1987 to a projected 17 to 18 by the end of FY 1991. The Africa Bureau is also currently credited with the most vigorous advocacy of population programs among the AID Regional Bureaus; Larry Saiers, the Bureau's energetic Deputy Assistant Administrator, has pressed hard to get USAID Missions in Africa to initiate bilateral population projects. The DFA gives the Bureau substantial flexibility; Saiers is reportedly anxious to protect the DFA mechanism by satisfying Congress that the Bureau is giving adequate attention to population activities, even in the absence of an explicit earmark or sector allocation.

Regional and country population programs in AID's other geographic Bureaus, which are funded from the main population account, have not fared quite as well in this year's budget allocation process. The combination of the earmark for centrally-funded programs, the diversion of funds to non-population activities, and politically-established budget ceilings has squeezed resources for some individual country programs. The set-aside of $162.5 million for the Office of Population left only about $77 million for programs in AID's Latin America and Caribbean (LAC), Asia and Private Enterprise (APRE), and Europe and Near East (ENE) Bureaus. Initially, the LAC Bureau appeared especially hard hit. However, the Office of Population has now agreed to cover activities affected by the Bureau shortfall. Overall, funding for the LAC, ENE and APRE Bureaus is expected to remain at roughly the same levels as in FY 1990.

Table 1
POPULATION ALLOCATIONS, BY A.I.D. BUREAU*
(U.S. $ millions)

	FY 1989	FY 1990	FY 1991 (estimate)
Science and Technology Bureau			
Office of Population	$111	$142	$162
Asia/Private Enterprise Bureau	(	(	24
	(59**	(52**	
Europe/Near East Bureau	(	(	30
Latin America & Caribbean Bureau	29	26	23
Africa Bureau	38	36	52
TOTAL	237	256	291

* Excludes Economic Support Funds and small allocations to the Bureau for Program and Policy Coordination (PPC)

**Combined Budget for former Asia & Near East Bureau

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The White House, Office of the Press Secretarym March 8, 1991:
Interview of the President by Nadir Yata, Al-Bayan of Morocco; Said Sonbol, Al-Akhbar of Egypt; Mohammed Rumaihi, Saut Al-Kuwait; and Othman Al-Omeir, Al-Sharq Al-Awsat of Saudi Arabia

Q Democracy and development.

THE PRESIDENT: Of course, the United States -- you know, we're for democracy. Obviously, the more democratic processes that are put into effect in whatever country, we rejoice in that. That's been the history of our country. We're not trying to dictate to some country how to do its internal affairs. But the more compatible the values, the better it is for the future. We urge as much democratic process as possible in the area and in all areas.

So we just stand as a beacon, we think, for democracy and we will continue to try to do it. As you know, halfway around the world I was criticized for not standing stronger for democracy in China. I thought I stood very strongly for it. But there's a balance here between expressing your own convictions about your own values and having respect for problems that others have.

So on development, I think the resources are there. And if those resources can be turned to peaceful means, so not only a country that has valued peace -- take Kuwait -- but it has had to worry about whether it would be aggressed against or whether its neighbors were going to do something.

But if we can get this new order out there, then I think the means are there for the development of the entire region. But it isn't going to be done with the barrel of the gun. And you can't say to Saudia Arabia, to Kuwait, "Hey, trust me, all is well, throw down your arms," as long as you have a situation in the Gulf that's unstable.

Q Well, Mr. President, one of the main reasons of instability in the region originally in the Mideast, is the big gap between the rich and the poor countries. And recently, after the Gulf war, there have been many ideas proposed to tackle this problem. And I think Secretary Baker -- he once mentioned a sort of new, international development bank for the Middle East or something like that. What are your ideas, Mr. President, I mean the U.S. ideas to deal with this problem?

THE PRESIDENT: I don't want to try to preempt the Baker trip. He's going out there to discuss economic development. And there are a lot of resources in the area. People look at the United States and say, "Hey there's a lot of resources in the United States, too." And there are. But when we tried to assist Egypt with its rather substantial debt to the United States, you know I came under great attack here. Hey wait a minute, what the hell are you doing worrying about Egypt's debt? What about Iowa and Kansas and Texas and other places in our own country? What about our budget deficit of hundreds of billions of dollars?

So we are not in a great position to be putting ourselves up as the wealthy guy that can solve all the problems in other areas. But there are discrepancies in wealth in the area, just as there are in my own country. There are a lot of people here in poverty. Some people live very well. The same thing is true in the entire Middle East. But I think the way to work it out is through consultation and through planning and through regional answers to it. We can't dictate. We can't say to a wealthy country out there, hey you've got to spend X-dollars to help your guy next door. I don't think that's the way -- I mean, that would be really resented in that part of the world. Just as I would resent it if some wealthy countries in other parts, or Europe, for example, started telling me how to take care of poverty in the United States.

So, again I want to fall back on the Baker consultations, which will have this economic ingredient, this development ingredient as part of it. Having said that, I think all of us as human beings have to be concerned when there's a lot of inequity. And I feel it here. I don't get given any credit in this country for feeling it, but I do. I worry about it. And I certainly worry about it in other parts.

But to try to justify aggression on the basis of "the haves versus the have nots" is unacceptable. And I don't think we can ever permit that kind of demagogic rationalization to justify the takeover of one country by another. And I, to be honest with you on that point, I had never considered Iraq a have-not country. I've considered them a country that has tremendous resources that they splurged on trying to buy support with Mercedes-Benzes and arming themselves to the teeth so that they could bully the neighborhood. Well, those days are over, and I'm damn proud that we had a part, working with our partners, in putting an end to it. I say they're over; they better be over, or Iraq will not have normalized relations with this country. I can speak for the U.S.

Q No, what I mean, it's not just to give -- to help in development, because through development, this will have a solution for these problems.

THE PRESIDENT: It would be a fantastic thing to do. No, excuse me, I wasn't lecturing you on the fact that we don't need development. I'm simply saying it is something that is going to have to be addressed, but that we can't use -- we can't permit one neighbor to take over another because he's doing it in the name of have or versus have not. But I think there's a wonderful chance now for economic development where one country will want to help another. The United States has always been in that mode and we'll want to try to help. All I'm saying is we're going to need -- we're not going to pull back into some sphere of isolation as a result of all this.

But once again, it's with respect that I say, "Hey, we need some regional answers out here. We need some Arab solutions. And let us be a part of it, but not try to dictate it," is all I'm saying on development. And on how we handle the inequities of wealth versus nonwealth.

Q Mr. President, you talked about Iraq recently, and you said you are not going to pay any penny for rebuilding Iraq. What about if there is a new government of Iraq?

THE PRESIDENT: What we're willing to do is immediately help in a humanitarian way. If there's a hungry child, if there's a sick family, we'll go there today; yesterday, we'll be there. We've always done that. But as you look at the overall reconstruction of Iraq, what they need to do is come up with a plan where they use their wealth for their own reconstruction, and then be able to have a good life for their people from there on. They can do it. They've got enormous wealth.

And if they had a new government that had a broad futuristic view, that contained the willingness to live at peace with their neighbors; throw down these excessive arms, what they've got left; keep what they need for their own internal security; guarantee their neighbors they have nothing to fear from them, then of course we'd be willing, in a broad sense through these international agencies and others, to be helpful in terms of reconstruction.

But it is not the case where we are going to turn around as Uncle Sucker, not Uncle Sam, but Uncle Sucker and turn around and start sending taxpayers' money that are going to rebuild the arrogance that has led to this instability in the first place. And I'll tell you the American people feel strongly about it. And there's 265 million of us and nobody feels more strongly about it than the guy sitting right here.

We're not inhumane, but let's see the new government develop. Let's see them give the assurances to their neighbors they want to live at peace. Let's see them show the concern for their own people, that they should have. And that means not spending it all on rifles from the Soviet Union or tanks, but it's on trying to help. Turn on those oil wells, get those going again. And help their people.

Country Reports on Human Rights Practices for 1990

Report submitted to the Committee on Foreign Relations U.S. Senate and the Committee on Foreign Affairs House of Representatives by the State Department, February 1991

INTRODUCTION

1990 Human Rights Report

This report is submitted to the Congress by the Department of State in compliance with Sections 116(d)(1) and 502B(b) of the Foreign Assistance Act of 1961, as amended.[1] The legislation requires human rights reports on all countries that receive aid from the United States and all countries that are members of the United Nations. In the belief that the information would be useful to the Congress and other readers, we have also included reports on the few countries which do not fall into either of these categories and which thus are not covered by the Congressional requirement.

Congress amended the Foreign Assistance Act with the foregoing sections of law so as to be able to consult these reports when considering assistance programs for specific foreign countries. One of the very important consequences—perhaps unintended—of these legislative provisions is that they have made human rights concerns an integral part of the State Department's daily reporting and daily decisionmaking. A human rights officer in an Embassy overseas who wants to write a good annual human rights report on the country in which he or she works must carefully monitor and observe human rights developments throughout the year on a daily basis. As a consequence he or she will report on such developments whenever something of human rights significance happens in the country of assignment. In the past 12 years, the State Department has become decidedly better informed on and sensitized to human rights violations as they occur around the globe.

A year ago in this space we posed the question whether the human rights gains of 1989 in Eastern Europe and other parts of the world would be lasting achievements, or whether there was danger of relapse. For most of the year 1990, the gains of 1989 were being largely consolidated, in spite of major problems encountered by the countries making difficult transitions from command to

[1] Section 116(d)(1) of the Foreign Assistance Act provides as follows:

"The Secretary of State shall transmit to the Speaker of the House of Representatives and the Committee on Foreign Relations of the Senate, by January 31 of each year, a full and complete report regarding * * *

"(1) the status of internationally recognized human rights, within the meaning of subsection (a) * * *

(A) in countries that received assistance under this part, and

(B) in all other foreign countries which are members of the United Nations and which are not otherwise the subject of a human rights report under this Act."

Section 502(B)(b) of the Foreign Assistance Act provides as follows:

"The Secretary of State shall transmit to Congress, as part of the presentation materials for security assistance programs proposed for each fiscal year, a full and complete report, prepared with the assistance of the Assistant Secretary of State for Human Rights and Humanitarian Affairs, with respect to practices regarding the observance of and respect for internationally recognized human rights in each country proposed as a recipient of security assistance."

market economies and from totalitarian communism to democracy. Iraq's brutal invasion of Kuwait on August 2, 1990, initiated a reign of terror and human rights abuses that reminded the world of the dangers that repressive regimes can pose to regional security and international order.

In Europe, multiparty elections had taken place in the countries which had been joined to the Soviet Union in the Warsaw Pact. Following such elections, the former German Democratic Republic had, by decision of a democratically elected government, joined the Federal Republic of Germany. Freely contested elections had also taken place in all of the constituent republics of Yugoslavia. Even in hardline Albania, there was evidence of increasing popular pressure for greater freedom.

Across Eastern Europe and the Soviet Union, the process of democratization was in some areas hampered by the totalitarian legacy and by interethnic antagonisms that had been suppressed for decades. The United States expressed concern about violence against social and ethnic groups in Romania. The repressive measures taken by the Serbian republic against ethnic Albanians were among the worst in Europe in 1990. Yet, there were also some positive developments in interethnic relations in the region. Under the impact of democratization and increasing concern for human rights, Bulgaria was able to improve significantly the treatment of its ethnic and religious minorities.

In the Soviet Union in 1990, vast numbers of citizens continued to exercise newly won political rights, including freedoms of expression, assembly, and religion. Hundreds of thousands were permitted to emigrate. However, reforms were unevenly implemented in the country as a whole, and many are not yet secured by law or buttressed by an independent judiciary. Toward the end of the year and in early 1991, the central government's moves to reassert authority over the republics, particularly the use of military force in Latvia and Lithuania, raised concern over the future of the recent reforms, with dangerous implications for the entire country.

While Europe was struggling to consolidate its democratic gains, new democratic ferment was most clearly in evidence in Africa. There was significant movement away from apartheid in South Africa, and in many other sub-Saharan African countries important steps were taken toward democratic rule. Following multiparty elections, Namibia joined the ranks of independent states in March. A government pledged to democracy and human rights succeeded the regime of Benin. Laws authorizing new political parties, which would thus allow for free, contested elections were enacted in Gabon, Cote D'Ivoire, Congo, and Zambia. Contested elections were indeed held in Gabon and Cote d'Ivoire. In Cape Verde, and Sao Tome and Principe, the one-party governments lost free elections and have said they will honor the results. However, the intergroup rivalries that beset many parts of the continent resulted in large-scale death and devastation. The hostilities surrounding the fall of President Doe of Liberia, clan-based or intratribal warfare in Somalia, civil strife in Ethiopia with Eritrean and Tigrean insurgents, the civil war in Sudan, the measures taken by Mauritania against its black population in the south, and the violence in South Africa among black groups, caused many hundreds of deaths in

some countries and thousands in others. The Sudanese government's failure to cooperate in food deliveries may lead to widespread starvation in southern Sudan in 1991.

In the Western Hemisphere, the election and inauguration of a democratic government in Nicaragua left the repressive dictatorship of Fidel Castro the only Marxist-Leninist regime in the region. After close to 17 years of military rule, a democratically elected President and Congress took office in Chile. A new President was elected in Haiti in a free and fair election. Democratic government and respect for human rights were further consolidated in other countries of the hemisphere, though the struggle for democracy continued in Suriname. In four democratic countries—Colombia, El Salvador, Guatemala, and Peru—leftist insurgencies (in Colombia and Peru at times in alliance with narcotraffickers) and excessive responses by government security forces have resulted in scores of noncombat deaths in El Salvador, hundreds in both Colombia and Guatemala, and 3,000 to 4,000 in Peru.

Cultural patterns and political systems differ widely on the huge Asian continent. Yet some of the developments, both positive and negative, which could be noticed elsewhere in the world affected a number of Asian countries as well. Two widely different countries, Marxist-Leninist Mongolia and the traditional monarchy of Nepal, moved toward democracy in the course of the year. There is hope now that democracy will gain a foothold in Bangladesh. In China, North Korea, Vietnam, and to a lesser extent in Laos, Cambodia, and Afghanistan, Marxism-Leninism continues to be the official political ideology. North Korea remains one of the most severely repressive regimes in the world. In China, serious human rights abuses continued in 1990. As the year ended, hundreds of Chinese people remained imprisoned for their role in the democracy movement, while students and intellectuals who took leadership roles in the 1989 protests were being brought to trial and sentenced to prison terms.

Severe and brutal repression of all forms of political dissent characterizes the situation in Burma. There a military government had allowed free elections and then refused to accept the outcome, thus rejecting the overwhelming desire of the people to return to parliamentary democracy. Two South Asian democracies, India and Sri Lanka, were beset by domestic conflict based on ethnic, religious, and political differences, leading to thousands of deaths in each of these countries.

In the Occupied Territories the Palestinian intifada continues. In both Israel and the Occupied Territories, a total of 148 Palestinians and 17 Israelis were killed in violence between Palestinians and Israelis, while 165 people were killed in intra-Palestinian violence.

As the human rights balance sheet for 1990 is drawn and as we look for further progress in 1991, one of the key questions will be posed by the Soviet Union. Will the combination of entrenched conservative forces, economic turmoil, and social upheaval bring the reform era to an end? Or alternatively, will the disparate democratic forces and proponents of the free market overcome the counterattack of the hardliners and solidify and institutionalize the human rights progress thus far achieved? If they do, there success

will be felt not only in the Soviet Union but elsewhere in the world as well.

Another important region to watch is sub-Saharan Africa. Will the initial democratic stirrings ripen into further significant political movements? Will the region's authoritarian regimes allow free and fair elections to be held and then surrender power peacefully to the choices of the people?

And, finally, there is the question of the aftermath of the world community's move to halt the international outlawry perpetrated by Saddam Hussein. What will be the spillover effect for international support for human rights principles?

This year, as last, there are 168 separate reports. The guidelines followed in preparing the reports are explained in detail in Appendix A. In Appendix B is a discussion of reporting on worker rights, as required by Section 505(c) of the Trade Act of 1974, as amended by Title V of the Trade and Tariff Act of 1984 (Generalized System of Preferences Renewal Act of 1984).[2]

Although the legislation requires reports on worker rights only in developing countries that have been beneficiaries under the Generalized System of Preferences, in the interest of uniformity, and to provide a ready basis for comparison, we have here applied the same reporting standards that we have applied to all countries on which we prepare reports. Appendix C contains a list of 12 international human rights covenants and agreements and indicates which countries have ratified them. Appendix D contains explanatory notes on the statistical table in Appendix E, which shows the amounts obligated for U.S. economic and military assistance for fiscal year 1989.

Definition of Human Rights

Human rights, as defined in Section 116(a) of the Foreign Assistance Act, include freedom from torture or other cruel, inhuman, or degrading treatment or punishment; prolonged detention without charges; disappearance due to abduction or clandestine detention; and other flagrant denial of the rights to life, liberty, and the security of the person. Internationally recognized worker rights, as defined Section 502(a) of the Trade Act, include (A) the right of association; (B) the right to organize and bargain collectively; (C) prohibition on the use of any form of forced or compulsory labor; (D) a minimum age for the employment of children; and (E) acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health.

In addition to discussing the topics specified in the legislation, our reports, as in previous years, cover other internationally recognized political and civil rights and describe the political system of each country.

In applying these internationally recognized standards, we seek to be objective. But the reports unashamedly reflect the U.S. view that the right of self-government is a basic political right, that government is legitimate only when grounded on the consent of the

[2] Section 505 (c) of the Trade Act provides as follows:
"The President shall submit an annual report to the Congress on the status of internationally recognized worker rights within each beneficiary developing country."

governed, and that government thus grounded should not be used to deny life, liberty, and the pursuit of happiness. Individuals in a society have the inalienable right to be free from governmental violations of the integrity of the person; to enjoy civil liberties such as freedom of expression, assembly, religion, and movement, without discrimination based on race, ancestry, or sex; and to change their government by peaceful means. The reports also take into account the fact that terrorists and guerrilla groups often kill, torture, or maim citizens or deprive them of their liberties; such violations are no less reprehensible if committed by violent opponents of the government than if committed by the government itself.

We have found that the concept of economic, social, and cultural rights is often confused, sometimes willfully, by repressive governments claiming that, in order to promote these "rights," they may deny their citizens the right to integrity of the person as well as political and civil rights. There exists a profound connection between human rights and economic development. Experience demonstrates that it is individual freedom that sets the stage for economic and social development; it is repression that stifles it. Those who try to justify subordinating political and civil rights on the ground that they are concentrating on economic aspirations invariably deliver neither. That is why we consider it imperative to focus urgent attention on violations of basic political and civil rights. If these basic rights are not secured, experience has shown, the goals of economic development are not reached either. This is a point which the Soviet Union's reformers seem to have recognized.

United States Human Rights Policy

From this premise, that basic human rights may not be abridged or denied, it follows that our human rights policy is concerned with the limitations on the powers of government that are required to protect the integrity and dignity of the individual. Further, it is in our national interest to promote democratic processes in order to help build a world environment more favorable to respect for human rights and hence more conducive to stability and peace. We have developed, therefore, a dual policy, reactive in the sense that we continue to oppose specific human rights violations wherever they occur, but at the same time active in working over the long term to strengthen democracy.

In much of the world, the United States has a variety of means at its disposal to respond to human rights violations. We engage in traditional diplomacy, particularly with friendly governments, where frank diplomatic exchanges are possible and productive. Where we find limited opportunities for the United States to exert significant influence through bilateral relations, we resort to public statements of our concerns, calling attention to countries where respect for human rights is lacking. In a number of instances, we employ a mixture of traditional diplomacy and public affirmation of American interest in the issue.

The United States also employs a variety of means to encourage greater respect for human rights over the long term. Since 1983 the National Endowment for Democracy has been carrying out programs designed to promote democratic practices abroad, involving the two major United States political parties, labor unions, busi-

ness groups, and many private institutions. Also, through Section 116(e) of the Foreign Assistance Act, funds are disbursed by the Agency for International Development for programs designed to promote civil and political rights abroad. We also seek greater international commitment to the protection of human rights and respect for democracy through our efforts in the United Nations and other international organizations, and in the process devised by the Conference on Security and Cooperation in Europe.

Preparation of these annual reports constitutes an important element of our human rights policy. The process, since it involves continuous and well-publicized attention to human rights, has contributed to the strengthening of an international human rights agenda. Many countries that are strong supporters of human rights are taking steps of their own to engage in human rights reporting and have established offices specifically responsible for international human rights policy. Even among countries without strong human rights records, sensitivity to these reports increasingly takes the form of constructive response, or at least a willingness to engage in a discussion of human rights policy. In calling upon the Department of State to prepare these reports, Congress has created a useful instrument for advancing the cause of human rights.

RICHARD SCHIFTER,
Assistant Secretary of State for
Human Rights and Humanitarian Affairs.

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El Salvador under Cristiani: U.S. Foreign Assistance Decisions

by K. Larry Storrs
Foreign Affairs and National Defense Division

SUMMARY

In 1991 Congress will be considering the Administration's FY1992 request for $294.2 million in economic and military aid for the Cristiani government in El Salvador, and will be monitoring compliance with last year's congressional conditions for the restoration or reduction of U.S. aid. Major events influencing the decisions include: the FMLN guerrillas'major military offensive in November-December 1989; the killing by elements of the military of six Jesuit priests on Nov. 16, 1989; the deadlocked but continuing peace talks under U.N. mediation; the resurgence of guerrilla military activity in November-December 1990; the execution in early January 1991 of two U.S. military advisers after their helicopter was shot down by the guerrillas; the determination by President Bush, on Jan. 15, 1991, to release the withheld military aid, but to suspend delivery for 60 days to encourage a negotiated settlement of the conflict; and the upcoming legislative and municipal elections on Mar. 10, 1991.

Alfredo Cristiani was elected in March 1989 under the banner of the rightist Nationalist Republican Alliance (ARENA) and was inaugurated as President on June 1, 1989, ending nearly a decade of U.S.-supported centrist governments in which the Christian Democratic party was a key ally. Supporters of the President's request argue that Cristiani is a moderate with widespread business and popular support who has been pressing for prosecution of those responsible for human rights abuses and seeking to achieve a negotiated settlement of the conflict through peace talks under U.N. auspices since April 1990 despite continuing guerrilla attacks. Critics, noting a continuation of human rights abuses and uncertainty about the outcome of the prosecution of military officers and enlisted men charged with the killing of the Jesuit priests, argue for strictly limiting military aid, and for withholding a significant portion of the aid to provide incentives for both sides to achieve a negotiated settlement.

Last year, the major action by Congress on El Salvador was passage in October 1990 of a foreign aid appropriation bill (H.R. 5114) subsequently signed by the President (P.L. 101-513) that limited FY1991 military assistance for El Salvador to $85 million, withheld 50% of the assistance to create incentives for both sides to achieve a negotiated settlement, and transferred any unrestored aid to a fund for cease-fire monitoring and the transition to peace. (For more detail on past congressional action, see CRS Issue Brief 90011, El Salvador and U.S. Aid: Congressional Action in 1989-1990.)

President Bush made a determination to release the withheld aid on Jan. 15, 1991, finding that the FMLN was violating two of the congressional conditions, namely that it was continuing to receive significant shipments of lethal arms from outside El Salvador, and that it was engaging in acts of violence directed at civilian targets. He decided, however, to suspend delivery of the released aid for 60 days to encourage a negotiated settlement under U.N. auspices.

US Assistance to the Soviet Union

President Bush

Statement at a White House news conference, Washington, DC, December 12, 1990

I have just had an opportunity to discuss with Foreign Minister [Eduard] Shevardnadze a number of issues of US-Soviet relations, including our cooperation in the Gulf. And I'm pleased with the great progress that we made on START [strategic arms reduction talks] and hopeful that we will be ready to sign a treaty at a summit in Moscow on February 11-13.

We also talked at length about the situation in the Soviet Union and the response of the United States to the economic problems there. I asked Minister Shevardnadze to convey to President Gorbachev my desire to respond both to the short-term needs of the Soviet Union and to contribute to fundamental economic reform—[we've] long supported *perestroika* and continue to [do so].

We discussed frankly the relationship of economic change in the Soviet Union to the critical task of democratization. I reiterated our strong desire to see both political and economic reform continue because they are inextricably linked. I outlined specific and important steps that we're willing to take in support of reform. After consulting closely with [Agriculture] Secretary [Clayton] Yeutter as well as Secretaries [Nicholas] Brady [Treasury] and Baker [State], I told Minister Shevardnadze that I am prepared to respond to a Soviet request for credit guarantees for purchase of agricultural commodities through a waiver of the Jackson-Vanik Amendment.

While I've taken this step, I still look forward to a passage of the Soviet emigration law codifying the generally excellent practices of the past year. This then will permit us to make further progress toward the normalization of the US-Soviet economic relationship.

In addition, we have proposed to the Soviets a special technical assistance project to help in assessing their food distribution problem and to support market reforms. I will also authorize a joint public-private medical assistance effort to help the Soviet Union cope with immediate shortages of pharmaceuticals and basic medical supplies.

In the longer term, only steps that the Soviet Union itself takes can assure the economic health there. Thus, to promote fundamental economic reform I will propose that the World Bank and the IMF [International Monetary Fund] work out with the Soviet Union a special association to give the USSR access to the considerable financial and economic expertise of those institutions.

I have asked Secretary of the Treasury Nick Brady, as US governor of both institutions, to pursue this proposal with them and also with our other allies, who I'm sure will be in accord.

As I have said before, I want *perestroika* to succeed. The Soviet Union is facing tough times, difficult times. But I believe that this is a good reason to act now in order to help the Soviet Union stay the course of democratization and to undertake market reforms. The United States has an interest in the Soviet Union, able to play a role as a full and prosperous member of the international community of states. I am hopeful that these initiatives will further that goal. ■

Assistance Measures

On December 12, following a meeting with Soviet Foreign Minister Eduard Shevardnadze, President Bush announced several initiatives to address immediate food needs and to contribute to fundamental economic reform in the Soviet Union.

Accordingly, the President:

- Decided to waive the Jackson-Vanik Amendment to the Trade Act of 1974, making the Soviet Union eligible for export credit guarantees provided by the US Department of Agriculture. Export credit guarantees are offered for purchase of agricultural products to promote US agricultural exports.
- Announced that the US was prepared to send to the Soviet Union this month a team of private and public sector technical experts in food distribution and marketing to identify ways to strengthen and support market forces in the USSR's food marketing system, consider alternatives to assist vulnerable populations, and recommend measures to improve availability of food to the Soviet people.
- Established a mixed public-private medical assistance effort to help the Soviet Union deal with acute, immediate shortages of pharmaceutical and basic medical supplies. This effort would rely on private voluntary organizations, with US Government support, to provide and distribute medicines and medical supplies within the USSR. Initially, US firms would donate these medicines and medical supplies.
- Proposed a special association of the Soviet Union with the International Monetary Fund (IMF) and the World Bank to give Moscow access to the economic and financial expertise in those institutions. A new special association could allow the IMF and World Bank to build on a nearly complete study of the Soviet economy and to advance the process of economic reform and liberalization in the Soviet Union.

Stephen S. Rosenfeld

The Third World: No Longer Fought Over, but Ignored

A cruel paradox is overtaking the difficult matter of the welfare of the Third World and the West's relationship to it. This was the area that was supposed to reap some sort of economic and political peace dividend with the end of the Cold War. The standard lament was that East-West strategic competition was stealing resources and energies that might otherwise have given the world's poor a hand up. The mostly conservative supporters of a hard line were commonly assigned the lion's share of responsibility for this state of affairs.

But here we are at the end of the Cold War, and few if any of the hoped-for rewards are to be seen flowing the Third World's way. Earlier, heavy resources were being expended to fight the Communist East, but they are now being directed to feed, aid and rebuild the same countries repackaged as a politically acceptable formerly Communist East. The peace dividend, such as it is, is being snagged by an unexpected competitor. It turns out that the Cold War is not so much over as in an extra and expensive phase of being institutionally liquidated in the places where it did the most harm.

This time, moreover, the culprits include a broad band of liberals, the gang you might have thought would be saying it's the Third World's turn. They are the ones whose preoccupation with moving past nuclear and political confrontation has led them to fasten on the full democratic regeneration of the East as the guarantor of world peace. They are right, of course, but what is overlooked is that someone else is paying a price.

It is not just that private charitable contributions to Third World causes appear to have fallen off dismally, even as Westerners outdo themselves in shipping winter aid to the Soviet Union. Symbolically, the U.S. Peace Corps, trying to be with it, is cutting back on aid to former clients in the Third World and diverting those resources chiefly to Eastern Europe. Just the other day the U.N. Food and Agriculture Organization, surveying a panoply of misery in sub-Saharan Africa, explicitly appealed to would-be donors "not to let domestic economic constraints and concern for the problems of Eastern Europe divert their attention from the food needs of millions of Africans."

Many Africans are dying through no fault of their own.

This last is serious. It is true that the Africans have messed up terribly. Not without foreign encouragement, they have prosecuted internal wars they cannot afford, conducted foolish experiments in imported socialist doctrines and stimulated "compassion fatigue" with their repeated earlier pleas for Western aid. But it remains that large numbers of individual Africans are dying through no fault of their own. They are the direct victims of others' decisions to extend relief to places where the suffering is of an altogether different, politically appealing but less urgent order.

There is a constant strand of idealism in American policy. It can emerge as enlightened generosity and also as a culturally limited and patronizing missionary urge. It is emerging now as an emotional response to the fact that a large and no doubt distressed community of European peoples is once again politically open and available to Americans. Millions of us have family roots in this rediscovered terrain, and many more millions feel drawn to the incredible drama of the making whole of the transatlantic family, which is what the end of the Cold War is finally about.

Against these deep cultural and personal currents running through the American society, competitive calls for Americans to reach out to other troubled areas and peoples are bound to have tough going. Appeals of pity, brotherhood, duty, interest: these are met more readily when they are issued in the name of the American mainstream. The power of ethnicity keeps surprising us as we see it revealed in new ways.

A certain kind of Third World nightmare threatens to become real. In it, these countries on the edge have lost even what residual benefit could be gained from being objects of contention between East and West. Now they stand to befall a fate worse in some aspects than being fought over—being ignored. Moscow is drawn away by a policy of retrenchment and by the fact of galloping internal disintegration. Washington loses interest by virtue of having won the Cold War.

Maybe we have rushed too fast into the future. It was supposed to amount to more than a celebration of Europe, worthy as that is, and more than a deepening divide between haves and have-nots, unworthy as that is. A country with a claim to leadership needs to have a broader, yes, vision.

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American Enterprise Institute for Public Policy Research

Outside Issues

In Foreign Aid, the Best Course Shuns Dependence

By Nicholas N. Eberstadt

In response to the revolutions of 1989, the U.S. government is about to embark on its latest initiative in "development assistance": an aid program for the newly free countries of Central and Eastern Europe. While the project has already been authorized by Congress and the administration, its specifics remain unclear. The size and duration of the initiative, for example, are undetermined. Even the sorts of policies the United States would finance have not been spelled out.

Such apparent hesitation and confusion speak to the fact that America's foreign-aid effort is in disarray.

A stunningly candid report by the U.S. Agency for International Development, which administers most of America's nonmilitary aid, said as much last year. Reviewing the programs of the 1960s, 1970s, and 1980s, the report concluded that "all too often, dependency has won out over development," that "only a handful of [recipient governments] ever graduated from dependent status," and that "radically reshaping future official assistance programs" must be "both an immediate concern and a major long-term national priority."

The problem is that we have forgotten the lessons that used to guide our policies. In the 1950s and early 1960s, U.S. aid flowed to such countries as Taiwan, Korea, and Greece—places that subsequently enjoyed rapid and self-sustaining material advance.

The record of American development aid since its inception in 1949 suggests that some approaches are distinctly more likely to be beneficial to new recipients in Eastern Europe than are others. Here are a few suggestions:

• *Announce an end-date for the program.* The success of development aid should be signaled by its termination. Many recipient governments have acted as if they expected foreign taxpayers to finance their activities not only today but for generations to come. The Marshall Plan was an aid program for recovery, not development, but its administrators wisely announced its duration in advance. Similarly, when our aid officials informed South Korea in the early 1960s that development funds would soon be phased out, the news sparked an economic boom. Scrambling to replace Washington's aid, Seoul embraced an export-oriented strategy.

• *Recognize and build upon opportunities in the world economy.* The greatest success of American "development" efforts is the postwar world market system, which we helped create. Trillions of dollars in goods and services are now traded internationally every year, and a vast pool of finance capital flows across national boundaries in search of reward.

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The economic future of the countries of Eastern Europe will depend in large part on how fully they involve themselves in these world markets; potential benefits vastly exceed any imaginable aid totals from the West.

But America must also keep its domestic markets open. It would be perverse to proffer handouts to these newly independent states while preventing our consumers from purchasing their products.

• *Emphasize the importance of business climate.* Unlike more recent programs, which have largely attempted to raise living standards through social-welfare services and other unsustainable transfers, America's initial aid programs took the connection between business climate and development to be obvious.

A country's business climate was said to be mainly conditioned by its government's policies and practices. Rule of law, respect for individual rights, sound money, budget discipline, and a liberal trade orientation were only some of the factors seen as conducive to investor confidence, economic activity, and increased productivity. The U.S. Chamber of Commerce's recent mission to Bulgaria, which brought American specialists in tax law, commercial codes, and other business fundamentals to Sofia, is exactly the sort of technical-assistance package U.S. aid once excelled in providing.

• *Steer clear of the international financial institutions.* These agencies—such as the World Bank and the International Monetary Fund—have outlived the problems they were created to solve. Helping Eastern Europe would surely be a good new assignment. But what these organizations would contribute is by no means obvious. For more than a decade, the World Bank tried financing "policy reform" in poor countries but recently announced it was abandoning the effort: promises of reform simply were not bankable. The IMF is now deeply involved in the Third World debt crisis but may actually have deepened and extended that crisis through its own actions. As for the new European Development Bank now being created, little can yet be said, but the appointment to its presidency of the adviser who masterminded France's disastrous experiment with socialism in the early 1980s would hardly seem auspicious.

• *Frame aid policies around basic American principles.* For several decades, U.S. development programs have financed and even required practices in foreign countries that would be utterly unacceptable at home. In the 1980s, for example, our aid sponsored a "land reform" in El Salvador that tied peasants to the soil as virtual serfs. We also helped to subsidize China's coercive population-control campaign. We should not offer aid to others that we ourselves would reject.

[from the *Los Angeles Times*, December 17, 1990]

Nicholas N. Eberstadt is a visiting scholar at the American Enterprise Institute. He is author of *U.S. Foreign Aid Policies—A Critique* (Foreign Policy Association, 1990).

DEVELOPMENT STRATEGIES

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Post War Economic Recovery in the Persian Gulf

Rapporteur's Report
By Timothy P. Meehan

Thursday, March 29, 1991
Mumford Room
James Madison Memorial Building
The Library of Congress
Congressional Research Service-Joint Economic Committee

I. The Economic Situation Prior to the War

(Speaker: Yahya Sadowski, the Brookings Institution)

1. Problems of statistical accuracy in the Middle East

A. Politics supersedes economics--Inflationary and deflationary measures are routinely implemented to serve the regime's need at a given time. Such policies make comparisons over both time and countries fraught with error.

B. The problem of "rich" versus "poor" Arab states--There are no "rich" Arab states, all have living standards below that of most Latin American countries. In addition, Jordan, a quintessential "poor" Arab state, had a higher GDP per capita than Iraq throughout the 1980's and its quality of life is generally higher than that of Saudi Arabia. There is conflict between "liquid" and "non-liquid" states; that is, between those who possess capital assets and those who don't, but this conflict doesn't necessarily reflect comparative wealth.

2. Pre-War politics

A. The 1970's and 1980's, despite popular conception, were relatively calm time periods. This was in distinct contrast to the 1960's, a period marked by the "Arab Cold War"--conflict between radical military regimes on the one-hand, and conservative monarchies on the other.

B. After the humiliating Arab defeat in the 1967 War, the respective leaders of the blocs, President Nasser of Egypt and King Faisal of Saudi Arabia, agreed to a truce in order to concentrate on Israel, formalizing a private agreement among the two dating from 1965. Nasser agreed to stop fanning the fires of revolution in the Gulf states, while in return King Faisal promised to help rebuild the radical regimes with excess oil money. So was born the "Arab Political System"--a status quo system destroyed by the Gulf War, the results of which promise new alignments in the Arab Cold War II.

(Speaker: Hani Findakly, Potomac Capital Incorporated)

1. Shared economic attributes

A. Dominance of the public sector--rivals that of the USSR.

B. Non-consistent monetary policies--Interest rates are set

arbitrarily, eliminating incentives to save and causing private investment to focus more on real estate than capital, while also causing the flight of existing capital abroad.

C. Lack of an efficient economic infrastructure--No stock exchanges, investment banks, private banks, or privately-owned housing or industrial corporations exist.

D. Lack of economic linkages between Arab states--Trade is primarily with the West, and to a lesser degree with former COMECON nations. The formation of any linkage in the post-Gulf War is likely to reflect the new realignment in Arab politics.

II. Economic Consequences of the War
(Speaker: Bernard Reich, George Washington University)

1. Politics supersedes economics

A. Arab leaders are interested in economics for what economics can do for political stability. Economic stability and development are important to leaders, economic reform isn't.

B. Political stability is the main prerequisite for economic recovery. Forcing democratization on regimes from the outside is inherently de-stabilizing.

C. Domestic tranquility is the major goal of all Arab leaders. The solution to existing regional problems is secondary so long as these don't threaten the internal legitimacy of existing regimes.

(Speaker: Melinda Kimble, The Department of State)

1. Severe regional costs of the Gulf War

A. $300-500 billion in rebuilding costs for Iraq and Kuwait.

B. GDP for the whole Arab World will decrease by 15% in 1991 and will be slow to recover thereafter.

C. Explosion in unemployment due to the return of expatriate workers from the Gulf states to their already economically depressed homeland.

D. Tourism losses are immeasurable, especially for Egypt where tourist income accounts for almost 100% of private sector revenues.

E. The cost of oil clean-up will be greater than $1 billion in monetary terms along with incalculable environmental costs.

F. The human costs for Kuwait and Iraq will be severe, especially for Iraq where the demographic echoes of 100,000 men lost in the Gulf War, compounded with tens of thousands lost in the eight-year war with Iran from 1980-1988, will be severe.

(Speaker: John Lichtblau, Petroleum Industry Research Foundation)

1. The loss of Kuwaiti and Iraqi oil has been more than offset by voluntary increases on the part of other OPEC members, especially Saudi Arabia which increased exports 5.5 million barrels a day.

2. OPEC (excluding Kuwait and Iraq) is now producing 23.3 million

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b/d while the estimated capacity is only 24 million b/d.

3. Provided sanctions were removed and civil unrest calmed, Iraq could quickly export a large percentage of its previous output while Kuwait will not export oil for at least the next two years.

4. In the long-term, oil prices should remain steady as Iraq and Kuwait begin exporting again and other OPEC nations reduce their current amount. In the short-term, prices also are likely to remain stable unless Iraq begins to export very soon which will result in a price decrease.

III. Costs of Reconstruction
(Speaker: Richard Feinberg, Overseas Development Council)

1. There is a need to de-militarize Middle East Studies.
A. Too little attention is paid to economics while energy and interest is focused on the Arab-Israeli Conflict. Shifting the focus to economics will lead to domestic self-criticism which stimulates new and creative thinking. Likewise, capital shortages are not necessarily bad--such situations make people rethink their use of existing capital which leads to more efficiency.

2. Effects of international aspects on reconstruction
A. International competition forces every nation to adjust their economic policies--the issue isn't economic reform on the one-hand and economic stability and development on the other. If reform doesn't take place, neither will development. Likewise, a reformed economy doesn't threaten political stability (at least in the long-run); but rather, economic stagnation is the real threat to political stability.
B. The zero-sum game with the Soviets has ended in the Middle East. The United States can no longer justify a position of anti-reform for fear of destabilizing friendly regimes and losing "our man" to the Russians.
C. There is less money available for bilateral economic aid. Increasingly, aid is likely to depend on the receiving country's ability to perform well in both the economic and political spheres.

3. Lessons from previous experiences
A. Prioritization of items for reconstruction is crucial.
B. Often, construction is what is needed rather than reconstruction. It is usually better to construct something new than to reconstruct something old.
C. An absorption-capacity is needed for reconstruction. This includes a functioning transportation system, valuable human capital, and an industrial infrastructure.
D. There is a political economy of reconstruction. Economics can't ignore politics anymore than politics can ignore economics.
E. Reconstruction is best accomplished on a multilateral

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basis. This maximizes both political legitimacy and economic strength.

(Speaker: Fareed Mohamedi, Petroleum Finance Corporation)

1. Change in the Middle East will occur
   A. Regional disintegration will intensify.
   B. Pressures from external creditors will be complimented by pressures from within for political and economic change.

2. Change will occur in Kuwait first
   A. Private corporations will gain in stature and strength while the government focuses its attention on the task of rebuilding.
   B. Eventually these corporations will challenge the government on reconstruction policies. Challenging the regime on an economic basis will lead to political challenges as well.

3. Change must also occur in Iraq
   A. Iraq's income-generating potential has been completely destroyed. Its oil export capacity initially will enable the purchase of only basic necessities after Iraq finances its outstanding debt and war reparations.
   B. Iraq will have to agree to reparations in order to reach a settlement with the Allied powers and regain control of frozen Iraqi assets.
   C. Iraq must also enter into negotiations with outstanding creditors in order to receive more international financing. For this to happen, Iraq will be forced to make important changes in its economic infrastructure. These will then lead to political changes as well.

(Speaker: John Steinbruner, the Brookings Institution)

1. Imperatives for the U.S. in the region
   A. Formalized, regional security alliance, reflecting a distinct move from confrontation to cooperation.
      1) Remove ambiguity surrounding the question of who one can turn to in times of trouble.
      2) Configure the alliances forces defensively in order not to frighten non-members (i.e., Israel and Iran).
      <u>Incentives:</u>
      --Better security at a lower cost
      --Military aid from the U.S. only to alliance members
      --Economic aid from Gulf states only to the alliance
   B. Export-control for weapons
      1) Make exports conditional on disclosure of their use
      2) Requires close international cooperation
      <u>Implications and Applications:</u>
      --formalized prohibition on weapons of mass destruction
      --disclosure and monitoring for compliance of the above
      --arrangement for scaling arms sales

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--disclosure of long-range conventional weapons
--increase for U.S. intelligence in terms of both personnel and finance for monitoring purposes

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Report to the Secretary General of the United Nations on Humanitarian needs in Kuwait and Iraq in the Immediate Post-Crisis Environment by a Mission to the area led by Mr. Martti Ahtisaari, Under-Secretary-General for Administration and Management, March 20, 1991

A. General remarks

8. I and the members of my mission were fully conversant with media reports regarding the situation in Iraq and, of course, with the recent WHO/UNICEF report on water, sanitary and health conditions in the Greater Baghdad area. It should, however, be said at once that nothing that we had seen or read had quite prepared us for the particular form of devastation which has now befallen the country. The recent conflict has wrought near-apocalyptic results upon the economic infrastructure of what had been, until January 1991, a rather highly urbanised and mechanized society. Now, most means of modern life support have been destroyed or rendered tenuous. Iraq has, for some time to come, been relegated to a pre-industrial age, but with all the disabilities of post-industrial dependency on an intensive use of energy and technology.

9. My mandate was limited to assessing the need for urgent humanitarian assistance. It did not extend to the huge task of assessing the requirements for reconstructing Iraq's destroyed infrastructure, much less, to developmental matters. Accordingly, my report to you, in its several technical sections, seeks with as much exactitude as possible to convey the extent of needs in the primary areas of humanitarian concern: for safe water and sanitation, basic health and medical support; for food; for shelter; and for the logistical means to make such support actually available. Underlying each analysis is the inexorable reality that, as a result of war, virtually all previously viable sources of fuel and power (apart from a limited number of mobile generators) and modern means of communication are now, essentially, defunct. The far-reaching implications of this energy and communications' vacuum as regards urgent humanitarian support are of crucial significance for the nature and effectiveness of the international response.

10. These conditions, together with recent civil unrest in some parts of the country, mean that the authorities are as yet scarcely able even to measure the dimensions of the calamity, much less respond to its consequences, because they cannot obtain full and accurate data. Additionally, there is much less than the minimum fuel required to provide the energy needed for movement or transportation, irrigation or generators for power to pump water and sewage. For instance, emergency medical supplies can be moved to health centres only with extreme difficulty and, usually, major delay. Information regarding local needs is slow and sparse. Most employees are simply unable to come to work. Both the authorities and the trade unions estimate that approximately 90 per cent of industrial workers have been reduced to inactivity and will be deprived of income as of the end of March. Government departments have at present only marginal attendance. Prior to recent events, Iraq was importing about 70 per cent of its food needs. Now, owing to the fuel shortage, the inability to import and the virtual breakdown of the distribution system, the flow of food through the private sector has been reduced to a trickle, with costs accelerating upwards. Many food prices are already beyond the purchasing reach of most Iraqi families. Agricultural production is highly mechanized, and much land depends on pumped-water irrigation. Should the main harvest in June 1991 be seriously affected by a lack of energy to drive machines and pump water, then an already grave situation will be further aggravated. As shown below, prospects for the 1992 harvest could, for combined reasons, be in at least as much jeopardy. Having regard to the nature of

Iraq's society and economy, the energy vacuum is an omnipresent obstacle to the success of even a short-term, massive effort to maintain life-sustaining conditions in each area of humanitarian need.

B. Food and agriculture

11. Mission members held working sessions with counterparts from the relevant ministries, visited social centres where various vulnerable groups are cared for, agricultural production areas, a seed production centre, a veterinary health centre and a dairy production unit. The mission noted that Iraq has been heavily dependent on food imports which have amounted to at least 70 per cent of consumption needs. Seed was also imported. Sanctions decided upon by the Security Council had already adversely affected the country's ability to feed its people. New measures relating to rationing and enhanced production were introduced in September 1990. These were, however, in turn, negatively affected by the hostilities which impacted upon most areas of agricultural production and distribution.

12. Food is currently made available to the population both through government allocation and rations, and through the market. The Ministry of Trade's monthly allocation to the population of staple food items fell from 343,000 tons in September 1990 to 182,000 tons, when rationing was introduced, and was further reduced to 135,000 tons in January 1991 (39 per cent of the pre-sanctions level). While the mission was unable to gauge the precise quantities still held in government warehouses, all evidence indicates that flour is now at a critically low level, and that supplies of sugar, rice, tea, vegetable oil, powdered milk and pulses are currently at critically low levels or have been exhausted. Distribution of powdered milk, for instance, is now reserved exclusively for sick children on medical prescription.

13. Livestock farming has been seriously affected by sanctions because many feed products were imported. The sole laboratory producing veterinary vaccines was destroyed during the conflict, as inspected by the mission. The authorities are no longer able to support livestock farmers in the combat of disease, as all stocks of vaccine were stated to have been destroyed in the same sequence of bombardments on this centre, which was an FAO regional project.

14. The country has had a particular dependence upon foreign vegetable seeds, and the mission was able to inspect destroyed seed warehouses. The relevant agricultural authorities informed the mission that all stocks of potatoes and vegetable seeds had been exhausted. Next season's planting will be jeopardized if seeds are not provided before October 1991.

15. This year's grain harvest in June is seriously compromised for a number of reasons, including failure of irrigation/drainage (no power for pumps, lack of spare parts); lack of pesticides and fertilizers (previously imported); and lack of fuel and spare parts for the highly-mechanized and fuel-dependent harvesting machines. Should this harvest fail, or be far below average, as is very likely barring a rapid change in the situation, widespread starvation conditions become a real possibility.

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16. The official programme for the support of socially dependent groups of the population (the elderly, disabled, mothers and children, hospital patients, orphans, refugees, etc.) is affected by the overall grave deficiencies in the food situation.

17. The mission had the opportunity to conduct independent research relating to household costs and living standards in Baghdad. Such standards have declined rapidly in the last months, while food and fuel prices have climbed dramatically. Price increases in the August to January period reflected shortages of supply, but since January there has been a further acceleration of price increases reflecting both supply shortages and the breakdown of the transport system. Interviews with private wholesale food distributors revealed that their stocks are near depletion and they no longer have an organized private transport capacity, owing to fuel shortages. The government-initiated rationing system was designed to provide families with a fraction of their basic necessities at prices comparable to those prevailing before August. The system allows families either 5 kilograms per person, per month, of flour or 3 loaves of baked bread; 10 kilograms per family, per month, of liquid cooking gas; 1 bar of soap per person, per month, etc. However, independent surveys conducted by the mission in several diverse areas of Baghdad showed that many families cannot draw their full rations, since the distribution centres are often depleted and they have great difficulty in travelling to other centres. The quality of food distributed has itself deteriorated to the point of causing health problems. Most families also reported that they could not meet their needs through the private markets. Despite official price controls, the independent market surveys conducted by the mission showed hyperinflation since August. The price of most basic necessities has increased by 1,000 per cent or more. For example, flour is now 5-6 dinars per kilogram (and seemingly still rising); rice has risen to 6 dinars per kilogram; sugar to 5 dinars per kilogram; lentils to 4 dinars per kilogram; and whole milk to 10 dinars. In contrast to this hyperinflation, many incomes have collapsed. Many employees cannot draw salaries, the banking system has in large measure closed down and withdrawals are limited to 100 dinars per month. The minimum monthly wage was 54 dinars and the average monthly salary of a civil servant was 70 dinars. In short, most families lack access to adequate rations or the purchasing power to meet normal minimal standards.

18. The mission recommends that, in these circumstances of present severe hardship and in view of the bleak prognosis, sanctions in respect of food supplies should be immediately removed, as should those relating to the import of agricultural equipment and supplies. The urgent supply of basic commodities to safeguard vulnerable groups is strongly recommended, and the provision of major quantities of the following staples for the general population: milk, wheat flour, rice, sugar, vegetable oil and tea. These are required to meet minimum general requirements until the next harvest. Safeguarding the harvest means the urgent importation of fertilizers, pesticides, spare parts, veterinary drugs, agricultural machinery and equipment, etc. The mission was able to quantify many of those needs. The disappearance of vegetables from the country's markets also appears likely by the summer, and seed importation is crucial.

19. The mission observes that, without a restoration of energy supplies to the agricultural production and distribution sectors, implementation of many of the above recommendations would be to little effect. Drastic international measures across the whole agricultural spectrum are most urgent.

F. Observations

37. The account given above describes as accurately as the mission has been able, using all sources, including much independent observation, to ascertain the situation, which, within the time available and the travel limitations referred to earlier, was perceived to exist in regard to urgent humanitarian needs in Iraq during the week of 10-17 March. I, together with all my colleagues, am convinced that there needs to be a major mobilization and movement of resources to deal with aspects of this deep crisis in the fields of agriculture and food, water, sanitation and health. Yet the situation raises, in acute form, other questions. For it will be difficult, if not impossible, to remedy these immediate humanitarian needs without dealing with the underlying need for energy, on an equally urgent basis. The need for energy means, initially, emergency oil imports and the rapid patching up of a limited refining and electricity production capacity, with essential supplies from other countries. Otherwise, food that is imported cannot be preserved and distributed; water cannot be purified; sewage cannot be pumped away and cleansed; crops cannot be irrigated; medicaments cannot be conveyed where they are required; needs cannot even be effectively assessed. It is unmistakable that the Iraqi people may soon face a further imminent catastrophe, which could include epidemic and famine, if massive life-supporting needs are not rapidly met. The long summer, with its often 45 or even 50 degree temperatures (113-122 degrees Fahrenheit), is only weeks away. Time is short.

THE NEW YORK TIMES, SATURDAY, MARCH 23, 1991

Rebuild Iraq — After Hussein Goes

By Roy P. Mottahedeh

CAMBRIDGE, Mass.

The U.N. report that the "near apocalyptic" allied bombardment of Iraq reduced the country to a "pre-industrial age" means the U.S. owes Iraq's people — but not its leaders — full-scale humanitarian aid immediately and reconstruction help as soon as it is feasible.

Once Baghdad accepts the stringent U.S.-sponsored Security Council resolution that formally ends the war, the degree of U.S. help for reconstruction must hinge on political reform.

In any case, yesterday's decision by the Security Council sanctions committee to lift restrictions on food shipments is welcome. Now, given the U.N. report's findings that "most means of modern life support have been destroyed or rendered tenuous," the U.S. should immediately permit shipments of water-purification and sewage-treatment technology as well as electric generators.

The U.N. resolution now being debated is likely to require Iraq to put aside a portion of its future oil revenues to satisfy reparations claims by Kuwait and others. Iraq's damaged oil industry infrastructure cannot be rebuilt without short-term loans from the International Monetary Fund and long-term loans from the World Bank. These loans, needing the support of the U.S. and other industrial democracies, should come only after the regime has been reformed.

By what standard can the Administration and its allies judge that the Iraqi regime has been reformed? Ideally, when Saddam Hussein has departed. But, realistically, that departure is far from certain. Although the Administration apparently thinks he will be gone before the end of 1991, no one really can guess when — or whether — he will go.

Suppose Mr. Hussein, from whom the Iraqi people will never buy promises of democratic reform, remains in power? In that situation, the U.S can morally avoid reconstruction assistance and give just humanitarian aid.

The U.S. wants a democratic, pluralistic Iraq. It will not be easy, and may be impossible, to achieve this goal. But it seems nearer realization than ever because a genuine alliance between the Shiites and Kurds (and 15 other groups) that has been forming for a year or so has begun to find sympathy among alienated elements in the ruling Baath Party.

No need to worry about the Shiites.

Pragmatism suggests that, short of democracy, a new authoritarian regime that showed an interest in easing repression and investing Iraqi assets in development rather than arms would merit some degree of U.S. support for renewal.

In Central America, while recognizing governments we considered authoritarian and dangerous, we openly supported the democratic participation of opposition parties. Can we ask for less in Iraq?

While the U.S. has given conflicting signs about its position on the civil war in southern and northern Iraq, we should let the Iraqi people know we don't want a fragmentation of their country and consequent aggrandizement of its neighbors. A conditional commitment to reconstruction would be such a sign.

Right after the war, Washington's official wisdom was that no opposition movement could survive more than a day. But the Shiite and Kurdish rebellions have lasted for weeks.

Washington need not be overly concerned that an Iraqi Government in which the Shiite majority outweighed the Sunnis would be dominated by Iran. Iraqi Shiites, with a brief exception, have refused to accept anyone in Iran as their supreme religious leader; their preference for the leaders of the Iraqi Shiite centers of religious learning held firm during Ayatollah Ruhollah Khomeini's life.

Many doubt that the newly formed opposition, consisting of 17 ideologically disparate groups — including not only Islamic interests and Kurds but also Communists — can work together even if it forced Mr. Hussein's ouster. There are, however, some grounds for optimism. Yesterday, Masoud Barzani, who heads Iraq's Kurdish opposition front, urged other opposition leaders to join him in northern Iraq to discuss forming a provisional government.

What's clear to the opposition is that Iraq's ethnic, religious and regional disunity has enabled the regime to flourish. If the new coalition can hold together long enough to implant the beginnings of a parliamentary process, its practice in power-sharing would give the U.S. the confidence it needs to help bring Iraq back at least to its prewar condition. □

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Resources for the Future

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RESOURCES®

Sustainable development: principles into practice

Robert W. Fri

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Experts argue over the ability of society to meet the challenge of sustainable development. Will technology continue to satisfy the wants of society without serious resource constraints, or is there a limit to the productivity of resource use? Those who believe there is such a limit ask if the technology behind the optimists' faith in increasingly productive resource use really exists. Perhaps a more important question is whether new principles for allocating scarce resources will be put into practice.

As Woody Guthrie refrain goes, "ain't no country extra fine that's just a mile from the end of the line." His song—"End of My Line," written in 1941—praised the new dams that were bringing cheap electricity to the Columbia River Basin. The line he mentions is, of course, a power line.

Today's songs about the Columbia River are more likely to praise salmon than power lines. Still, Guthrie reminds us of where priorities lay, even in the United States, only two generations ago. As we now face the challenge of a sharply growing and mostly poor world population, it is an instructive reminder.

The 1987 report of the World Commission on Environment and Development, *Our Common Future* (commonly known as the Brundtland Report), is less lyrical than Woody Guthrie, but is equally instructive. It insists that we attend to the economic needs of the world's people, as well as to the quality of their environment. And the report rests on the principle of sustainable development, arguing that we must meet the needs of the present without compromising the ability of future generations to meet their own needs.

This is a tall order, but the Brundtland Report takes it on with a remarkable sense of hope. Thus the report "is not a prediction of ever increasing environmental decay, poverty, and hardship in an ever more polluted world among ever decreasing resources. We see instead the possibility for a new era of economic growth, one that must be based on policies that sustain and expand the environmental resource base."

Not everyone sees it this way. For example, Bill McKibbin, in "The End of Nature," argues that we simply consume too much, and he questions "the industrial basis of our civilization, the need to forever grow in wealth and numbers, and the entire way we live." Paul and Anne Ehrlich focus on the population problem. Some of their sense of gloom comes through in their observation, in *The Population Explosion*, that "if current population trends continue, [they] could bring us essentially to the same sort of

Photo courtesy of The World Bank

Sharing financial and knowledge resources with the developing world, where economic and environmental security are hardest to achieve, seems prudent.

world as would be left after a nuclear war and a nuclear winter—just more slowly." And in "Land, Energy, and Water: The Constraints Govern Ideal U.S. Population Size," David and Marcia Pimentel foresee such impressive resource constraints that if "the U.S. population wishes to continue its current high level of energy use and standard of living and prosperity, then its ideal population should be targeted at 40–100 million people."

This is pretty heady stuff, and makes it worth asking whether the optimism of the Brundtland Report is misplaced. Can we manage our affairs in a sustainable way? And if we can, what are the chances that we will? Unfortunately, the first question has a more promising answer than the second.

The challenge is formidable. Demographers estimate that world population might level out at more than ten billion people sometime in the twenty-first century. More than 90 percent of this growth will occur in developing countries, where the current average per capita income is about one-tenth of that in the member countries of the Organization for Economic Cooperation and Development (OECD). For the developing world to achieve, say, one-third of the per capita income level that the developed nations enjoy, the world economy would have to expand more than thirtyfold over the next one hundred years.

Daunting as this challenge may seem, we have little option but to face it. If meeting the economic needs of the poor is not reason enough, the Brundtland Report stresses that environmental degradation equals the absence of development. In short, neither rich nor poor can have economic or environmental security without economic development.

Nor is it easy to conclude that a doubling of the world's population is a mistake requiring drastic remedy. The world's population is growing in large part because improvements in public health have depressed the mortality rate in the developing nations, a humanitarian effort worthy of some praise. The problem now is to make the predictable lag between reduced mortality and lower fertility as brief as possible. While fertility control is clearly a part of the solution, economic development is also a necessary contributor to the social change that will persuade parents to have fewer children.

Can technology save us?

For these reasons, it seems to me the vision of the Brundtland Report is inescapably correct. But if we accept the need for economic development and the inevitability of some population growth, then we must look to technology as the chief engine of sustainability. The central issue is whether technology—both hardware and the knowledge to use it wisely—will allow us to manage our natural and environmental resources sustainably. And this issue is in dispute.

On one side stand those who believe that technology will continue to satisfy the wants of society without serious resource constraints. These optimists—many of them economists—believe in markets in which incipient scarcity triggers an increase in the price of the affected resources. Responding to this price signal, technology emerges that lets us use scarce resources more efficiently.

History supports this view. According to the Brundtland Report, the global economy multiplied fiftyfold in the last hundred years, four-fifths of this growth coming since 1950. Yet the prices of many natural resources have not risen much in real terms for decades, suggesting that the market has dealt with resource scarcity at acceptable costs. Moreover, economists have shown that markets can also efficiently resolve scarcities of environmental resources, given the right price signals.

The alternative view raises the possibility of ultimate limits. Consumption of material goods cannot forever increase, and in any case we should prefer quality over quantity of consumption. From thermodynamics comes the idea that it takes an ever-increasing amount of work to put nonrenewable resources into usable shape—one cannot recycle the same beer can forever. We are ultimately left to rely on the sun's energy as our sole source of support. When this daily ration of energy falls below that needed to overcome the dissipative use of nonrenewable resources, economic growth ceases.

Of course, growth will end someday, but this conclusion is only a troubling curiosity if technology gives us ample time before the limits are reached. It is on just this point that the skeptics' argument is the most powerful, for they simply insist that productivity of resource use cannot increase forever. Thus the optimists had better be prepared to show that real technology exists to support their assertion. And given the constraint of

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sustainability, it had better be the right kind of technology.

This is a heavy burden of proof, as the example of agriculture suggests. The optimist need only assume that agricultural productivity will grow at its historical rate to show that there will be plenty of food and fiber for the population of the next century. But present agricultural technology can do environmental harm by introducing polluting fertilizers and pesticides, and by encouraging the overuse of marginal land and water resources. What is required is not simply more of the same, but new technologies that produce more food and fiber without the environmental consequences of the current ones.

The same situation—a technology that overcame resource constraints in the past but may not do so in the future—exists in regard to other natural resources. Energy analysts argue that we can meet future energy needs and solve the pollution problems that energy creates, but not with yesterday's technology. We need not cut old-growth and tropical forests to have adequate timber supplies, but it will take an approach different from today's. The world's water resources are ample to sustain a much larger population, though not if we manage these resources as we do now.

On balance, the technological possibilities for providing a growing population with at least an adequate level of economic well-being seem encouraging. Still, the optimists have yet to meet the test of showing that there is real technology behind their faith in increasingly productive resource use. Surely, closing on this issue must be one of the chief tasks facing economists and technologists in the immediate future.

From principles to policy

That the available evidence is equivocal leads to a difficult challenge for policy. We have a goal that seems to be inescapable, but our ability to meet that goal is uncertain. Given this dilemma, what policies for allocating our scarce financial, natural, and environmental resources give us the best shot at success?

In an age of sustainable development, new principles for allocating resources apply. These principles are still too unfocused to be called policy prescriptions. Yet their weight is already beginning to be felt, and it is not hard to see their major outlines.

Above all, we must invest heavily in creating the new knowledge we need to increase the productivity of our use of natural and environmental resources. What is required is a long-term technological vision and a corresponding commitment to it—an act that is both financially expensive and politically rare. Still, the payoffs are immense.

Second, we should rely on decentralized decision making to allocate resources—preferably market mechanisms. Markets need the right price signals to work properly, and so, in the language of economics, externalities must be internalized in private markets. We can expect greater interest in getting prices right, as the consideration of carbon taxes to contain CO_2 emissions suggests. Although not an easy task, getting the prices right is infinitely preferable to the prospect of global command-and-control regulation.

Optimists have yet to show that there is real technology behind their assertion of increasingly productive resource use.

Third, global interdependence means sharing scarce financial and knowledge resources. The developing world is the chief battleground for achieving economic well-being and environmental sustainability, but most of the financial and technological weapons exist in the industrialized nations. Inevitably, we must face the issue of transferring these resources from the wealthy to the poor, even at some expense to the former.

Finally, we must be more risk-averse in deciding to use resources. Human activity can now disturb global physical and ecological systems, such as the climate. Until we know more about some of these systems, it is not unreasonable to suspect that they are as likely to be fragile as robust. This situation enlarges the danger of inadvertently and irreversibly crippling a valuable resource. Since the obvious way to avoid irreversible damage is not to use a resource at all, it follows that there will be a rising level of aversion to risk in decisions about resource use.

The obvious difficulty of successfully applying these principles in shaping public policy would seem less formidable if our record of managing scarce resources were not so dismal. Many nations subsidize agriculture at great economic and environmental cost. The United States pays too little for energy, a fact brought home by the recent turmoil in the Middle East. We refuse to manage water according to its true value, and so seem to have too little of it.

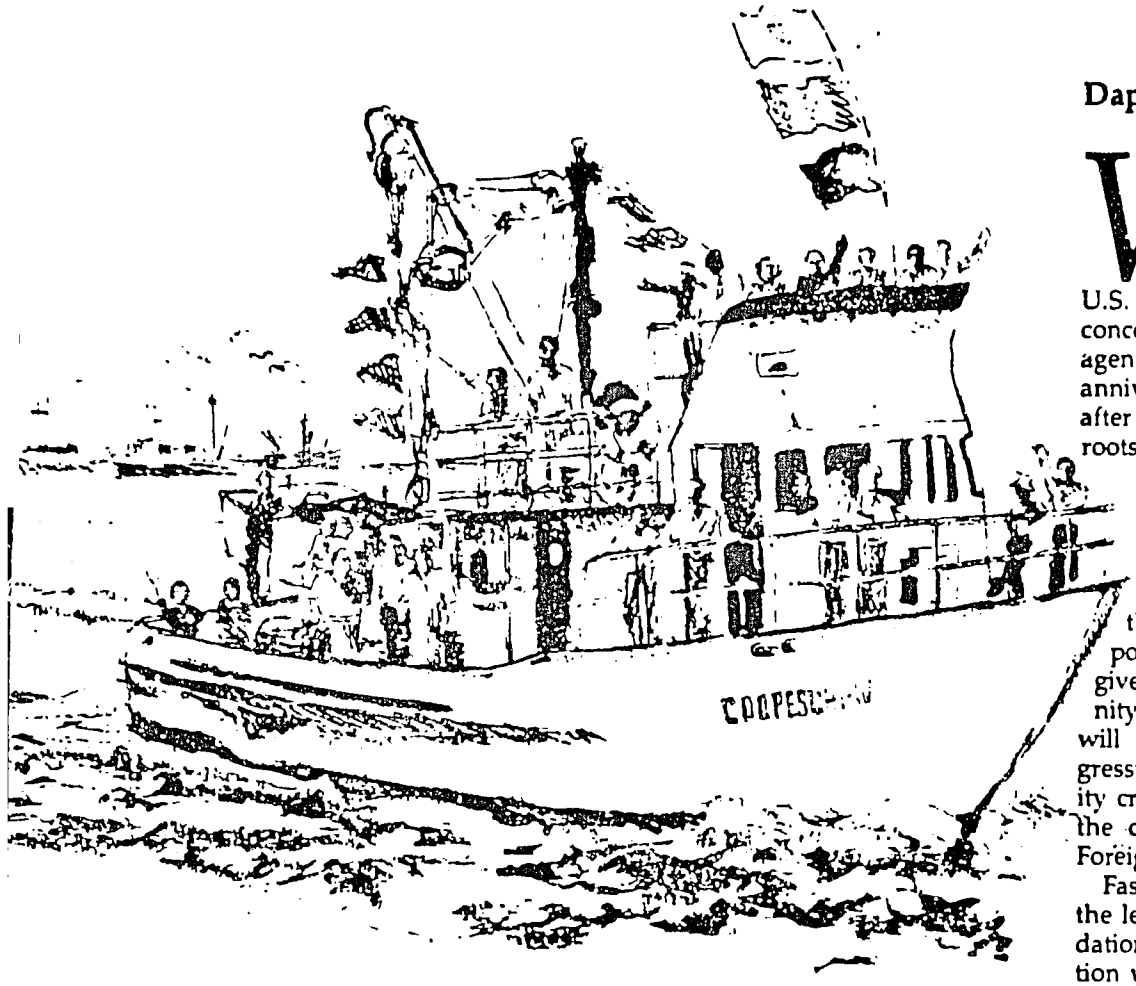
Nor are our environmental policies models of careful resource use. The toxic pollution control provisions of the Clean Air Act amendments will cost $5 to $10 billion per year to save at most a few hundred cancer cases annually. It is hard to imagine that this expenditure could not be put to better use even to reduce the incidence of cancer in the United States. More globally, William Ruckelshaus finds "something unsettling about a world where every day twenty-five thousand people die from easily preventable waterborne diseases. And yet we continue to argue in America about ever smaller increments of pollution abatement with diminishing health benefits."

It is surely elementary that, if sustainable development means anything at all, it means not wasting resources. Nevertheless, we seem more often than not to adopt policies that only make matters worse—that create scarcity where none need exist. In the glow of our devotion to the principle of sustainable development, this seems a special hypocrisy.

That the task is hard should not weaken the conviction that we must seek to provide adequately for the growing population of our planet. Old technology that is unsustainable does nothing to diminish the importance of developing new technology that is. And our penchant for making matters worse hardly means that we ought to ignore policies that make matters better. What all this does say, however, is that it is time to put our practice on a par with our principles. ■

Robert W. Fri is president of and a senior fellow at RFF.

Celebrating 20 Years of Work at the Grassroots



In November 1971, the Inter-American Foundation made its first grant to a fishing cooperative in Peru, the Cooperativa Pesquera Chimbote. With $68,000 from the IAF, the group purchased its first fishing boat, pictured here on its maiden voyage. Since then, the Foundation has made over 3,000 grants to self-help organizations throughout Latin America and the Caribbean, for a total of over $300 million.

In this Focus section of Grassroots Development, *readers are invited to share in the events of the twentieth anniversary celebration, held last May in Washington, D.C., and to reflect with us on the challenges and opportunities ahead as the Foundation enters its third decade.*

Illustration: Bill Firestone

Daphne White

When legislation creating the Inter-American Foundation was first introduced in the U.S. Congress, many thought the concept was so radical that the agency would never reach its first anniversary. But on May 3, 1990—after two decades of promoting grassroots self-help efforts in Latin America and the Caribbean—the Foundation returned to Capitol Hill to celebrate its twentieth anniversary.

"The message has gotten through: People are capable, the potential is there. You just have to give them the chance, the opportunity to help themselves, and they will supply the motivation," Congressman Dante Fascell told a capacity crowd of 250 people gathered in the committee room of the House Foreign Affairs Committee.

Fascell, who in 1969 cosponsored the legislation authorizing the Foundation, was honored at this celebration with the creation of an IAF fellowship bearing his name. The Dante B. Fascell Inter-American Fellowship will provide money for Latin Americans each year to disseminate information about successful grassroots development efforts in the region.

"The idea of personal communications embodied in the fellowship is one we have long dreamed of," Fascell said. "After 20 years, it is exciting to realize that all the ideas of the legislation, and all the efforts of the first board" have been implemented and been shown to be effective, said Fascell.

"The Foundation has been a courageous institution, sometimes sailing

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against the wind," noted Enrique Iglesias, president of the Inter-American Development Bank (IDB) and the event's keynote speaker. "We have learned a lot with the Foundation: about the realities of poverty, about the abilities of the impoverished, and also about how to identify solutions."

The IDB is now working with some of the same microenterprises that were first identified and promoted by the Foundation, Iglesias said. "The Foundation, with singular success, has spotlighted the potential of nongovernmental organizations and helped them do the job they need to do," he noted.

The IAF recognizes that "a society is more than governments and institutions—it is groups of people working together in a democratic atmosphere," Iglesias said. In a region where one-third of society lives in absolute poverty, the Foundation's direct work with grassroots organizations is crucial, he added.

That theme was also explored in a special documentary videotape produced for the occasion, featuring journalist Bill Moyers. The IAF was created as "a new and experimental approach to U.S. foreign assistance," Moyers said in the documentary. "Many in the Congress had concluded that much of our bilateral aid was not reaching the poor for whom it was intended." While recently created nongovernmental organizations (NGOs) had started working with grassroots organizations in the late 1960s, official "foreign aid programs often overlooked many of these grassroots efforts," Moyers said.

The philosophy of the IAF is "as basic as Jeffersonian democracy, offering an approach that respects the dignity and self-esteem of the poor," Moyers concluded.

"In its own quiet way, the Inter-American Foundation has proven that an international agency can support people-centered development," agreed Valdemar Oliveira Neto, a Brazilian lawyer who works among the poor in the slums of Recife. The Foundation shares a vision with several other multilateral agencies, "a vision in which people stand at the very center, not merely as beneficiaries to be measured or counted, but as the creators, planners, and implementers of their own development process," Neto said at the anniversary celebration.

"The Foundation, ahead of the times, made possible small-scale experiences that improved the quality of life in innovative ways; that promoted learning at all levels; that put the beneficiary in the driver's seat; that are replicable and relevant to social policies; and that, directly or indirectly, generate well-being and goods and services for the participating poor," said Mónica Jiménez, a Chilean social worker, university professor, and civic leader. The Foundation's work has "enriched the soil from which a democratic Chile now can grow," Jiménez told the gathering.

The Foundation's first president, William Dyal, was one of the last to speak on May 3. In his brief comments, he emphasized that "the real Foundation is out there, among the people of Latin America and the Caribbean." His last statement as president to the IAF board of directors in 1979, Dyal added, remains a valid prologue for the challenge of the 1990s: "While some funders grapple with the rhetoric of basic human needs or the definition of who the poor are, the Foundation is busy funding the poor so *they* can grapple with the basics."

WHY CELEBRATE?

Deborah Szekely, the Foundation's outgoing president, was the impetus behind this twentieth anniversary celebration. "Essentially, it was an opportunity to tell our story on Capitol Hill," Szekely says.

"Our mandate is to fund, learn, and disseminate, and I want Congress to use our expertise when they are discussing Latin America," she explains. Even though the IAF is one of the smallest federal agencies—with a staff of just over 70 people and an annual budget of about $30 million—it is one of the most knowledgeable when it comes to grassroots efforts in the hemisphere, Szekely notes.

This celebration and its attendant publicity, she adds, informs people of how that expertise qualifies the IAF to sit at the table whenever Latin American and Caribbean issues are discussed in Congress, at think-tanks, or among policymakers.

"The Foundation took awhile getting born, but in the future I would like it to take its rightful place in the development world," she says.

In her remarks on Capitol Hill, Szekely said: "Twenty years ago, Congress mandated that we be independent, above and beyond short-term foreign policy, that we be risk-takers, and that as we work we should learn from experiences in each and every country of Latin America and the Caribbean. That foresight enabled this very small agency with a budget of one-tenth of one percent of

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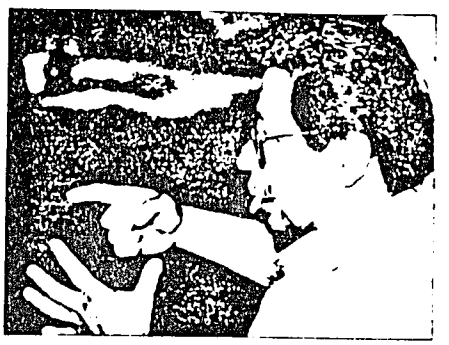
Photos: Paul Kennedy



Clockwise from left: *Anniversary celebrants included U.S. Congressman Dante Fascell, IDB President Enrique Iglesias, and CONSAL member Ramón Velázquez Nazar.*

U.S. foreign assistance funds to affect the lives of tens of thousands of the underprivileged."

After six years as president of the IAF, Szekely resigned in September 1990 to start a new foundation called Eureka. At Eureka, Szekely will work to transfer some of the lessons she learned in Latin America to organizations working with at-risk children in the United States. Eureka will focus on agencies serving children from the prenatal period through the age of nine.

The new foundation will identify successful community-based agencies to serve as "partner" organizations, and then offer staff from other promising grassroots groups working sabbaticals to visit these agencies and learn first-hand how to sharpen their own techniques.

It is a learning and dissemination model similar to that developed at the IAF, Szekely says. "The Eureka Foundation does not intend to create programs that require new money," she says. "Rather, it will transplant successful innovative approaches from one existing program to another and in the process multiply the value of grants long since made."

FASCELL FELLOWSHIPS

To broaden its dissemination effort, the IAF announced a new fellowship program to encourage people from Latin America and the Caribbean to pool information about grassroots development.

"The Dante Fascell Inter-American Fellowship is targeted at Latin American and Caribbean leaders who have distinguished themselves in the field of grassroots development, are skilled at dissemination, and want to publicly promote a successful approach to grassroots development," explains Robert Sogge, IAF Director of fellowships.

Unlike the three other IAF fellowship programs, this one does not involve university study. "This fellowship deals exclusively with dissemination and communication, so people in Latin America can learn from each other and improve the way they deal with problems at the grassroots level," Sogge notes.

The fellowships, which will not exceed $50,000 or last longer than 12 months, will pay for a full-time or part-time working sabbatical. Fellows may stay at their existing jobs, as long as they are not government employees; and they may work on on-going projects as long as these include dissemination. Fellows are not expected to move away from their homes during the fellowship period. As many as three fellows will be named each year.

Candidates may apply directly or be nominated. Once nominated, candidates will be asked to submit a short description of proposed activities during their fellowship period. A panel of Latin American and Caribbean development specialists will review the final applications and recommend candidates for selection by the IAF.

A wide variety of people could qualify for fellowships, including journalists, authors, artists, development practitioners, scientists, social scientists, and volunteers, Sogge says. For example, an Andean musician may propose a series of master classes and workshops to strengthen pride in traditional culture and inspire people to organize for change; or a university professor who has written about microenterprises may set up seminars to train small businessmen. A scientist might want to sponsor a regional conference on deforestation, or work with NGOs on a series of town-hall meetings to mobilize local communities. Sogge adds, "We expect that whatever activity is launched during the fellowship will not end when the grant is over. We are looking for people experienced in dissemination who have a long-term commitment."

Although the Fascell fellowship is intended to stimulate dialogue within the Latin American and Caribbean region, some of its ripple effects could

Continued on page 7

also include presentations at conferences in North America.

CONSAL

The IAF is already deepening regional dissemination through the efforts of the Consejo de Servicios de Apoyo Local (CONSAL), which met in Washington, D.C., during the same week that the Foundation celebrated its twentieth anniversary. CONSAL consists of one representative from the In-Country Support teams in each of the IAF's seven regions, and works to advise the Foundation president and staff about regional developments that cut across national boundaries.

One such issue resulted from the collapse of the International Coffee Agreement in 1989, which hurt small coffee producers in several Caribbean and Central American countries as well as Mexico. Partly as a result of CONSAL's work, the Foundation is now considering a proposal to support an international union of small coffee organizations called UPROCAFE. The union will spread infrastructure costs and act as a single marketing agent for the small producers, generating sufficient economies of scale to allow them to compete effectively with large growers.

LOOKING TOWARD THE FUTURE

Having celebrated its first 20 years, the Foundation is now in a time of transition. A new president has not yet been named to replace Szekely, and in the interim, Vice President for Programs Stephen Vetter has been appointed acting president.

Frank Yturria has just started his term as the new chairman of the board (a profile of Yturria appears on page 47), and three new members have also joined the board in recent months. Board member Norton Stevens, an international businessman from New York, has traveled extensively in Latin America and is especially interested in Ecuador and the Andean region. The two new members from the public sector are Bernard Aronson, assistant secretary of state for inter-American affairs, and James Michel, assistant administrator for Latin America and the Caribbean for the U.S. Agency for International Development.

Five more members must be appointed by the Bush administration to bring the board up to full strength.

"Although we are in a period of tremendous change, it is also a time of rebirth, renewal, rededication, and recommitment," says Patrick Breslin, IAF research coordinator and the author of several books and articles about the Foundation. "After 20 years, the basic values of the Foundation still make sense, but it's a question of how you reinterpret them."

Whereas two decades ago the IAF had just started working with fledgling grassroots groups, this sector has grown in size and capability. This has led the Foundation into a period of evolution rather than revolution, Breslin says. "From rhetoric about funding people, we have shifted to funding networks and interchanges across frontiers," he adds.

One of the challenges now facing the Foundation is encouraging other development agencies to become more involved with the burgeoning grassroots sector. "Twenty years ago it was a radical idea to fund grassroots groups, but now the World Bank is wondering how to fund them," Breslin says. The spread of democracy in Latin America bodes well for the survival and growth of grassroots organizations, Breslin notes, increasing both the opportunity and need for informed donor support.

Finally, Breslin suggests that in upcoming years the Foundation might help link Latin Americans with their North American counterparts. The Foundation already has a development education program reaching out to schools in the United States, and linkages have been made between Latin American and U.S. grassroots organizations working on similar problems.

"I think over the next 10 years we will be looking more and more for connections to our own country, transmitting ideas and experiences about how poor people help themselves," Breslin says.

And Edmund Benner, acting vice president for programs, suggests that the Foundation will also be linking microdevelopment efforts to macro efforts in the future. "The small groups we are funding are getting together to speak with a louder voice, especially in the emerging democracies," Benner says. "As a result, they can approach the larger funders and undertake larger projects as a group. Together they can also attempt to influence public policy."

"The world of grassroots organizations is much more sophisticated than it was 20 years ago," Breslin concludes. But as public social services shrink and national economies continue to founder, the task of improving the lives of the poor has also become more complex. The work of the Foundation still has far to go. ◇

Outgoing President Deborah Szekely at reception honoring the IAF's twentieth anniversary: "Essentially, it was an opportunity to tell our story on Capitol Hill."

Paul Kennedy

DAPHNE WHITE is a Washington, D.C.-based journalist who writes on development and conservation issues.

THE NINETIES

The benefits of policy reform

An IDB study shows light at the end of the tunnel

by Ronan Le Berre and Lutz Kilian

Throughout Latin America, countries are in the process of jettisoning half a century of economic policies. Gone is the conviction that economic growth must be achieved through import substitution and by giving the state a dominant economic role. Today, governments are opening up their economies to the winds of international competition and handing over a much larger share of economic decision making to the private sector.

As the reform process unfolds, one of the most frequently asked questions in Latin America is whether the future benefits of the policy changes will indeed outweigh their present costs in the form of unemployment, income losses and cutbacks in social services. Especially in countries where economic policy changes are more recent—such as Mexico, Venezuela, Argentina, Brazil, and Peru —the reform process could still be undermined by technical failure and a possible lack of domestic support or political determination. Therefore, the question of the potential benefits of the reforms over the next decade is a critical one.

To provide at least a preliminary answer, we constructed two "what-if" scenarios (not projections). Our first scenario assumes the continuity of policy reforms through the 1990s. It analyzes the impact of the growth pattern associated with the reform effort on the current account, external financing and debt. Our second scenario, in a similar fashion, examines the effects of a reversal of these reforms early in the decade.

For both scenarios the external environment is the same. The world economy is assumed to slow at the beginning of the decade as a result of higher oil prices and a soft landing of the U.S. economy. Beginning in 1992, accelerating growth in the United States and an end to the Gulf crisis would stimulate economic activity in the industrial nations to an annual rate of 3 percent. World trade would expand at 5 percent per year for the rest of the decade.

The reform process could still be undermined by technical failure and a possible lack of domestic support or political determination.

Scenario 1: Continuing the reforms

Although the specific components of economic policy reforms must vary from country to country, in all cases their aim is to achieve successful macroeconomic management. Hence, the reform scenario presumes moderate inflation, a realistic exchange rate and sound public finances.

Consumption is assumed to grow slower than GDP in this scenario to allow an increase in the domestic savings ratio. Government fixed investment would grow at a somewhat higher rate than government consumption in order to finance investments in the infrastructure needed to support economic growth.

In addition, the study devotes particular attention to the areas of trade, foreign investment, and the return of flight capital.

It seems reasonable to assume that if world trade were to grow at 5 percent in the 1990s, exports from Latin America could expand at the same rate. Most of the growth in exports would come from nontraditional goods, which are expected to respond quickly to the new economic climate by reaching an annual rate of 6 percent.

It should be noted, however, that trade liberalization could be a perilous course in the short run. Pent-up demand could cause imports to increase faster than output. A careful management of tariff policies would be needed in some countries in order to prevent too rapid a surge in imports.

A critical condition for long-term sustained growth is a country's ability to finance the current account deficit associated with an economic growth target with higher foreign investment, the return of flight capital or foreign borrowing. In the reform scenario, foreign investment and the return of flight capital would provide more than 75 percent of the external financing required in the 1990s. These sources of financing were negligible or negative in the 1980s.

Today, in contrast, many Latin American governments have accepted the need for foreign investment. For instance, some countries are currently fostering foreign investment through large privatization programs. In addition, the recent increases in rates of return, a more predictable business environment, and the lifting of restrictions make possible an unprecedented growth of foreign investment. From 1992 on, foreign investment is assumed to grow at

Ronan Le Berre and Lutz Kilian are economists with the IDB's Economic and Social Development Department.

The extent of economic expansion will ultimately be determined by the countries' resolve to pursue the difficult path of reform.

between 5 and 10 percent in real terms. However, with 1.1 percent the share of foreign direct investment in GDP would still be low at the end of the decade.

More attractive investment opportunities would also encourage a return of Latin American flight capital, estimated in 1989 at $155 billion. Yet, the scenario is conservative in estimating that only the real income from flight capital would return to the region. Such flows would reach a maximum of 0.5 percent of Latin American GDP at the end of the decade.

Results. The study demonstrates that under these conditions GDP growth rates of between 3.9 and 5.2 percent are financially sustainable for Argentina, Brazil, Colombia, Chile, Mexico, and Venezuela, provided that some additional net borrowing is channeled to the region. For the seven major Latin American countries, the stock of debt, at $365 billion in 1989, would stabilize at under $380 billion at the end of the century, even without additional debt reduction. The ratio of debt to export earnings would improve from 313 percent in 1989 to 128 percent in the year 2000.

The study also shows that the current account deficit of the seven largest Latin American countries would stabilize at around 1.4 percent of GDP after an initial increase in 1992 and 1993. The increase owes in part to the decline of oil prices, and in part to the opening of the economies of Argentina, Brazil, Peru and Venezuela to imports.

The smaller countries of the region would find themselves in a less favorable situation. Most would be unable to sustain even a modest growth of 3 percent a year. Although the debt-export ratio for the group would fall significantly, its stock of debt would still rise from $56 billion in 1989 to $84 billion in 2000.

The small countries on average would run a large current account deficit. As foreign investment is low in most of these countries and unlikely to increase rapidly, the deficit would translate into a substantial and persistent need to borrow.

GDP growth rates of between 3.9 and 5.2 percent are financially sustainable for Argentina, Brazil, Colombia, Chile, Mexico, and Venezuela.

These results are derived from purposefully conservative assumptions. For instance, the amount of foreign investment and return of flight capital could actually be greater than assumed. Also, the scenario does not consider the positive effects of a possible free-trade agreement between the United States, Mexico and Canada. Nor does it include the possible benefits of United States President George Bush's "Enterprise for the Americas" initiative to create a free-trade area from Alaska to Tierra del Fuego. Finally, the exercise does not consider the possible effects of future debt reductions.

Scenario 2: Reversing the reforms

In the second scenario, economic policy reforms are reversed early in the decade in five of the seven major countries and in most of the smaller ones. Only Chile and Colombia are assumed to be relatively immune to this slippage. As the experience of the last decade has abundantly demonstrated, such economic policies would bring about deteriorated public finances, overvalued real exchange rates, and high inflation.

Government consumption and investment growth rates would be as low as 1.8 and 2.2 percent, respectively. Consumption would grow at about the same rate as GDP, leaving the share of domestic savings in GDP unchanged.

Export growth in this scenario would be 2.7 percent per year. Foreign investment would stop growing in real terms after 1991. At the same time, domestic capital would leave the country to take advantage of better investment opportunities abroad.

Results. In this scenario, the countries' GDP growth rate would drop to 2.3 percent starting in 1993. There would be no increases in per capita income. While the current account deficit generated by lower economic growth would be smaller than in the case of continuous policy reforms, the reduced deficit would be more than offset by the drop in foreign investment and renewed capital flight. As a result, the stock of debt would stand at $470 billion at the end of the decade, slightly higher than in the other scenario, in spite of much lower growth.

This is not, however, the worst case scenario. For instance, the scenario's 2.3 percent average GDP growth rate is still better than the 1.1 percent recorded for Latin America during the eighties.

* * *

Thus, after the dismal decade of the 1980s, Latin America's future looks encouraging. The adjustments already made, the determination to implement reforms exhibited by most governments, and prospects for attracting capital from abroad, all point to the possibility of a brighter picture for the 1990s. But the extent of the economic expansion will ultimately be determined by the countries' resolve to pursue the difficult path of reform.

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APAP II
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Buy-in Updates

Studies Find that Releasing Price Controls Could Help the Rural Poor in Honduras

Research on agricultural price controls is part of a series of studies that APAP II is conducting in an effort to help advise the new administration of Honduran President Callejas as it develops a domestic plan of action. The research is being done for USAID/Tegucigalpa under the direction of Agricultural Officer Bob Wilson.

Price controls on goods whose domestic prices are near international prices should be released to improve the economic well-being of the rural population, according to the study conducted by George McCandless, University of Chicago, and Evan Tanner, University of Miami.

The price controls have reduced fluctuations in prices, protecting consumers and producers from international shocks. However, this smoothing of price paths also prevented the domestic market from allocating the costs induced by weather shocks between consumers and producers. Instead, producers had to bear the costs of these fluctuations.

The controls have resulted in a long-term decline in the price of wheat flour, which has in turn driven down the prices of corn, rice, and beans. The concessionary rates received from seller countries, especially from the U.S. through the PL 480 program, have aided the Government in maintaining the price controls.

However, the controls have not substantially reduced the cost of the agricultural goods consumed by the poorest Hondurans—those who live in rural areas—and they have had a very negative effect on their wages. The declining prices have reduced production of both corn and rice, substantially reducing implicit wages in both industries.

In addition, the Government has encountered difficulties in maintaining nominal price controls in the face of increases in domestic inflation as well as in international prices for agricultural goods. The early 1990 devaluation of the Honduran lempira exacerbates the task of maintaining controls.

The report concludes that while the controlled prices could be raised, with the increases passed along to consumers, this method causes urban residents to blame the Government, and especially the price control office, for the resulting economic pinch.

For goods whose domestic prices are near world prices, releasing the controls should result in only modest consumer price increases, yet should still eventually bring about higher prices for producers. For example, raising the price of wheat and reducing wheat imports should result in increased production of the traditional grains and more income for the Honduran farmer. It is unlikely that releasing price controls will cause a decline in the domestic price of any of the goods, according to the report.

A follow-on study on the Honduran price control system reenforced the primary study, finding that the poorest Hondurans are subsidizing those who are relatively better off, especially with respect to price controls on agricultural goods. Releasing the prices for these goods, or at the very least raising them, should substantially improve the welfare of the rural population and reduce the flow of migrants into the cities. Allowing unrestricted imports of many controlled items might be better than continuing price controls. While it is not necessary to import much, the possibility of free imports reduces the oligopoly rents that producers can extract. ■

International Freedom Foundation

DEVELOPING WORLD MONITOR

A monthly analysis of political, strategic, and economic developments in Africa, Asia, the Caribbean, and Latin America.

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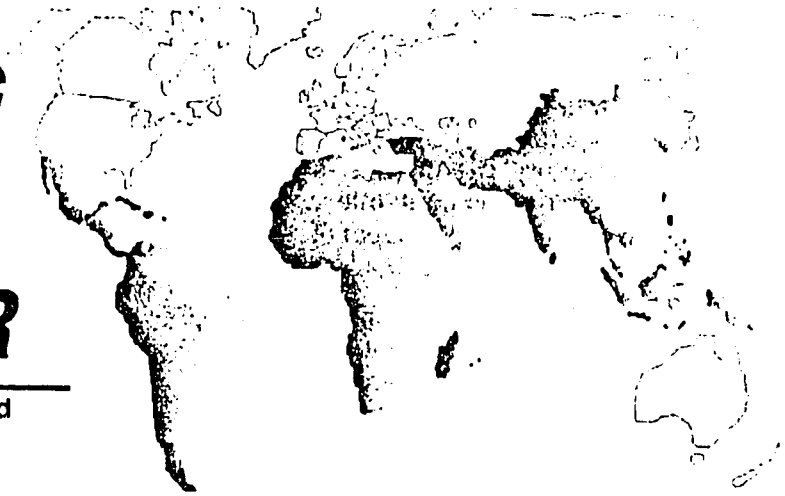

Africa

In Africa, the Rumblings of Democracy and a Window of Hope

No more than a year ago, the world was ready to write Africa off the international political agenda. The continent was (as it seemingly always has been) economically bankrupt, and there appeared little promise for a turnaround. Gross domestic products were down; foreign investment was down; starvation and disease, from Sudan to Mozambique, were commonplace; and African leaders—with only a few exceptions—were demonstrating little interest in taking the assertive steps necessary to correct the situation.

With global attention focused on the liberation of Eastern Europe, the up-and-down reform program in the Soviet Union, and later the showdown in the Persian Gulf, Africa was finding it virtually impossible to draw the attention of Western policy makers, and their frustration was evident in many arenas. At a conference on the Persian Gulf war and its ramifications for Africa last month in Harare, Zimbabwe, for instance, Zimbabwean political science professor **H.R. Patel**, representing the viewpoints of many Africans sensing an increased international isolation, lamented that "for many years, events in Africa were given great animus by the East-West struggle. . . . Now we are on the margins of the world debate as never before."

The conference was just the latest expression of alienation by African leaders and intellectuals, who, sensing their economic weakness in the global economy and their diminished geopolitical relevance with the reduction in East-West tensions, now face international political disenchantment. Looking at Africa one year ago, the economic and political trends indicated that the continent was likely to slip further into international irrelevance—catching the attention of only those who sought to minimize its suffering.

Sensing this disturbing trend, the World Bank last year sought to read the riot act to African leaders. In *Sub-Saharan Africa: From Crisis to Sustainable Growth*, the bank made the case for economic growth in Africa and explained why free market economic reform would be essential to saving the continent from perpetual economic malaise. Still, the publication, important as it was, appeared on the scene as a virtual epitaph for Africa, whose "poor performance during the past ten years," it reported, "has been reflected in weak growth in the productive sectors, poor export performance, mounting debt, deteriorating social conditions, environmental degradation, and the increasing decay of institutional capacity."

Just how poor is Africa? The World Bank spelled it out: In 1987, Africa's 450 million people had a total gross domestic product (GDP) of approximately $135 billion, about the same as that of Belgium and its 10 million people. One quarter of sub-Saharan Africa's population—more than 100 million people—face chronic food insecurity. Population growth rates in Africa (about three percent) are now outpacing the continent's GDP growth. These numbers are the facts behind the sad African stories Westerners hear about most: starving, crying children, mass famine, and illiteracy—all on a continent without hope.

Many factors are at the root of the African crisis—lack of economic infrastructure, socialist-oriented economic planning, pervasive corruption, political instability, the lingering effects of colonialism, and others. But perhaps no factor has been more debilitating to the continent than its post-colonial authoritarian political structure, which has enabled statist economic

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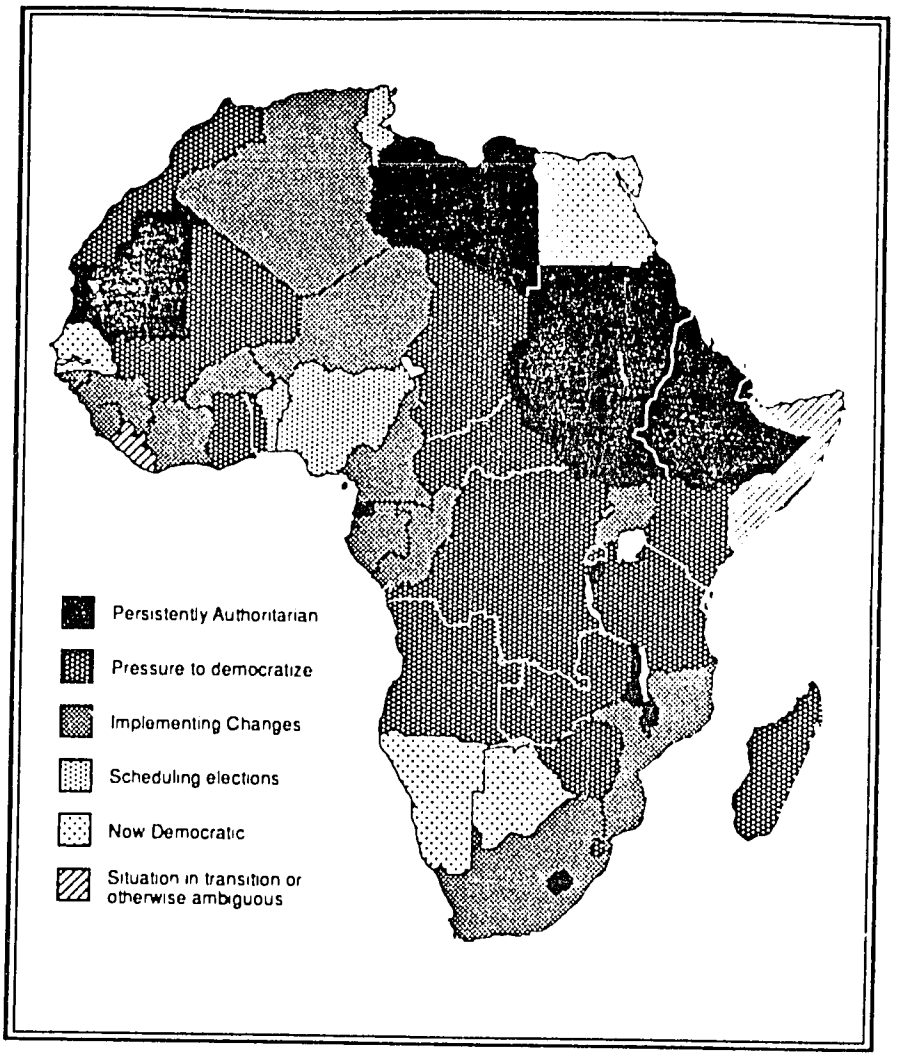
policies to continue despite widespread indigenous opposition to them. Political unaccountability in Africa has permitted economic unaccountability, which, in turn, has been at the root of Africa's poverty.

But now a glimmer of hope is emerging in Africa. Throughout the continent, many governments are beginning to reject one-party and military rule, while others are facing restless, demanding populations that are calling for political liberty in their respective countries. There is no guarantee that the democratic opposition movements forming in Africa, or even those governments now promising democratic change, will succeed in bringing an end to autocracy on the African continent. After all, Africa possesses virtually no democratic structures, and it remains unclear how many of Africa's largely non-democratic institutions—the military, the civil service, and others—will respond to the mounting demands for democratization. Furthermore, the continent suffers from deeply-rooted ethnic rivalries, which could complicate democratization efforts.



Yet, some nations in Africa are likely to move quickly into the democratic camp. These include: Benin, Nigeria (the African continent's most populous nation), and Tunisia, which now are building democratic infrastructure and scheduling elections. Still others—Algeria, Burkina Faso, Cameroon, Congo, Ivory Coast, Gabon, Guinea, Guinea-Bissau, Mozambique, Niger, Sierra Leone, South Africa and Uganda—are considering, or beginning to implement, changes toward a democratic political structure. And many other African nations—Angola, Central African Republic, Chad, Ghana, Kenya, Madagascar, Mali, Morocco, Rwanda, Swaziland, Tanzania, Togo, Zaire, Zambia and Zimbabwe—are either facing intense pressure to democratize or have begun making some steps in this direction.

The importance of greater levels of democracy in Africa is not merely that political liberty will likely entail an improvement in Africa's abominable human and political rights record, but that it also is likely to lead to economic accountability. In Africa, the statist economic policies pursued by many African autocrats—price controls on agricultural produce, state-owned farming, industry, and manufacturing, lack of private property rights, and others—are vastly unpopular. So when a democratically elected African government is forced to defend these policies, it is likely to find extensive opposition, which likely will lead the government to abandon these ill-advised policies. This could be the first step toward genuine development in Africa.

As prospects for democratization heighten, there exist signs that various American institutions are preparing to respond to these rumblings for democracy. The U.S. Agency for International Development (AID), for instance, is considering launching a major initiative designed to support democratization in Africa. Last December, AID released a report entitled "The Democracy Initiative," which calls on AID to play a far more assertive role in encouraging democratization in the regions in which it operates, including Africa. However, it remains to be seen whether AID will adopt the report's recommendations, which include: 1) strengthening democratic institutions by providing expanded AID support for "effective electoral bodies, informed legislatures and independent judiciaries, as well as broader civic associations"; 2) integrating democracy into AID programs by making "the promo-

tion of democratic institutions and processes" a strategic goal; 3) considering progress toward democratization as a factor in the allocation of AID funds; and 4) establishing a "rapid response mechanism," through which AID would be granted legislative authority to respond quickly in providing assistance to new democracies.

Echoing the arguments of many African analysts in the West, the AID report contends that "there is growing evidence that open societies which value individual rights, respect the rule of law and have open and accountable governments provide better opportunities for sustained economic development than do closed systems which stifle individual initiative. Democracy, therefore, is an economic development issue, as well as a political one."

In addition to AID, the Washington-based National Endowment for Democracy (NED) also is taking a greater interest in Africa. This year's budget for democracy-building programs in Africa is $750,000, up from around $300,000 in 1990. Last November, NED sponsored a conference in Dakar, Senegal on "The Consolidation of Pluralistic Democracy," which centered on the challenges and opportunities for democratic gains in Africa. The conference drew over 100 participants from 18 African nations, Europe, Canada, and the United States.

The prospect for a greater commitment to democratization in Africa by AID and NED increase the likelihood that democracy will gain further ground in Africa. But they also raise the question of where democratization will stand on the list of priorities of American policy toward the continent. Last year, Washington sent $1.06 billion in foreign economic aid, and an estimated $38.73 million in military aid to Africa. Some members of Congress, led by **Dan Burton**, the Indiana Republican who serves as the ranking minority member of the House Africa Subcommittee, want to see U.S. aid to Africa tied to the respective countries' progress toward democratization. This sort of policy, if implemented, is likely to dramatically increase the pressure on African autocrats to open their political systems.

Regardless of what policies are eventually pursued, the prospects for democratic, free market change in Africa, combined with the possibility that Washington may support such change, already is altering the attitudes of many Africans who are becoming less inhibited in expressing their support for economic and political freedom.

When the prime minister of once-socialist Mozambique, **Mario Machungo**, was asked recently what advice he would give black South African political leader **Nelson Mandela**, Machungo replied: "Do not try to impose central planning or socialism. We have learned from bitter experience that they do not work." And in Nigeria, the *Washington Post* reported last month, a gathering of council members in Lagos already seems to be getting the message about democracy. "To make [democracy] work," political educator **Elizabeth Atiomo** reportedly told the group in December, "we must finally have good government. That is the only way. We must have government of the people. . ."

Before she could finish, the crowd joined in: ". . . by the people, for the people."

"That's exactly right," Atiomo said, clapping her hands in delight. In Africa, the seemingly most hopeless, most autocratic region of the world, a glimmer of hope—political liberty—is gaining converts. But where the movement goes from here could depend largely on the West's response.

For further information on democracy in Africa, see "A Dose of Democracy," **Developing World Monitor**, *Volume 1, No. 1, May 1990, pp. 1-2.*

DWM

The African Capacity Building Initiative--Toward Improved Policy Analysis and Development Management

World Bank 1991

Introduction

The African Capacity Building Initiative (ACBI) is aimed at building and strengthening local capacities in policy analysis and development management in Sub-Saharan Africa. The African Development Bank, the United Nations Development Programme, and the World Bank are the lead cosponsors of the ACBI. The Initiative represents a broad partnership between Sub-Saharan African countries and the international donor community.

The ACBI is a framework that will evolve as it is implemented. It addresses the major parties working in this field—principally, African governments, and donor organizations—and proposes a new partnership between them to build, over the long term, a critical mass of professional African policy analysts and economic managers and to ensure the more effective use of those already trained. The ultimate objective is substantially improved indigenous analysis and management of Africa's economic and development processes.

The ACBI recognizes the shortage of a wide range of development management skills in Sub-Saharan Africa. The need for capacity building is very broad indeed. In light of the current economic crisis facing the region, however, the ACBI focuses on policy analysis and development management—because these skills are crucial and affect all other development issues. The scope of the Initiative is thus clearly defined and relatively modest, but its impact should be deep and widespread.

Essential goals of the ACBI are to build professional policy analysis and development management skills and institutions in Africa and to enhance utilization of already existing resources; to create a forum for full and active African participation in the design and implementation of capacity-building programs; to improve donor coordination and help develop greater focus, prioritization, and rationalization in the development of economic policy research and management capacity—leading to substantial cost savings as well as improved programs; and to mobilize financial and technical resources for increased investment in human capital and institutions in Africa on a consistent and long-term basis. These features are too often lacking in current approaches to capacity building in policy analysis and development management in Africa.

The ACBI's action program includes new interventions and strengthens effective ongoing actions. There will be a focus on six principal components:

- The rehabilitation and improvement of selected **national institutions**—already existing departments of economics or public administration in universities or colleges, or research and management institutes
- The building or strengthening of a small number of **regional institutions** for policy analysis and development management; these regional centers would be principally training institutions in policy analysis and development management skills, and sources of policy analysis and advice.
- The strengthening or creation of government **policy units** in the Office of the President, Ministries of Finance, Planning and Central Banks
- The provision of **fellowships** to support selected African individuals in their research and training needs
- The expansion of **in-service training** and work experiences for African professionals
- The strengthening of **local consulting firms**, professional associations, and other nonofficial organizations.

The mutually reinforcing linkages among these

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components will be emphasized, including the anticipated positive impact on both the public and private sectors. It is also recognized that the proposed ACBI action program will need to be carefully phased over a long period and rigorously evaluated. The intention is to start out gradually and build upon experience.

In order to implement the action program, new mechanisms will be needed to help coordinate interventions and mobilize resources. Three major mechanisms are proposed through which the ACBI will function:

• **An ACB Fund** to support actions to build capacity in policy analysis and development management in Sub-Saharan Africa. The Fund, comprised of contributions from donors, will also be used to support an ACBI administrative structure (described below). Financing from the Fund will be on a grant basis. The Fund is a central component of the Initiative and will allow the ACBI to provide direct continuity of financial support for capacity-building actions. An amount of US$100 million is proposed to support the ACB Fund over the first four-year period.

• **Cofinancing** is another mechanism whereby donors may join some of their current capacity-building resources with financing from the ACB Fund, and direct those resources to support a specific capacity-building program or institution.

• **Associated programs** are a third mechanism whereby donors can design and implement their own capacity-building actions, but inform and liaise with the ACBI in order to enhance coordination. By associating their programs with the ACBI, donors will help to create a central networking and information-sharing center from which they and African recipients will benefit.

These various mechanisms for implementation will provide a flexible environment for capacity building in policy analysis and development management in Africa.

To coordinate ACBI actions, and to manage the ACB Fund, it is proposed that a new institution, the **African Capacity Building Foundation (ACB Foundation)**, be established, with a small administrative structure as follows:

• **A Board of Governors** consisting of donors and African contributors to the ACB Fund.

• **An Executive Board of Directors** consisting of African and non-African experts in the field of policy analysis and development management. The Executive Board will approve the ACB Foundation's work program and be custodian of the ACB Fund.

• A small **Secretariat**, consisting of talented and experienced professionals, and an Executive Secretary (appointed by the Board of Executive Directors) to operate the ACB Foundation's work program. The Secretariat will be responsible for identifying programs, monitoring and evaluating operations and committing the ACB Fund resources under mandate of the Executive Board. The ACB Foundation Secretariat will also play the principal coordinating role among donors and African institutions. The Secretariat is to be located in Harare, Zimbabwe.

These administrative arrangements will provide for the requisite technical and financial oversight of the ACBI and ensure the strong participation of Africans in the program.

The ACBI should be viewed as a pilot program in its initial, four-year phase. It will be rigorously monitored and evaluated and its continuation and level of support will be contingent upon its proven effectiveness. It should be emphasized, however, that capacity building in Africa is a long-term objective.

The opportunity for a concerted international effort to build African capacity in policy analysis and development management now exists. Donors recognize the need for improvement in their approach in this area. African governments, many of them already engaged in economic reform efforts, are also increasingly cognizant of the urgent need for internal capacity to analyze and manage their economic programs.

On April 26, 1990, the World Bank's Board of Executive Directors approved Bank participation in and strong support for the ACBI. The Bank's Board approved a contribution of up to 15 percent of an anticipated total ACB Fund of US$100 million. The Board also urged other donors to contribute as soon as possible. To this end, the World Bank convened a meeting of donors in Paris in June 1990 to formalize donor support and financial commitments for the ACBI, and to exchange views on the ACBI's proposed program components and implementation arrangements. Donors expressed strong support for the objectives of the ACBI and indicated willingness to contribute to the ACB Fund. The ACBI will begin operation in 1991.

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Public Reference Bureau

Fertility Drops in Some Countries of Sub-Saharan Africa

For the first time, national fertility declines are being documented in Botswana, Kenya, and Zimbabwe–three countries of sub-Saharan Africa. High fertility combined with declining mortality had produced levels of population growth in the region that were among the highest ever recorded. Population policies and family planning programs in sub-Saharan Africa have tended to lag behind other regions due to low levels of socioeconomic development, traditional values that favor large families, poor service delivery infrastructure, and lack of information upon which to base population policies.

Currently, women in sub-Saharan Africa have an average of 6.4 children. Only an estimated 10 percent of couples use contraception.

Yet, recent surveys in African countries indicate a high potential demand for family planning. Substantial numbers of women not currently using contraception want no more children or want to space births. A 1989 Kenya survey found that 26 percent of currently married women interviewed wanted to wait at least two years before their next birth, and an additional 49 percent wanted no more children. Yet, only 27 percent of all married women were using any contraception.

The use of contraceptives is rising in the three countries surveyed. Between 1984 and 1988-1989, contraceptive prevalence (modern plus traditional methods) rose from 16 to 33 percent in Botswana, 17 to 27 percent in Kenya, and 38 to 43 percent in Zimbabwe. Lifetime births per woman dropped from 6.5 to 5.0 in Botswana, from 7.7 to 6.7 in Kenya, and from 6.7 to 5.3 in Zimbabwe.

During the 1980s, many sub-Saharan African countries began developing comprehensive national population policies and expanding family planning programs.

–Virginia H. Poole

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Journal of Commerce, January 11, 1991

Looking in a Marxist Mirror

By LOUIS O. KELSO
and PATRICIA HETTER KELSO

Now that the Marxist-Leninist economies have failed in practice, the Soviet Union, Poland, Hungary, Czechoslovakia and the other Eastern European nations are resigning themselves to the Western-style market economy as the only viable alternative.

To Marxian-molded sensibilities, of course, this decision is the economic equivalent of re-enthroning the czars. The West, however, sees it as the ultimate confirmation of a system that the Marxist-Leninists vowed to destroy — and for the better part of this century, did their best to destroy. Magnanimous as usual in victory, our side is dispatching cadres of well-meaning free market missionaries — bankers, economists, accountants, lawyers, marketers, stockbrokers, communicators and other presumably indispensable professional talents — to fill the ideological and institutional void before anarchy rushes in. President Bush has even proposed that the United States formalize this redemptive mission by organizing task forces to tutor the fallen Marxists in free market theory and discipline.

But the Western market economy, however enviable it may seem to those still mired in varying stages of pre-industrial poverty or post-industrial socialist poverty, more closely resembles in several fundamental respects the ship the socialists are trying to jump rather than the one they are sighting to board. Private property is as indispensable to the free market as it is to political liberty.

Although ideologically committed to the institution of private property, Western industrial economies, like their socialist counterparts, rely on ever higher levels of income redistribution to stave off market collapse. The world regards the United States, for example, as capitalism's flagship. But more than half of federal, state and local taxes — collected from those who produce higher incomes (mostly through their capital) — are redistributed in the form of welfare payments, open or disguised, to those who earn low incomes or none.

In other words, the communist principle of distribution, "to each according to his need," is also an operational expedient of the Western-style free market. Ownership of capital, private in theory and on paper, is, in fact, socialized through coerced redistribution. In economies like the United States, where redistribution depends heavily on taxation, ever larger deficits make up the shortfall between income and expenditures.

Both market and socialist economies have exploited the Cold War — "communist threat" — to justify their massive redistributive spending.

Both the socialist and the Western free market models are dominated by monopolies. Both are committed to the same economic goal, i.e., full employment, with its social end product, proletarianization. What is a proletarian, after all, but an individual who owns no capital and thus is doomed to total economic dependence on labor or welfare? That description covers most of the citizens of Western industrial democracies, including the United States. Theoretically everyone may own capital, in reality, ownership is concentrated at the pinnacle.

Both the socialized economy and the Western market economy produce a high standard of living only for their respective elites — nomenklatura there, plutocracy here.

In both economies, poverty is endemic, ineradicable and spreading.

The U.S. budget deficit is itself an important measure of the economy's failure to operate on current account. The free market is an input-outtake system. Its logic is simply double-entry bookkeeping. Productive input on one side delivers income outtake on the other, with the "invisible hand" being the private property mechanism that competitively evaluates individually owned capital and labor, keeping productive input and distributive outtake in balance. A successful market economy has no permanent deficits, either budget or trade.

Why, then, does the U.S. economy have perpetual and ever-rising budget deficits? Because the government must borrow money to support redistribution. Why redistribution? Because a majority of the people, as producers, cannot, through their labor alone, even when wages and salaries are coercively and progressively inflated, earn enough income to buy the goods and services primarily produced by capital that they do not own.

In other words, people are not personally equipped by ownership with enough productive power to enjoy the fruits of the Industrial Revolution even at its present stage. As technological change progresses, the gulf between production and market-supported consumption (as distinguished from consumption supported by government redistribution) can only grow wider.

The moral of this story is that the West only partially comprehends the market economy as Adam Smith first identified and analyzed it. We remain curiously oblivious to the impact of the Industrial Revolution, now well into its third century, on Mr. Smith's free market rules and logic. Thus, Western free market tutorials can only in the long run teach the Soviet Union and Eastern Europe to imitate a system that cannot operate without socialist-style redistribution and Keynesian-style deficits. As the French say, "The more things change, the more they remain the same."

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Summary and Conclusions

(i) Only some twenty years ago Indonesia was one of the poorest countries in the world. In 1967, Indonesia's GNP per capita was US$50, roughly half that of India, Bangladesh and Nigeria. Poverty was widespread throughout the country; the earliest estimates of poverty indicated that in 1970, 60% of the population or 70 million Indonesians were living in absolute poverty. Beginning in the late 1960s, the Government adopted a development strategy, which has been pursued through successive five-year plans, with a commitment to broad-based economic growth, particularly rural development. This was also an appropriate strategy for poverty reduction, as the bulk of Indonesia's population and its poor resided in rural areas.

(ii) The Government's development efforts were focused primarily on agriculture (especially rice), education, and transport infrastructure. The emphasis was on increasing incomes and employment through the productive use of Indonesia's labor and natural resources; there was little reliance on direct transfer programs, consumer subsidies or public employment. Many of these programs and policies established in the early 1970s continued to contribute to the economy's growth and poverty reduction through the late 1980s. As a result of these efforts, dramatic gains in poverty reduction were achieved beginning in 1978, primarily due to the performance of the rice sector. The percentage of the population below the official poverty line declined from 40% in 1976 to 22% in 1984. Although the incidence of poverty was still high in 1984 with about 35 million people in absolute poverty, this was nearly 20 million fewer people than in 1976. Income inequality also declined moderately during this period. This impressive performance in poverty reduction during the late 1970s and early 1980s provided an important backdrop to trends in poverty during the adjustment period (1983-88).

Trends in the Incidence of Poverty during the Adjustment Period

(iii) Beginning in 1983, sharp drops in the price of oil and associated changes in the international economy drastically altered the economic environment. While Indonesia is generally credited with having implemented a successful macroeconomic adjustment program, there have been concerns about the social costs of the adjustment effort.

(iv) During 1984-87, per capita incomes, as recorded by the National Socioeconomic Survey (SUSENAS) increased by about 16%. Rural areas experienced a faster rate of growth than urban areas, indicating that the benefits of economic growth during this period favored rural areas. However, mean incomes in 1987 in urban areas remained substantially higher than in

rural areas. Income inequality also continued to decline during the adjustment period, with the expenditure shares of the lowest income groups increasing.

(v) Measuring the incidence of poverty and its trend is more difficult, as the choice of a "poverty line" inevitably involves a number of assumptions. According to the Official Poverty line, which is based on 2,100 calories and an allowance for essential nonfood expenditures, there was a decline in the incidence of poverty over these three years, from 22% in 1984 to about 17% in 1987, implying an absolute decline in the number of poor Indonesians from about 35 million in 1984 to about 30 million in 1987. Other estimates of the incidence of poverty, including alternative estimates prepared for this report, also indicate a significant decline over this period. This trend in poverty is also supported by an analysis of food expenditures and caloric intake levels. Mean caloric intake levels increased by about 6% during this period. Moreover, the proportion of Indonesia's population who could be considered malnourished declined.

(vi) As noted above, a significant number of Indonesians have moved out of absolute poverty in the last decade. This is particularly impressive given the difficult economic situation which Indonesia has faced since 1983. However, many Indonesians, the "near poor", have incomes only marginally above the absolute poverty line. These individuals remain extremely vulnerable to changes in their economic circumstances and the Government's strategy for poverty reduction needs to be designed to improve their welfare, as well as those at or below the poverty line.

(vii) The decline in the incidence of poverty observed in aggregate for Indonesia varied across regions and according to the principal source of household income. Dramatic declines in the prevalence of poverty were realized in rural Java. The eastern areas of Indonesia also experienced declines in aggregate, but the incidence of poverty remains high in these areas. Moreover, the incidence of poverty declined across all sectors of the economy, as measured by the principal source of household income. By 1987, two broad conclusions about the distribution of the incidence of poverty were apparent: (i) geographically, poverty has become more concentrated in specific locations in Java, and in the eastern areas of Indonesia; and (ii) sectorally, poverty is concentrated in agriculture, as the vast majority of all poor households identify agriculture as their principal source of income.

Factors underlying the Reduction in Poverty during the Adjustment Period

(viii) The Government's success in reducing poverty during the adjustment period is attributable to the conditions prevailing prior to the external shocks, and the nature and speed of the Government's policy response to these external shocks. One important precondition was Indonesia's low expenditure inequality, which permitted large reductions in the incidence of poverty to be generated from modest growth in per capita consumption. A second precondition was the Government's past development strategy, which had established a strong rural economy especially on Java, and put into place an extensive network of social and physical infrastructure. The benefits from these programs and policies provided an impetus to income growth and employment during the adjustment period.

(ix) The Government's response to the external shocks was also a key element in the reduction of poverty achieved during this period. By undertaking both prompt macroeconomic adjustment measures and comprehensive structural reforms, the Government was able to achieve significant progress in economic adjustment, while maintaining positive growth rates throughout the period. At the same time, the evidence is that poverty declined. This was possible because the adjustment program contained elements which were geared towards sustaining progress on poverty reduction. Two elements were particularly important. First, the pace and pattern of economic growth was sufficiently robust to allow improvements in real earnings for most workers in lower income groups. In the agricultural sector, the adjustment burden was lessened by the exchange rate depreciations which largely offset lower agricultural export prices, agricultural pricing policies, and some diversification away from rice towards more profitable nonrice crops. In the manufacturing and service sectors, the combination of trade and industrial deregulation and real exchange rate adjustments led to a surge in non-oil exports and a rapid recovery in manufacturing growth and investment, as well as an increase in real wages and employment levels. Second, the Government's management of the public expenditure program ameliorated the effects on the poor of the expenditure reductions. The overall strategy was to cut public investment and preserve public consumption, allowing the productive use of much of the infrastructure created during the 1970s and early 1980s. Furthermore in reducing development expenditures, expenditures in "poverty-related" sectors--agriculture, human resource development and transfers to lower-level governments--were protected relative to public expenditures of less benefit to the poor, notably in industry and mining.

The Nature of the Poverty Problem

(x) Despite the progress made in the past two decades, poverty reduction remains a Government priority for several reasons:

(a) the number of poor remains high. There are about 30 million Indonesians still living in absolute poverty and a large portion of the population, the "near poor", have incomes only slightly above the poverty line;

(b) the regional variance in the incidence of poverty is also high. Large proportions of the population are still poor in a number of areas, particularly in the eastern areas of Indonesia;

(c) Indonesia still lags behind other Asian countries in a number of social indicators, such as life expectancy, infant mortality and nutritional status;

(d) labor force growth will be high during the 1990s, with about 2.4 million people p.a. expected to enter the labor market during the decade.

Designing a program to achieve further poverty reduction and more balanced regional development will be a key challenge to the Government during the 1990s. Moreover, the changed nature of the poverty problem necessitates some

changes in the Government's approach to poverty reduction, as recognized in REPELITA V, in order to reach those groups and areas of the country which have benefitted relatively less in the past.

(xi) One important aspect of the changed nature of the poverty problem is the shift in the spatial incidence of poverty. An analysis of the regional incidence of poverty in Indonesia and its trend indicates two important characteristics. First, income gains during the 1980s in Indonesia have not been evenly distributed across the provinces, with corresponding variations in the reduction of poverty. Moreover, the incidence of poverty remains high in the eastern part of Indonesia. Second, the bulk of the poor, about 66%, still reside on Java. However, unlike the situation in the 1970s where poverty was widespread in Java, it is now concentrated in specific areas that could be more effectively reached by existing Government programs.

A Strategy for a Sustained Reduction in Poverty

(xii) The first thrust of a poverty-reduction strategy is sustained economic growth. Economies with sustained economic growth and increased efficiency of resource use have generally experienced significant reductions in poverty. Indonesia's own experience demonstrates that growth and poverty reduction are largely complementary. Further reductions in poverty, therefore, require a continuation of the Government's macroeconomic policies designed to maintain a high rate of economic growth as well as sectoral policies aimed at improving private sector profitability. This entails implementation of the Government's program of deregulation of trade, industrial and agricultural policies, and efforts to strengthen support services, especially in finance and transport.

(xiii) While these general macro-policies will help sustain the economic growth necessary for poverty reduction, the benefits of economic growth may accrue only slowly to certain groups of the poor or certain disadvantaged areas of the country. This is demonstrated by the regional variations in growth and hence, poverty reduction which has occurred in Indonesia during the 1980s. As the Government recognizes in REPELITA V, macroeconomic policies, therefore, need to be supplemented by additional measures in order to reach disadvantaged groups and areas more effectively.

(xiv) In this regard, several measures could be considered by the Government. First, providing the poor and underemployed with greater access to Indonesia's available land resources and improved agricultural technology can make an important contribution. In the Outer Islands, there is a substantial amount of underutilized and degraded land that could potentially be made available. Much of this land is suitable only for activities such as tree crops, which require a relatively high degree of infrastructure and inputs, including appropriate financing. Second, Central Government transfers to local governments are another vehicle to stimulate income-generating activities and employment particularly in poorer areas. The INPRES program is a potentially important instrument in this regard, and there may be scope for targeting these expenditures more effectively to poorer areas. In the 1990/91 budget, the Government made important steps in this direction through modifications in the allocation criteria for the General INPRES. Third, increasing the effectiveness of small-scale credit schemes to raise incomes

and employment in agriculture, micro-enterprises, and the informal sector can also make a contribution to poverty reduction. The many existing programs need to be rationalized, with an emphasis on improving the access of the poor to these schemes rather than on providing "subsidized" credit. The KUPEDES program administered by Bank Rakyat Indonesia could serve as a model in this regard. Finally, as the Government recognizes in REPELITA V, measures to target human resource development towards the poor are needed. This would have both an investment effect, in the form of augmenting the human capital of the poor leading to increased productivity and incomes, and a consumption effect, by improving present welfare. This is true for the social services--health, education and nutrition--as well as other basic services--water supply, sanitation and related infrastructure--which directly affect living conditions and hence health status.

(xv) In REPELITA V, the Government recognized the magnitude of the poverty problem in Indonesia and the need to mount an intensified effort to reduce poverty. First, the Government reiterated its commitment to a process of growth and structural change with an emphasis on developing an efficient manufacturing sector, supporting the agriculture sector and providing the infrastructure necessary for sustaining a rapid rate of economic growth. Second, in order to address more directly the needs of the poor, the Government is undertaking a number of poverty-related programs during the REPELITA V period, some are new programs being initiated and others are existing programs which are being strengthened. The Government will: (i) promote the even distribution of social and basic services; (ii) provide water to lower-income groups in water-stressed urban slum areas and in rural areas; and (iii) stimulate development in poorer areas through a series of integrated area development projects. These programs constitute an important effort at poverty alleviation for the REPELITA V period. The success of these initiatives will depend upon the Government's ability to identify the needs of the poor, particularly in agriculture and in the social and basic services, and target the programs towards these needs. In addition, the development of an appropriate institutional setting for coordinating and complementing these programs will also assist in achieving the Government's objectives.

Sustaining Agriculture's Role in Poverty Reduction

(xvi) The agriculture sector has made a major contribution to Indonesia's economic development and the reduction in poverty. Agriculture remains central to the Government's growth and poverty reduction strategy. This is because poverty is still heavily concentrated in agriculture, with about three quarters of all poor households in Indonesia deriving their principal source of income from agriculture. Achieving further reductions in the incidence of poverty in rural areas, however, will be more difficult because rice is unlikely to provide the same impetus to economic growth and employment generation as in the past.

(xvii) During REPELITA V, the Government, therefore, is making a concerted effort to foster new sources of growth in nonrice food crops, smallholder treecrops and nonfood farm activities, especially in the Outer Islands and to strengthen the poverty content of existing agricultural

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programs. The first thrust of a poverty reduction strategy in agriculture is to maintain a high rate of agriculture growth and thus alleviate poverty directly through raising the productivity and hence, incomes of small farmers, as well as producing affordable food for domestic consumers. Achieving this goal will entail a progressive deregulation of area and production controls to permit farmers greater latitude in choosing their crop patterns in response to market signals; encouraging more private sector participation in agricultural production, processing and marketing; and, improving the economic and financial efficiency of sector operations. This growth strategy will benefit the poor, since the greatest potential for growth is locked up among the least productive and poorest smallholders who cultivate secondary crops and treecrops.

(xviii) The second thrust of a poverty reduction strategy in agriculture is to ensure that mainline agricultural programs reach the poor more effectively. Currently, many agricultural programs are still primarily focussed on irrigated rice farmers and treecrop farmers in Government-sponsored schemes. Building a more deliberate focus on other crops and poor farmers in agricultural support services and commodity development programs will make an important contribution to further reductions in poverty. As demonstrated in Indonesia during the 1970s and 1980s, the most important contribution that the Government can make is to offer small farmers a mix of technology through research and extension, financing through rural credit, and infrastructure particularly irrigation, to expand their productivity and incomes. Broadening these Government programs into nonrice food crops and nonfood farm activities is, therefore, a key challenge for the Government during REPELITA V. Similarly in treecrop development, past programs have benefitted only a small proportion of existing estate crop producers. To unlock the potential of the mass of unassisted smallholders, there is a need to develop, test and disseminate technical packages that can be applied on a larger scale. Another important priority of the Government is fishing families, as they probably constitute the poorest segment of Indonesian society A strategy to reach these fishermen would increase their efficiency through better boats, fishing gear and supporting services in areas where fish are plentiful, but in other areas aquaculture and other area development initiatives would be a more appropriate strategy.

(xix) Despite the scope for improving agricultural growth and the poverty focus of existing agricultural programs, some of the poorest households will still not be reached, due to their lack of capital (particularly land), illiteracy, or geographical isolation. The Government has therefore recognized the need to supplement ongoing subsectoral programs with special programs specifically targeted at the poor. There are two basic approaches. The Government is targeting areas through an area development approach. In this regard, Government efforts to ensure the sustainability of these programs through strengthening the implementation capacity of local governments and developing techniques that can be replicated through regular sectoral programs will be important. The Government is also targeting poverty groups through an ongoing pilot project supported by FAO/UNDP, Income Generating Project for Small Farmers (P4K). The P4K has much to offer as an instrument for reaching the poor, and therefore, merits support.

Improving Social and Basic Services for the Poor

(xx) Improving access to and the consumption of basic services (education, health, family planning and water supply and sanitation) is a necessary condition for the Government's poverty reduction programs to be successful in the long run. These interventions address the most severe consequences of being poor. But they also constitute investments in human capital which provide the basis for long-term poverty reduction.

(xxi) Education plays an important role in reducing poverty over the long term, by providing the poor with the skills necessary to raise their productivity and incomes. Primary education or its equivalent are critical for this, as shown by the high social rates of return to primary school education in Indonesia. In the past decade, the Government has made a concerted effort to improve the availability of education. This program has succeeded in providing access to primary schooling to virtually all Indonesian children of primary school age. This expansion of primary schooling is one of the most successful cases of large-scale school system expansion on record.

(xxii) The nearly complete coverage of primary schooling leaves little room for differentials in enrollment by income class. Equalizing educational opportunities at primary level is, therefore, principally an issue of equalizing the quality of education. Income-related quality differentials still remain in both primary and secondary education. One indicator is primary school repetition rates, which vary across provinces. The differences in quality arise from differences in the capacity of individual communities to supplement limited budgetary resources. Thus, those communities or individuals that cannot afford to pay higher fees face a lower quality of education because their schools do not have the complementary inputs necessary to improve education quality. The problem is that the allocation of Central Government funds for primary education does not currently compensate for the inability of poor areas to mobilize local resources.

(xxiii) The Government has stated its commitment to raising the quality of basic education under REPELITA V. Two policy measures would help improve the access of the poor to the full benefits of education. First, while primary school enrollment is virtually complete, there is evidence that inability to pay the costs of schooling increases primary school drop-out rates among the poor and is a deterrent to school attendance among the poor at higher levels of schooling. The Government might consider providing financial support to the poor for this purpose. Second, there is scope to improve the quality of primary and secondary education provided to poor children and in poor areas. The most important needs are for adequate financing of essential supplies such as textbooks, teacher's manuals and chalk together with improving teacher quality through in-service training. Some reorientation of budgetary priorities within the education sector would therefore be appropriate. In particular, increasing budgetary outlays for improving the quality of primary education, while restraining the growth of public expenditures and increasing cost recovery for higher education, would improve the efficiency and equity of the system. In addition, it will be essential to develop a proper mechanism for directing larger subsidies to primary schools in poor communities.

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(xxiv) Non-formal education (NFE) also has a role to play in poverty reduction. First, there is a close association between illiteracy and poverty. About one third of the poor are illiterate and almost 50% of the poor above the age of 29 are illiterate. Second, since the rapid expansion in primary school enrollments occurred only in the early 1980s, many older Indonesians have not had the opportunity to acquire the basic education skills needed to participate actively in the labor market. The Government has a number of programs designed to teach basic literacy and numeracy, raise community awareness, and support local income generating activities. The options to improve NFE during the REPELITA V period include: (a) expanding the resources available to these NFE programs; (b) increasing the number of extension workers, as well as improve their training in the income generating aspects of NFE programs; and (c) targeting NFE activities to those areas where poverty is the highest.

(xxv) Indonesia's record of mortality reduction has been solid and impressive. A key indicator is infant mortality, which has been roughly halved in the past two decades. However, the poor have benefited less from the progress in mortality reduction than the nonpoor. In addition, the sick poor use fewer modern curative health services than the nonpoor. Most of this difference in outpatient visits is due to the higher use of high-quality providers (doctors and hospitals) among the nonpoor. Hospital admission rates for the nonpoor average three times those of the poor. Moreover, overall these rates are extremely low in Indonesia, even for the nonpoor, compared to levels prevailing in other countries.

(xxvi) The low level of utilization of health services by the poor in Indonesia indicates a need to improve access by enhancing both the quality and quantity of available services. High priority needs to be given to raising recurrent expenditure on operations and maintenance inputs necessary to provide adequate service through fixed facilities and to improve the logistical support to preventive health facilities in the villages (POSYANDU). Key components of the effort to raise quality include: redistribution of specialist doctors from tertiary to lower level hospitals; increasing the supply of medical and paramedical staff to understaffed health centers; increasing the supply of health center drugs, which presently cover about three-quarters of annual requirements; and increasing the operational budget of health centers to ensure sufficient funds for travel in support of POSYANDU activities. On the investment side, priority could be given to increasing the supply of community health centers and subcenters in order to reduce travel time in poorer areas with more dispersed populations. Important steps were taken in this direction in the 1990/91 Budget; ensuring the implementation of these plans and adequate funding for operations and maintenance to new facilities will be important to the success of the effort.

(xxvi) Malnutrition increases the susceptibility to disease; it also affects school attendance and performance among children and labor productivity among adults. During the last decade, the incidence of malnutrition has declined throughout Indonesia, although it still remains high in some areas. The Government's nutrition program, which is now administered primarily through the POSYANDU, has two basic components: (i) a monthly weighing program; and (ii) IEC (information, education, and communication)

activities. During REPELITA V, the Government is committed to enhancing the effectiveness of its nutrition program. The most important improvement in the nutrition program would be the introduction of more effective supplemental feeding for children who suffer from severe malnutrition. Also, the Government's program could be better targeted by concentrating available resources and staff support on those areas where the incidence of malnutrition is high. Ensuring adequate logistical support from the health center network in these areas would make an important contribution to strengthening the program.

(xxviii) Improved water supply and sanitation in rural areas can have wide-ranging health, economic, social and environmental benefits. The greatest effect on health from the provision of rural water supply and sanitation (RWSS) is likely to come from improved sanitation facilities and an increase in water quantity. Furthermore, the benefits of RWSS can be especially important for women and children, as they play a major role in carrying water. RWSS service levels are low in Indonesia, with available coverage favoring water supply over sanitation and the nonpoor over the poor. The Government has committed itself to making an intensified effort in REPELITA V to increase substantially the coverage of RWSS. Options to increase coverage include: (a) a clear definition of institutional responsibilities and an effective coordinating mechanism; (b) the use of low-cost appropriate technology; (c) the use of a cost recovery mechanism to provide funds for the operations and maintenance of these systems with the capital cost provided through the INPRES program; and (d) the use of community-based groups in implementation to encourage local acceptance, provide education about health benefits, and help overcome the financial and staffing constraints of the Government.

(xxix) Progress has been made in improving access to safe drinking water in urban areas but disparities remain in the access between poor and nonpoor households. The situation for the poor is becoming critical, especially in the larger cities and the role of standpipes or a viable alternative has become increasingly important. Recognizing this, the Government has recently embarked on a major initiative to improve the access of the urban poor to water at affordable prices, involving a dramatic increase in the number of standpipes and deregulating the sale of water in Jakarta. Consolidating these initiatives into a long term solution to the water needs of the poor requires a further increase in the number of public standpipes, a strengthening of procedures for their operations and maintenance, and changes in the financing mechanism for the public standpipes program.

(xxx) Human waste disposal is generally unsanitary in Indonesian cities. This can have adverse effects upon human health, especially in crowded and congested urban areas. As with water, there is a disparity between the poor and the nonpoor, with almost one third of poor households indicating that they do not use formal sanitation facilities. Despite the need for and availability of appropriate technology, public expenditures on sanitation have lagged. The Government plans to give greater priority to the improvement of urban sanitation during REPELITA V. The focus will need to be on providing more and better toilets for poor households with on-site disposal. This could include the adoption of appropriate technologies on a larger scale, clarification of institutional roles, formulation of a list of

priority areas within cities, and greater involvement of the community. It is also important to improve the knowledge of poor urban residents about the benefits of sanitary disposal of human waste.

(xxxi) The Kampung Improvement Program (KIP) is a nationwide program for upgrading urban villages, particularly in lower-income communities and is, therefore an important mechanism for improving basic services for the urban poor. It provides a range of infrastructure at minimal standards including local roads, footpaths, drainage, water supply, public sanitation facilities and solid waste collection. In the past, this program has successfully focused on badly serviced areas in a number of cities. Recognizing its potential to address the needs of lower income groups, the Government is increasing its expenditures on the KIP program during REPELITA V. The effectiveness of expenditures in this area could be raised by more fully addressing community priorities, which is likely to result in more funding being allocated to sanitation, solid waste or water supply where the needs of the poor are the greatest. In order to improve the performance of these components, it will also be important to make complementary improvements to primary systems outside the kampung and to provide adequate funding for operations and maintenance.

(xxxii) Since the formation of the National Urban Development Corporation (PERUMNAS) to produce low cost housing and a home ownership financing program through the State Savings and Housing Bank (BTN) in 1974, Government housing programs have evolved from a relatively marginal activity to an important part of the housing market. During the REPELITA V period, the Government is undertaking efforts to target Government housing expenditures and in particular, subsidies more effectively to the poor. Several factors will be important to this effort. First, consideration could be given to expanding the range of housing products to make them more affordable and accessible to lower-income groups. Second, Government financing of low-cost/low-income rental housing also would assist the poor. Third, while significant steps have been taken to lower interest rate subsidies, the subsidies are not well targeted to the poor and need to be eliminated. To reach the poor, Government efforts could be directed towards the KIP program, which could be better targeted on low-income households. Finally, changes in the regulatory environment affecting the housing sector, such as improving land administration and adopting appropriate design and construction standards, would also serve to help the poor.

Developing an Institutional Framework for Poverty Reduction

(xxxiii) Given that the causes and consequences of poverty are multi-dimensional, antipoverty programs are by nature intersectoral. Formulating and implementing these programs necessarily entails the active involvement of many individual ministries, Government agencies, local-level governments, and community groups. International experience indicates that coordination is among the most difficult of government functions. Therefore, minimizing the need for intersectoral coordination during implementation will be an important factor in the success of antipoverty programs. Ex-ante planning for this should be an explicit objective of the Government in order to minimize difficulties in the execution of its poverty programs. In this regard, the

Government could establish a focal point in BAPPENAS to undertake these functions. Also in the line agencies, incorporating poverty reduction explicitly into a number of sectoral programs would help to ensure that mainline programs reach the poor more effectively. Finally in lower-level governments, there is a need to raise awareness of the Government's overall poverty-reduction strategy and in many cases strengthen planning and implementation capacity.

(xxxiv) This report has also identified a number of areas where community group could play a larger role in the design and implementation of poverty programs. Currently, there are a wide variety of community organizations in Indonesia: community self-help organizations; agencies that promote community self-help groups; religious, university, service and professional associations; and semigovernmental organizations. These organizations have already made important contributions to national development, which could serve as models for future collaboration with the Government in antipoverty programs. In family planning, private agencies have played a significant innovative role. Semigovernmental and social organizations have also made important contributions in improving health; most notably, the POSYANDU network relies almost exclusively on the Family Welfare Movement (PKK) at the village level. In irrigation, water users' associations, supported by the Ministry of Public Works, are beginning to play a larger role in maintaining and improving small-scale irrigation systems.

(xxxv) The Government has begun to recognize the importance of involving community groups more actively in its development programs. Both the Guidelines for State Policy (GBHN) and REPELITA V stress the need for more community participation. The Government could consider several initiatives during the REPELITA V period to foster community participation in the design and delivery of its poverty reduction programs: (i) allowing these organizations more scope for initiative is an important first step; (ii) continuing Government efforts to strengthen the Village Community Resilience Committee (LKMD) and PKK and make them more participatory; and (iii) expanding the use of community groups as consultants for training and assistance in community development, which will also help to educate Government officials about these groups and their potential usefulness. In the 1990/91 Budget, the Government took steps to strengthen village-level groups and foster more community participation.

MONDAY DEVELOPMENTS

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UNICEF Study Finds Improving Conditions For World's Children

Fewer children will die preventable deaths during the 1990s according to *The State of the World's Children* report. The annual data released by the United Nations Children's Fund (UNICEF) on December 20, 1990 noted that during this decade more children will be immunized and fewer will die before the age of 5 years, thus improving their chances for survival.

In 1981 only 15 percent of the children in the developing world were immunized. Today 80 percent of the children receive the necessary shots. Likewise, in the area of infant mortality, tremendous progress has been made. As we enter the new decade, a majority of countries in the developing world have been successful in lowering their infant mortality rate to 140 per thousand, a level at which experience shows parents have confidence that their children will survive and they begin to limit the size of their families.

The report which was released simultaneously from Berlin, Germany and Nairobi, Kenya also focused on the outcome of the historic World Summit on Children held September 29-30 and attended by 71 heads of state. Referring to this meeting, UNICEF's executive director, James P. Grant urged world leaders to honor the commitments made at the Summit to save and improve the lives of as many as 50 million children during the 1990s. "There could be no better measure of that commitment," states the report, "than progress towards the goals which a majority of the world's political leaders -- from both industrialized and developing worlds -- have already considered and endorsed."

The world leaders that attended the Summit gathering adopted more than 20 specific new goals for the year 2000. These include a one-third reduction in child deaths, a halving of child malnutrition, primary schooling for at least 80 percent of the poor world's children and a halving of the maternal mortality rate in developing countries. The heads of state also agreed to strive for universal observance of the Convention on the Rights of the Child which to date has been ratified by 67 countries and signed by 134. *The State of the World's Children* report includes the full texts of the Summit Declaration and Plan of Action and the Convention on the Rights of the Child.

"In sum," said Grant, "a great promise has been made to the children of the 1990s. Whether that promise will be kept is a question which will be answered not by the declarations of a day but by the deeds of a decade."

Copies of the report are available by writing to the US Committee for UNICEF, 100 Maryland Avenue, NE, Box 36, Washington, DC 20002.

NEWS RELEASE

COUNCIL ON FOREIGN RELATIONS

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PRESS BRIEFING NOTICE: Editor and contributing author Shafiqul Islam, Senior Fellow for International Finance at the Council on Foreign Relations, contributing author Masamichi Hanabusa, Consul-General of Japan in New York and Stephen Quick, Executive Director of the Joint Economic Committee will discuss *Yen for Development: Japanese Foreign Aid and the Politics of Burden-Sharing* on Tuesday, March 19, 1991 at 9:30 am at the National Press Club, National Press Building, 13th Floor, Zenger Room, 14 & F Streets, NW, Washington, D.C. Books will be available at that time. If you wish to attend, please contact the Public Affairs Office at (212) 734-0400 by March 14.

NEW STUDY SEES FOREIGN AID AS AREA FOR U.S.-JAPAN COOPERATION

New York, NY, March 1, 1991 — Japan's hesitant response to the Allied efforts in the Persian Gulf has reinforced the long-held perception that Japan is a selfish superpower that prospers under U.S. protection while shirking its international responsibilities. For some years now, Japan has been trying to reshape its global role and image by reducing the gap between its international commitments and economic capacity. One area where it has made the greatest strides in this effort is Third World development.

Japan has replaced the U.S. as the world's largest provider of official development assistance (ODA). It is now the top donor in 30 countries; it allocates 70 percent of its aid to low-income countries (whereas Washington allocates less than 50 percent to those countries); it gives more aid, mostly untied, to Sub-Saharan Africa than the United States does; and it gives more money to environment-related projects than any other donor. For a country that was repaying its own World Bank debts until July 1990, this is an astounding feat.

To examine Japan's expanding role in development cooperation and its implications for Japan's global position and U.S.-Japan relations, the Council on Foreign Relations organized a study group and invited distinguished Japanese and American aid and foreign policy experts to participate. The final outcome of that endeavor is a new Council study, *Yen for Development: Japanese Foreign Aid and the Politics of Burden-Sharing* (Council on Foreign Relations Press, March 1991). The study, edited by Shafiqul Islam, Senior Fellow for International Finance at the Council on Foreign Relations, examines the myths and misinterpretations

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that cloud the policy debate on Japan's aid program, reviews the role of the Japanese private sector in the Third World, and explores ways Japan can further strengthen and broaden its leadership role in development cooperation. One central conclusion of this volume is that while Japan's expanding commitment to the developing countries is enabling it to gradually assume greater global responsibility, it does not represent an answer to the burden-sharing issue as it is currently defined.

While *Yen for Development* points out that the global economics of development assistance do not fit well with the bilateral politics of burden-sharing, it identifies foreign aid as a potential area for U.S.-Japan cooperation and makes a number of concrete policy recommendations including:

- The policy debate on development assistance should focus more on the development needs of the recipients and less on the donor's narrow commercial interest. The discussion also should move away from an excessive reliance on a simplistic quantitative indicator such as the ODA/GNP ratio and qualitative indicators such as the share of basic human needs outlays in total aid to evaluate donor performance; instead there should be greater emphasis on the central issue of what makes development aid more effective in promoting self-sustaining development.

- The U.S. Congress should abandon its efforts for pressuring Japan to expand its development assistance program to address the question of burden-sharing. As no feasible expansion of development assistance can resolve this issue, such efforts will only create greater bilateral tension. Indeed, the concept of global partnership may be a better guide to U.S. foreign policy in today's multipolar post-Cold War World than the concept of burden-sharing.

- With a rapidly changing world, both Japan and the United States need to review and reform their foreign aid policies and programs. For Japan, the challenge is not to offer more money. It needs to allocate significant resources in developing human capital in order to strengthen its inadequate aid administrative capacity and assume a greater leadership role. For the United States, foreign aid policy should be re-oriented toward promoting development and away from fostering aid dependencies through "security charity" and "farm and arms assistance" programs.

(more)

- The United States must learn to share responsibility, rights and influence in international financial and development institutions with other major nations, notably Japan. The tendency to hold on to political power while prodding Japan to shoulder more of the financial burden erodes the credibility of American leadership, weakens the effectiveness of these organizations and hinders the emergence of a new world order conducive to promoting global peace and prosperity.

At a time when trade and investment frictions strain the bilateral relationship, development aid presents an opportunity for U.S.-Japan cooperation. Fruitful collaboration, however, will be possible only if the United States does not attempt to put "American minds to work with Japanese money," and both nations make a serious commitment to aid cooperation. *Yen for Development: Japanese Foreign Aid & the Politics of Burden-Sharing* is a timely and thought-provoking study that sheds new light on Japan's evolving global role and its implications for U.S. foreign policy.

The Council on Foreign Relations, established in 1921, is a nonpartisan and nonprofit membership organization dedicated to promoting improved understanding of U.S. foreign policy and international affairs through the free exchange of ideas.

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U.S. AND GLOBAL MACROECONOMIC TRENDS

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A Report to the Senate/House Committees on the Budget
The Economic and Budget Outlook Fiscal Years 1992-1996
Congress of the United States
January 1991

SUMMARY

The downturn in the economy and record outlays required to resolve failed banks and savings and loans will push the federal deficit near $300 billion in 1991. Not included in this estimate, but sure to add to it, are the costs of Operation Desert Storm. After 1991, as these factors begin to fade and as the savings from last year's budget agreement grow, the budgetary picture should brighten. By 1995, assuming that the new legal limits on discretionary spending are maintained, the Congressional Budget Office (CBO) projects that the total federal deficit will fall below $100 billion for the first time in 15 years and below 1 percent of gross national product (GNP) for the first time in 20 years.

CBO's budget projections assume that the U.S. economy is now in a brief recession, which will continue into the spring. After that, the prospects for a solid recovery with low inflation are good. Real GNP is projected to be flat in 1991 (on a year-over-year basis) and to grow by about 3 percent a year in 1992 through 1996.

THE BUDGET OUTLOOK

The Omnibus Budget Reconciliation Act of 1990, enacted late last year, included a record of nearly $500 billion in deficit reduction measures over the 1991-1995 period. The Budget Enforcement Act (Title XIII of the reconciliation act) established dollar limits on discretionary spending, a pay-as-you-go provision for most mandatory spending and revenues, and procedures to enforce these requirements. Although the Budget Enforcement Act does not contain fixed deficit targets, as were previously set in law, the spending cuts and tax increases contained in the reconciliation act should set the deficit on a downward trend after 1991.

Deficit Projections for 1991-1996

The budget baseline has traditionally been used to show what would happen if current budgetary policies were continued without change. For tax revenues and entitlement spending, the baseline generally assumes that laws now on the statute books will continue. For defense, international, and domestic discretionary spending, the projections are based on the most recent appropriations, increased only to keep pace with inflation. Under baseline assumptions, the deficit in 1992 would be the same as in 1991--$298 billion, or about 5 percent of GNP. The projected baseline deficit drops to $128 billion in 1995 but turns up slightly in 1996, when $14 billion in spending reductions and tax increases are scheduled to expire (see Summary Table 1).

SUMMARY TABLE 1. CBO DEFICIT PROJECTIONS
(By fiscal year)

	1990	1991	1992	1993	1994	1995	1996
			In Billions of Dollars				
Baseline Total Deficit	220	298	298	239	211	128	135
Assuming Discretionary Spending Limits[a]							
Total deficit	220	298	284	215	160	57	56
Deficit excluding deposit insurance	162	194	186	167	135	103	99
On-budget deficit[b]	277	360	354	294	258	170	185
			As a Percentage of GNP				
Baseline Total Deficit	4.1	5.3	5.0	3.7	3.1	1.8	1.8
Assuming Discretionary Spending Limits[a]							
Total deficit	4.1	5.3	4.7	3.4	2.4	0.8	0.7
Deficit excluding deposit insurance	3.0	3.5	3.1	2.6	2.0	1.4	1.3
On-budget deficit[b]	5.1	6.4	5.9	4.6	3.8	2.3	2.4

SOURCE: Congressional Budget Office.

a. The discretionary spending limits apply only through 1995. The 1996 figures are extrapolations.

b. Social Security and the Postal Service are outside the budget.

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The baseline no longer represents current budgetary policy, however, because the dollar limits for discretionary appropriations are below the levels assumed in the baseline. Adhering to these limits will require holding discretionary outlays below baseline levels by an estimated $13 billion in 1992, $22 billion in 1993, $46 billion in 1994, and $62 billion in 1995. Although the statutory caps do not extend beyond 1995, sticking to the caps through 1995 will also produce discretionary savings in 1996, as well as interest savings in all years. Assuming that discretionary spending is held to the caps, the deficit would be $284 billion in 1992, $57 billion in 1995, and $56 billion in 1996. By 1995, the deficit would fall to 1.8 percent of GNP in the baseline and 0.8 percent of GNP if the discretionary spending caps are effective.

While the total deficit measure discussed above has been the exclusive focus of attention in the past, two other deficit measures are now likely to be considered as well. The first is the deficit excluding deposit insurance spending--the best simple measure of the government's effect on the economy. In both 1991 and 1992, about $100 billion in federal spending will be required to close or subsidize the sale of insolvent savings and loan institutions and banks whose deposits have been insured by the federal government. By 1995 and 1996, however, the federal government's proceeds from selling the assets of failed institutions will cause deposit insurance spending to turn negative. These large year-to-year swings in deposit insurance spending do not represent changes in the federal government's effect on the economy and have little impact on interest rates. Excluding deposit insurance, the federal deficit is projected to rise from $162 billion in 1990 to $194 billion in 1991 and to decline slowly thereafter, as shown in the Summary Figure. In relation to the size of the economy, the deficit excluding deposit insurance declines from 3.5 percent of GNP in 1991 to 1.3 percent of GNP in 1996.

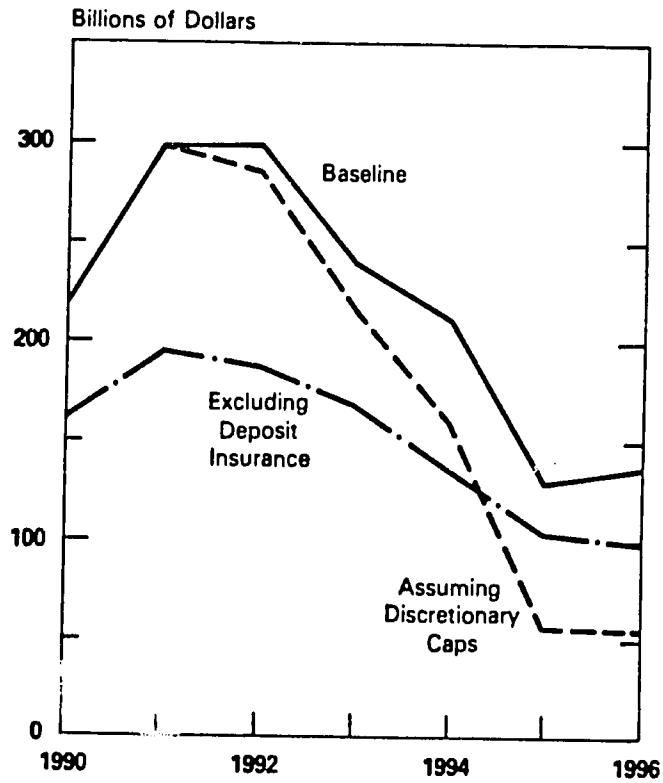
The second deficit measure that will receive attention is the on-budget deficit, which excludes the receipts and outlays of the Postal Service and the two Social Security trust funds. Assuming adherence to the discretionary caps, this on-budget deficit would be $360 billion in 1991, $354 billion in 1992, and $185 billion in 1996. From the

standpoint of economic policy, however, the on-budget deficit is not meaningful.

Changes in the Outlook Since July

While the long-term budget picture has improved since CBO's budget report last July, the short-term outlook has worsened considerably. The deficit reduction measures contained in the 1990 reconciliation act will be overshadowed for several years by a worsening of the economic outlook, higher deposit insurance spending, and other factors. As indicated in Summary Table 2, CBO estimates that the policies in the 1990 budget agreement will reduce the deficit by $33 billion in 1991, $69 billion in 1992, and $160 billion in 1995, compared with CBO's

Summary Figure. Deficit Projections



SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget.

July baseline. Over the 1991-1995 period, the package saves an estimated $482 billion--$264 billion from spending cuts, $158 billion from tax increases, and $59 billion in resulting savings on debt service.

For the next several years, however, changes in economic assumptions and other factors overwhelm the policy changes. CBO's new economic assumptions have increased the projected deficit by $50 billion in 1991, $63 billion in 1992, and $79 billion in 1995. These figures reflect both the current recession, which is temporary, and what appears to be a reduction in the economy's potential rate of growth.

SUMMARY TABLE 2. CHANGES IN CBO DEFICIT PROJECTIONS SINCE JULY (By fiscal year, in billions of dollars)

	1991	1992	1993	1994	1995	Cumulative Five-Year Changes
July Baseline	232	238	196	145	138	n.a.
Changes						
Policy changes						
Revenues	-18	-33	-32	-37	-39	-158
Entitlements and other mandatory spending	-9	-12	-16	-19	-19	-75
Enacted appropriations	-6	-6	-9	-12	-13	-46
Required reductions in discretionary spending	n.a.	-13	-22	-46	-62	-144
Debt service savings	-1	-4	-10	-17	-27	-59
Subtotal	-33	-69	-89	-131	-160	-482
Economic assumptions	50	63	63	70	79	n.a.
Technical reestimates						
Deposit insurance	23	20	7	32	-44	n.a.
Other	26	30	36	42	43	n.a.
Subtotal	49	50	43	74	-1	n.a.
Credit reform	0	2	3	2	a	n.a.
Total Changes	66	46	19	15	-81	n.a.
Current Estimate Assuming Discretionary Spending Limits	298	284	215	160	57	n.a.

SOURCE: Congressional Budget Office.

NOTES: The projections include Social Security and the Postal Service, which are off-budget.

n.a. = not applicable.

a. Less than $500 million.

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Changes in CBO's technical estimating assumptions have increased the projected deficits by an average of more than $50 billion per year in 1991 through 1994, but have reduced the deficit slightly in 1995. This pattern mirrors the changes in deposit insurance estimates, which average $20 billion higher in 1991 through 1994, but are $44 billion lower in 1995. In addition to upping the estimated short-run costs of the thrift bailout, CBO has substantially increased estimated spending in 1991 to deal with insolvent banks. CBO also projects faster growth in spending for Medicare and Medicaid. Other technical reestimates affect a wide variety of revenue sources and spending programs and add significantly to the costs of debt service.

THE ECONOMIC OUTLOOK

CBO believes that the U.S. economy has slipped into its ninth recession of the postwar period. Although the economic outlook is extraordinarily uncertain, this recession will probably be milder than the average downturn and will end by midyear. Several factors contribute to the likelihood of a relatively short recession:

- Inventories are relatively low compared with sales, and reductions in orders are therefore less likely than in previous recessions.

- Real exports are expected to remain strong as a result of the dollar's decline and a healthy growth in foreign demand.

- The war in the Persian Gulf is not likely to generate large disruptions in oil supplies.

- Inflation is lower than at the onset of earlier recessions, thereby permitting a further easing of monetary policy.

Forecast for 1991 and 1992

CBO's economic forecast incorporates a decline in economic activity in the fourth quarter of 1990 and the first quarter of 1991. Between the

fourth quarters of 1990 and 1991, real GNP is projected to grow by about 1½ percent (see Summary Table 3). Because the recession will expand the gap between actual production and the economy's capacity,

SUMMARY TABLE 3. COMPARISON OF CBO AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS

	Estimated 1990	Forecast 1991	Forecast 1992
Fourth Quarter to Fourth Quarter (Percentage change)			
Real GNP			
CBO	0.2	1.3	3.4
Blue Chip	0.2	0.9	2.8
Implicit GNP Deflator			
CBO	4.4	4.1	3.6
Blue Chip	4.5	4.0	3.6
Consumer Price Index (CPI-U)[a]			
CBO	6.1	4.0	3.5
Blue Chip	6.2	4.1	4.0
Calendar-Year Averages (Percent)			
Civilian Unemployment Rate			
CBO	5.5	6.8	6.4
Blue Chip	5.5	6.5	6.3
Three-Month Treasury Bill Rate			
CBO	7.5	6.6	7.0
Blue Chip	7.5	6.3	6.5
Ten-Year Treasury Note Rate			
CBO	8.6	7.9	7.7
Blue Chip	8.6	7.8	8.0

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1991); Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

a. CPI-U is the consumer price index for all urban consumers.

b. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

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higher growth will mark the recovery, as the economy catches up to its potential. For 1992, the growth rate is expected to rise to about 3½ percent.

The pain of a recession, however, will produce the traditional benefits of reduced inflation and lower long-term interest rates. The inflation rate is likely to remain between 3 percent and 4 percent on a sustained basis--significantly lower than it was during most of the 1980s. The interest rate on 10-year Treasury notes, which averaged 8.6 percent in 1990, is expected to fall to 7.9 percent in 1991 and remain low. Short-term interest rates should remain relatively low in the near term as the Federal Reserve continues to relax monetary policy, but will rebound as the economy recovers.

Projections for 1993-1996

CBO does not try to forecast short-term fluctuations in the economy more than two years into the future. Instead, for the 1993-1996 period, CBO makes projections based on trends in variables such as labor supply, productivity, and saving rates. CBO projects that potential GNP will grow on average by about 2¼ percent a year. This projection, which is slightly lower than CBO's estimates of last summer, reflects the July revisions to the national income accounts, which suggest that productivity has been growing more slowly in recent years than earlier reports had indicated. The projection of potential output also takes account of the expected slowing in the growth of the labor force, as well as the increase in the capital stock that will stem from reductions in the federal deficit. Real GNP is projected to grow at an average rate of 2.8 percent over the 1993-1996 period to close the gap between actual and potential GNP opened up by the recession (see Summary Table 4).

CBO's long-run projections of interest rates are set by reference to the historical pattern of interest rates and increases in national wealth. The reduction in the federal deficit will increase saving and capital formation, but increased European capital demands will offset the resulting downward pressure on interest rates. As a result, CBO projects real short-term interest rates in the mid-1990s of about 2 percent, and real long-term rates about 1½ percentage points higher.

SUMMARY TABLE 4. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1993 THROUGH 1996

	Estimated	Forecast		Projected			
	1990	1991	1992	1993	1994	1995	1996
Nominal GNP (Billions of dollars)	5,467	5,700	6,107	6,505	6,919	7,358	7,824
Nominal GNP (Percentage change)	5.1	4.3	7.1	6.5	6.4	6.3	6.3
Real GNP (Percentage change)	0.9	0.0	3.3	2.9	2.8	2.7	2.7
Implicit GNP Deflator (Percentage change)	4.2	4.3	3.7	3.5	3.5	3.5	3.5
Fixed-Weighted GNP Price Index (Percentage change)	4.6	4.6	3.8	3.8	3.8	3.8	3.8
CPI-U (Percentage change)	5.4	4.9	3.5	3.6	3.6	3.6	3.6
Unemployment Rate (Percent)	5.5	6.8	6.4	6.2	6.0	5.8	5.6
Three-Month Treasury Bill Rate (Percent)	7.5	6.6	7.0	6.7	6.3	5.9	5.7
Ten-Year Treasury Note Rate (Percent)	8.6	7.9	7.7	7.6	7.4	7.3	7.2

SOURCE: Congressional Budget Office.

NOTE: CPI-U is the consumer price index for all urban consumers.

CONCLUSION

CBO's economic forecast is slightly more optimistic than the current *Blue Chip* average, as Summary Table 3 shows. The 50 or so individual forecasts that make up the average, however, are more widely dispersed than normal, reflecting the unusual uncertainty prevailing today. Military and political analysts cannot foretell the course of the war or the shape of the postwar Middle East. Similarly, economists are notoriously poor at predicting the path of the economy near turning

points in the business cycle. In addition, there is a good deal of uncertainty about whether banks and other financial institutions are in a position to extend sufficient credit to the rest of the U.S. economy.

Fortunately, the Budget Enforcement Act has partly insulated the budget process from these unpredictable factors. It adjusts the deficit targets for economic and technical changes and no longer promises to balance the budget by a certain date. It exempts deposit insurance spending from the requirement that increases in mandatory spending be offset by other spending cuts or tax increases. And it exempts emergency spending--such as the cost of operations in the Persian Gulf--from the discretionary spending limits and pay-as-you-go requirements. If fiscal policy is kept on its current course, the deficit should shrink significantly in a few years, even if it suffers further reverses in the meantime.

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release February 22, 1991

The President today transmitted to the Congress a request for supplemental defense appropriations in support of Operation Desert Shield/Desert Storm.

The requested supplemental is for the estimated incremental costs of Operation Desert Shield/Storm for the period October 1, 1990 through March 31, 1991. It is comprised of two basic elements:

(1) Working Capital: $15 billion in budget authority to establish and fund the Desert Shield Working Capital Account.

This account would be funded initially by resources from the United States Government. Its funds would be available for transfer by the Secretary of Defense, with the approval of the Office of Management and Budget, in order to maintain continuity of payment for the incremental costs of Operation Desert Shield/Storm.

The Working Capital Account would be replenished by foreign contributions as funds become available from the Defense Cooperation Account. Any balance in the Working Capital Account available after payment of all Desert Shield/Storm incremental costs would revert to the Treasury.

NOTE: This $15 billion request is approximately equal to the (net) Desert Shield "placeholder" already included in the President's Budget and in the associated deficit estimates.

(2) Foreign Contributions: Authority to transfer funds from the Defense Cooperation Account, the purpose of which is to hold current and anticipated foreign contributions.

Such transfers would be made by the Secretary of Defense, with the approval of the Office of Management and Budget, to reimburse defense appropriation accounts depleted by the incremental costs of Operation Desert Shield/Storm.

NOTE: The Defense Cooperation Account currently holds $11.2 billion in foreign cash contributions received. Additional foreign contributions committed to Operation Desert Shield/Desert Storm, but not yet received, total $38.6 billion.

MORE

Background

The Omnibus Reconciliation Act of 1990 provided that:

> "The costs for Operation Desert Shield are to be treated as emergency funding requirements not subject to the defense spending limits. . . . Emergency Desert Shield costs mean those incremental costs associated with the increase in operations in the Middle East and do not include costs that would be experienced by the Department of Defense as part of its normal operations absent Operation Desert Shield."

In applying the Desert Shield "incremental cost" standard, estimates have been developed for the following categories -- with incremental costs as noted:

	Daily Rate ($ billion)	Total ($ billion)
o For the period October 1, 1990 - December 31, 1990 (i.e., the first quarter of FY'91 -- prior to combat), incremental costs already incurred (NOTE: Total incremental costs for the period August 2, 1990 - December 31, 1990 are $11.1 billion, for which $2 billion has already been appropriated in an FY'90 supplemental.) . . .	0.100	9.1
o For the period January 1, 1991 - March 31, 1991, incremental costs of reserve call-up, imminent danger pay, transportation, fuel, in-country costs, and support for over 500,000 personnel (i.e., the "base" incremental costs for the second quarter of FY'91 -- <u>excluding the costs of combat</u>, which began in this quarter) . . .	0.137	12.3
o <u>Additional costs of combat</u>, which commenced on January 16, 1991; which can vary widely day-to-day depending on tactics, enemy conduct, weather, etc.; and which cannot be definitively estimated with respect to the future . . .	0.150-1.650	N.A.

MORE

	Daily Rate	Total
	($ billions)	
o Specifically-identified near-term investment requirements necessary: (a) to move back toward previously-planned inventory levels for selected munitions and expendables; and (b) to accelerate acquisition of combat support equipment and weapons systems modifications . . .	N.A.	6.4
o Incremental in-theater costs during orderly post-combat phasedown . . .	N.A.	7.0
o Return of personnel and equipment, as appropriate (including return of ready reserve fleet to non-deployed status and payment for reservist accrued leave) . . .	N.A.	5.2

NOTE: Supporting detail for these estimates is being provided directly to the Appropriations Committees and will be discussed in Hearings that commence on February 26. The Administration has indicated that it is willing to provide relevant cost (and foreign contribution) data to the Congress routinely during Operation Desert Shield/Storm.

Transfers from the Working Capital and Defense Cooperation Accounts would be to accounts associated with each of the foregoing categories, in the approximate order of their presentation above.

The incremental costs for the period October 1, 1990 - March 31, 1991 (plus redeployment and return) total nearly $40 billion plus the incremental costs of combat, which cannot be definitively estimated at this point.

Total foreign commitments through March 31, 1991 total $53.5 billion, including in-kind contributions. (See attached tables.) If foreign commitments are fully honored, and if hostilities end by March 31, the $15 billion Working Capital account should be sufficient to cover the U.S. share of incremental costs. If these conditions are not met, however, it may be necessary to seek additional foreign contributions and U.S. appropriations.

Attachments: Tables re foreign contributions.

# # #

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TABLE 1

DESERT SHIELD: CY 1990 AND 1991 FOREIGN COMMITMENTS TO THE U.S. 1/

(Millions of Dollars)

	Commitments			Receipts			Future
	1990	1991	Total	Cash 2/	In-kind	Total	Receipts
GCC STATES	6,845	29,000	35,845	8,827	1,716	10,543	25,302
SAUDI ARABIA	3,339	13,500	16,839	4,457	1,566	6,023	10,816
KUWAIT	2,506	13,500	16,006	3,500	10	3,510	12,496
UAE	1,000	2,000 3/	3,000	870	140	1,010	1,990
GERMANY	1,072	5,500	6,572	2,432	531	2,963	3,609
JAPAN	1,740 4/	9,000 5/	10,740	866	457	1,323	9,417
KOREA	80 6/	305	385	50	21	71	314
OTHERS	3		3		3	3	
TOTAL	9,740	43,805	53,545	12,175	2,728	14,903	38,642

1/ Data compiled by OMB. Sources of data: Commitments -- Defense, State, Treasury; Cash received--Treasury; Receipts and value of in-kind assistance -- Defense

2/ $1 billion has been released from the Defense Cooperation Account to Defense in accordance with the FY '91 Appropriations Act.

3/ An additional amount above the $2 billion is under discussion.

4/ Japan pledged $260 million to other coalition forces for total contributions of $2 billion.

5/ Under consideration by Diet.

6/ Korea pledged $15 million to other coalition forces for total contributions of $95 million.

TABLE 2

DESERT SHIELD: CY 1990 FOREIGN COMMITMENTS TO THE U.S. 1/

(Millions of Dollars)

	Commitments	Receipts			Future Receipts
		Cash 2/	In-kind	Total	
GCC STATES	6,845	4,177	971	5,148	1,697
SAUDI ARABIA	3,339	807	854	1,661	1,678 3/
KUWAIT	2,506	2,500	6	2,506	
UAE	1,000	870	111	981	19 3/
GERMANY	1,072	272	531	803	269 4/
JAPAN	1,740 5/	866	457	1,323	417 4/
KOREA	80 6/	50	21	71	9 4/
OTHERS	3		3	3	
TOTAL	9,740	5,365	1,983	7,348	2,392

U.S. Share of CY 1990 Incremental Costs	1,354

Total CY 1990 Incremental Costs	11,094

1/ Data compiled by OMB. Sources of data: Commitments for August – December 31 — Defense, State, Treasury; Cash received—Treasury; Receipts and value of in-kind assistance — Defense; Total cost for August – December 31 — Defense.

2/ $1 billion has been released from the Defense Cooperation Account to Defense in accordance with the FY '91 Appropriations Act.

3/ Cash reimbursement from Saudi Arabia and UAE awaiting bill from Defense. Saudi reimbursement includes enroute transportation through December for the second deployment and in-theater expenses for food, building materials, fuel, and support.

4/ In-kind assistance from Germany, Japan, and Korea. Orders made and receipt of goods expected soon.

5/ Japan pledged $260 million to other coalition forces for total contributions of $2 billion.

6/ Korea pledged $15 million to other coalition forces for total contributions of $95 million.

TABLE 3

DESERT SHIELD MILITARY ASSISTANCE
CY 1991 (JAN 1 – MAR 31) COMMITMENTS
(Millions of Dollars)

	Commit-ments	Receipts			Future Receipts
		Cash	In-kind	Total	
GCC STATES	29,000	4,650	745	5,395	23,605
SAUDI ARABIA	13,500	3,650	712	4,362	9,138
KUWAIT	13,500	1,000	4	1,004	12,496
UAE	2,000 1/		29	29	1,971
GERMANY	5,500	2,160		2,160	3,340
JAPAN	9,000 2/				9,000
KOREA	305				305
OTHERS					
TOTAL	43,805	6,810	745	7,555	36,250

1/ An additional amount above the $2 billion is under discussion.
2/ Under consideration by Diet.

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Back to Budget Basics

by George L. Perry

It is time to put aside the debate over the budget deficit that has preoccupied Congress and the administration for so long. There is only so much time and energy available to expend on economic and social legislation. The consensus needed to legislate in our political system can take only a limited amount of strain, and fighting over how to reduce deficits has tested that limit. Even though we are not headed for the budget surplus that many economists would like, the deficit is under adequate control for now, and other important economic and social matters demand the attention of legislators.

The idea that deficits are under control deserves a little explaining. After all, this year's deficit will be a record $300-plus billion. But the current deficit is not the issue. It will be large both because economic activity is weakening, automatically cutting revenues and raising transfer payments, and because this year's deficit reduction agreement contained only small budget savings at the start. Steadily declining deficits in subsequent years lead to a projected surplus by 1995.

Although this longer-run path is what matters, it is fair to ask why anyone should believe it will happen. Past deficit projections under Gramm-Rudman-Hollings have never been met or even approached. But those projections specified only a wish list of deficits, with no spending or tax programs to achieve them. The new agreement specifies realistic and enforceable expenditure ceilings. Within broad expenditure categories, spending more on some program requires either spending less on another or adding new revenue. This leaves room for budget mischief, but not too much.

The official deficit projections still make unduly favorable economic as-

sumptions and include a surplus after 1993 for the thrift bailout. After adjusting for these, the projected 1995 deficit at high employment is 1 percent to 1½ percent of GNP. That may not be optimal fiscal policy. But it is a high-employment deficit only slightly larger than in the 1960s and 1970s, and well below the average of the 1980s.

Reopening the deficit debate would run a serious risk of being counterproductive if Democrats and Republicans started horsetrading over tax changes. You do not have to believe in the supply-side tooth fairy to prefer a tax system with a broader base, lower rates, and no loopholes to its opposite. Yet any attempt by the Democrats to raise more income tax revenues from upper income groups will renew the Republicans' drive to cut the tax rate on capital gains. There are plenty of arguments to be made on all sides of the capital gains issue. But what cannot be disputed is that a capital gains preference will open a new tax shelter industry that was largely closed by the 1986 tax reform. If tax shelters again become important to private decisions, a lot of investment funds will go not where they are most productive but where they are most sheltered from taxes. Such misdirection of funds would undo many billions of dollars of deficit reduction in its effect on growth and productivity.

Even more important, reopening the budget deficit would push other important issues off the political agenda. We need to find ways to contain the price and total cost of health care to slow consumer price inflation and the growing demands of medical care on the federal budget. At the same time, we should look hard for ways to reduce the risk for the 30-odd million Americans now without medical insurance. The financial crisis of the thrift industry is extending to other financial institutions that made bad real estate loans. The government needs to review its place in insuring and regulating such institutions as it considers overhaul of the banking system. Eastern Europe and the Soviet Union need our help in moving to democratic market economies. At home the problems of crime, drugs, and homelessness and the needs for better education and infrastructure all vie for our lawmakers' attention.

Some of these issues will cost additional money, others may save. But all deserve more attention than they have been getting during the past several years of unending budget crises. Congress and the administration can now afford to put the budget deficit issue aside, and they should. □

George L. Perry is a senior fellow in the Brookings Economic Studies program. He directs the Brookings Panel on Economic Activity with William C. Brainard.

Photo by Roslin Arington

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Ernest F. Hollings

The Great Budget Hoax

In his State of the Union address, President Bush sang hosannas to last fall's budget accord, claiming that it "finally put the federal government on a pay-as-you-go plan and cut the growth of debt by nearly $500 billion." Of course, this is just a restatement of the grandest of Washington inside hoaxes: the idea that the 1990 budget deal solved Uncle Sam's budget mess. Who says 535 men and women, plus one president, can't keep a dirty little secret?

Well, I hereby break the bipartisan code of silence on the 1990 budget agreement. That agreement is a lie and a fraud. The truth is that last fall's deal has catapulted the United States into a new era of hyper-deficits. The budget submitted Feb. 4 by the Office of Management and Budget acknowledges that we will add $378.6 billion to the national debt in 1991, plus another $343 billion in 1992; expect these numbers to be revised sharply upward as recession and war bite deeper.

To quote a general describing his battlefield retreat, the 1990 budget pact is "an attack in the opposite direction." It didn't solve our fiscal problem, but it did solve our political problem by gutting Gramm-Rudman-Hollings. G-R-H was a nuisance because it required us to meet ambitious deficit-reduction targets each year, eventually reaching a balanced budget. That is now gone. In its place, the 1990 deal talks only about achieving "proposed savings" in discretionary accounts. Meanwhile, no one is supposed to notice or care that the deficit has skyrocketed toward $400 billion. The actual deficit can continue to grow unchecked in each and every year of this agreement, but as long as we achieve our "proposed savings," then we get to give ourselves the good-government award.

It is no coincidence that the budget deal provides for only the most negligible "proposed savings" in the first three years ($0 in 1991, $13 billion in 1992 and $22 billion in 1993); after all, the budgets for these three years must all be passed *before* the 1992 election. The great bulk of the painful "proposed savings"—a whopping $108 billion worth—is put off until fiscal years 1994 and 1995, and only a fool believes that cuts of that magnitude will ever be made.

Another very fat assumption of the five-year budget agreement is that fiscal years 1994 to 1996 will benefit from a $110 billion "S&L bonanza" as the government sells off its massive inventory of S&L assets. The trouble is that whatever S&L assets remain unsold by 1994 will be strictly what the bankers call "nonperforming"—a great jambalaya of cats, dogs and white elephants that are essentially unsalable. We'll be lucky to get 10 cents on the dollar for these turkeys.

Finally, even by the promiscuous standards of past budget summits, the 1990 agreement really put the rouge on old Rosy Scenario. You get the drift by looking at two of the agreement's original (since revised) economic assumptions for 1992: GNP growth storming ahead at an average rate of 3.8 percent annually from 1992 to 1995, and—my personal favorite—interest rates dropping steadily to 4.2 percent in 1995.

For all the sophisticated monkeyshines of the budget deal, one thing that can't be finessed is the bottom-line increase in the national debt. The agreement raises the legal debt limit from last summer's level of $3.1 billion up to $4.1 billion, an increase that will be just enough—you guessed it—to get us past November 1992. In other words, what the president calls a "pay-as-you-go plan" will run up the national debt by another $1 trillion by late 1992.

Of course, the cost of all this debt and deceit shows up most directly in escalating interest payments. Gross interest on the national debt in fiscal year 1991 will total $292 billion—bigger than the entire defense budget. And to finance record budget deficits this year and next, interest costs will jump in annual increments of $30 billion or more. Sixty cents out of every dollar in personal income taxes now goes strictly to pay gross interest on the debt (in 1980, it was 30 cents of every dollar). Americans were shocked by a war that cost some $500 million a day, but no one blinks at the fact that we now pay $800 million daily in interest costs, 365 days a year.

Is there no end to this irresponsibility? We obviously need major new taxes, but so great is the anti-tax orthodoxy in both parties that my colleagues view me as some kind of kamikaze kook for proposing a national value-added tax. The president now likes to talk about the states as "laboratories" for innovative problem solving. I agree and note that no fewer than 32 states are dealing honestly with their recession-induced budget deficits this year by raising taxes.

Many insist that the deficit can be eliminated simply by cutting out bureaucracy and fat. But even if you wipe out the *entire* nondefense apparatus of the federal government (including the FBI, student loans, EPA, air traffic controllers, Congress, the judiciary and all executive-branch departments except the Pentagon) you would have cut only $212 billion; you'd still face a deficit approaching $190 billion.

Last fall's budget deal will accomplish its political objective of getting Republicans and Democrats through the 1992 election. But as a blueprint for genuine deficit reduction, this plan is a sham.

The writer is a Democratic senator from South Carolina.

By Robert J. Samuelson

Why Soaking the Rich Won't Work

Behind all the talk about "tax fairness" lies the eternal lure of the free lunch.

In America, there's remarkably little resentment of the rich. Most of us would like to be rich, but few of us view it as life's main goal. A recent Gallup poll asked whether people envied the rich. An astonishing 82 percent said no. The same poll queried whether the rich are happier, and only 11 percent said yes. The political appeal of soaking the rich—now brandished by Democrats as "tax fairness"—lies elsewhere.

It's the lure of the free lunch. Americans want more government, but they don't want to pay higher taxes. The contradiction lies at the core of our politics. Just about the loudest message from last year's election was that governors (Republicans and Democrats) who supported higher taxes suffered politically. Soaking the rich is seen as a way to conquer the contradiction. We'll just make the wicked wealthy pay.

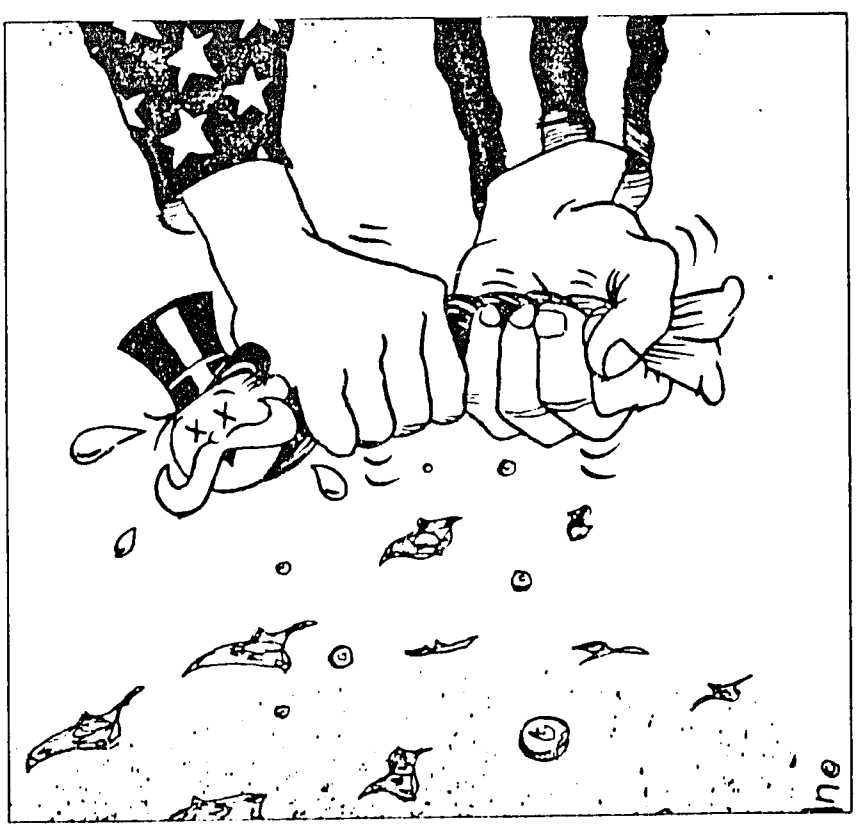
Everyone imagines a swarm of filthy rich shrewdly avoiding taxes. It's a mirage. There are many tax evaders, but most of the rich pay. On average, the wealthiest 1 percent of Americans pay 27 percent of their income as Federal taxes—and probably about half that in state and local taxes. You can argue about whether this is enough, but increasing their taxes sharply wouldn't provide money to meet all the demands for more health care, better schools, rebuilt highways, and improved social services.

If Americans want more government, people who consider themselves middle class will have to pay. Even people near the top of the income ladder see themselves as merely comfortable, not fabulously wealthy. According to the Congressional Budget Office, the richest 2 to 4 percent of families have an average pretax income of $126,000; after Federal taxes, that's $93,000. The wealthiest 5 to 10 percent of families have a pretax income of $82,000 and an after-tax income of $61,000. And finally, the richest 11 to 20 percent of families average $64,000 pretax and $48,000 after tax. State and local taxes would probably take another 9 to 13 percent of income. Let's now soak the superrich and see what it would buy.

In 1990, the richest 1 percent had average pretax incomes of $550,000. Their collective income amounts to $550 billion, or about 13 percent of U.S. families' total income ($4.25 trillion). They will pay about $150 billion in Federal taxes. That's about 15 percent of total taxes. Okay, we'll increase their taxes 30 percent. They'll pay 35 percent of their income—instead of today's 27 percent—to Uncle Sam. This is well beyond any recent proposals. In the budget battle, Democrats urged a 10 percent income tax surcharge on millionaires. A 30 percent tax increase might raise $45 billion. But now consider the demands for new spending:

The Pepper Commission on health care has proposed insuring the 32 million uninsured Americans under 65 and providing long-term care for the elderly. The annual cost is variously estimated between $55 billion and $67 billion.

We spend 7 percent of our gross na-



Jonathan Schneider

ROBERT J. SAMUELSON is a columnist for *Newsweek* and *The Washington Post*.

tional product on education. To raise that to 8 percent (a 14 percent increase) would cost about $55 billion annually.

We spend 2.5 percent of our gross national product on highways, bridges, airports, mass transit, sewage, and water systems. Raising that by 0.25 percent of GNP (a 10 percent increase) would cost $14 billion.

Spending all the $45 billion on the poorest fifth of Americans would allow us to raise their incomes nearly 30 percent (to almost $10,000) or provide an equivalent increase in government services (job training, housing, and so forth).

The list is hardly exhaustive. It excludes many areas where higher spending is routinely advocated: child care, police, and the environment. And enacting a $45 billion tax increase on the superrich might be politically impossible. There'd be ferocious objections that hitting them so hard would hurt private investment and charities.

A big tax increase might also raise less than expected, because the superrich are getting poorer. The superrich get half their income from investments and capital gains. Collapsing real estate values and the dropping stock market have taken their toll. *Forbes* magazine annually lists the 400 richest Americans. In 1990, the wealth required to make the list declined for the first time, from $275 million to $260 million. Donald Trump dropped off the list entirely. The number of billionaires (66) was five fewer than in 1989.

But forget these problems. Suppose we get another $45 billion from the superrich. Even this princely sum wouldn't end our political stalemate. At most, it would provide scattershot spending increases for many programs or a big infusion for one. Today's stalemate is that most Americans think government asks too much and provides too little. Disenchanted, they won't surrender any programs (which are already inadequate) or pay more taxes (which might be wasted).

No one wants to ask basic questions. Is government really performing badly? Or are people's expectations unrealistic? Are there radical ways to improve government's performance, to get more bang for our buck? If government should do more of some things, should it do less of others? Should we redefine individuals' and government's responsibilities? Democrats and Republicans alike sidestep these issues.

Even if we get another $45 billion from the superrich, we still won't be able to pay for the programs we want.

Each party strives to convince the public that it stands for something that it doesn't. Republicans pretend they want to cut taxes without saying which programs would be cut. Democrats preach social justice and "investing in the future" without advocating the taxes necessary to pay for their favored programs. And naturally, each party works hard to disguise its dishonesty.

Soaking the rich—a.k.a. "tax fairness"—is the Democrats' latest diversion. It implies (falsely) that we can have bigger government without steeper taxes. The rich will pay. Indeed, their taxes will probably rise. But they will never pay enough to cure today's discontent with government. There's no free lunch. ■

No Fiscal Peace

Last year's budget deal assures that President Bush and Congress won't be fighting over the size of the deficit. But both sides are gearing up for targeted skirmishes on high-profile issues.

BY LAWRENCE J. HAAS

Forecasts that last year's big budget deal would bring near-term peace on the fiscal front now look as premature as the reports of Mark Twain's death once were.

This time, President Bush and Congress aren't likely to fight over the size of the budget deficit. If the five-year budget deal, encompassing nearly $500 billion in spending and tax changes, did anything, it essentially removed the deficit as Washington's overriding fiscal issue.

Now, even if the deficit skyrockets—whether because a slow economy cuts into tax receipts, the Persian Gulf war sends military expenditures through the roof or something unforeseen occurs—the nation's leaders don't have to respond. Through a variety of loopholes and legal adjustments, last year's budget deal holds the parties harmless in such contingencies.

Indeed, it was this element of the deal, arrived at after a half-year of White House-congressional negotiations, that led to predictions of a year or so of fiscal peace. If the two branches, and the two political parties, didn't have the deficit to fight over, then surely they could agree on a 1992 fiscal plan—a budget resolution, the 13 appropriations bills and other implementing legislation—without the agonizing fights of recent years. *(See this issue, p. 316.)*

Not so fast. Now, even with the participants agreeing not to use the economic recession as an excuse to scrap the budget deal—the Senate voted overwhelmingly against doing so in late January, and the House isn't even expected to consider the question—they're gearing up for a series of targeted skirmishes on high-profile issues.

High on the list for likely combat are Bush's proposals to cut the tax rate on capital gains, save $25 billion in medicare by 1996 through such steps as forcing high-income recipients to pay more for physicians' services, redirect other subsidies away from the more-well-to-do and scrap 238 domestic programs and 3,591 projects. *(For a description of key provisions of the Bush budget, see pp. 333-34.)*

On the other hand, the framework of last year's budget deal may leave enough room for the White House and Congress to agree on all or parts of major changes in fiscal policy, such as Bush's proposal to turn $15 billion in federal aid programs back to the states. *(See this issue, p. 337.)*

As a sign of what's coming, consider what House Majority Leader Richard A. Gephardt of Missouri, a possible candidate for the 1992 Democratic presidential nomination, said about Bush's budget proposals.

"In one stroke, the President asks for the largest deficit in history, an enormous tax cut for the wealthy, huge cuts in medicare and in opportunities for the children of working families to go to college," Gephardt said. "I do not believe this budget will make America stronger economically next year than it is this year."

In fact, the $280.9 billion deficit that Bush projects for fiscal 1992 would be the second-largest, exceeded only by the expected $318.1 billion deficit for fiscal 1991, which began on Oct. 1. *(See table, p. 332.)* In any case, these are the deficits that all sides essentially agreed to when they drafted last year's five-year budget deal. Gephardt chaired those White House-congressional talks and helped sell the deal to Congress.

GOING UP OR DOWN?

At first blush, the budget deal and the projections of huge deficits through at least 1993 are strangely juxtaposed. The deal, after all, was supposed to reduce the deficit, not boost it. But a close look reveals why this juxtaposition is not so strange.

For one thing, as Office of Management and Budget (OMB) director Richard G. Darman noted, a huge slice of these near-term deficits is rooted in temporal events: principally, the recession and the costs of rescuing troubled savings and loan institutions, and, to a lesser extent, the costs of the Gulf war.

Just as important, the deal was, to a great extent, based on tax increases and spending savings that are being phased in

BUSH'S FISCAL 1992 BUDGET PLAN AT A GLANCE

(in billions, by fiscal year)

	1991	1992	1993	1994	1995	1996
Total spending	$1,409.6	$1,445.9	$1,454.2	$1,427.1	$1,470.3	$1,540.8
Discretionary	526.3	532.1	536.9	538.0	542.7	554.2
Defense	307.8	300.4	293.3	287.6	289.2	293.8
International	18.7	19.6	20.4	21.5	21.8	22.0
Domestic	199.8	212.0	223.2	228.9	231.7	238.5
Mandatory	686.2	707.5	705.3	673.5	713.8	775.6
Interest	197.0	206.3	212.0	215.5	213.8	211.0
Total revenue	1,091.4	1,165.0	1,252.7	1,365.3	1,467.3	1,560.7
Deficit (surplus)	318.1	280.9	201.5	61.8	2.9	(19.9)
Deficit, excluding social security	378.6	343.3	274.9	151.1	106.8	101.9
Deficit, excluding deposit insurance	206.6	192.8	157.3	99.9	45.3	10.0
Deficit, excluding social security and deposit insurance	267.1	255.2	230.7	189.2	149.1	131.8

SOURCE: Office of Management and Budget

rather than being made effective immediately. Thus, some of the biggest savings will come in the fourth and fifth years of the deal, mirroring the sharp drop that the deficit is expected to take.

Although the White House and Congress have, in the past, conspired more than once to pretend that down the road, the deficit was going to fall even though everyone knew otherwise, there's more reason to trust OMB's latest projection of sliding deficits.

For one thing, most of the projected savings were written into law as part of last year's budget reconciliation bill. For another, OMB isn't using the same level of optimism in its economic projections that it did in the past.

But if the deficit doesn't incite a full-scale budget brouhaha, other items on Gephardt's list of complaints might.

The level of fighting over a capital gains tax cut is likely to turn on Bush's enthusiasm for the measure. Although Bush, in his Jan. 29 State of the Union message, proclaimed his heartfelt support for a capital gains cut, the evidence is that he has included it in his budget more as a sop to right-wing Republicans than as a serious measure that he intends to push this year.

Bush and other Republicans were stung last year when the Democrats, pushing the "fairness" issue, complained that the GOP was willing to raise taxes on the middle class to cut the deficit but insisted at the same time on giving the wealthy a tax cut on their investments.

INESCAPABLE CONTROVERSY

Whether or not a capital gains fight erupts, Bush's medicare proposals surely will be controversial. Senate Finance Committee chairman Lloyd Bentsen, D-Texas, whose panel oversees medicare, has said that the proposals violate last year's budget deal, which included about $40 billion in deficit cutting medicare savings. Bentsen and others say they believed that those cutbacks would be the last for some time. At a Feb. 4 news conference, Senate Budget Committee chairman Jim Sasser, D-Tenn., cited Bentsen's assessment when asked for his own.

And consider what Rep. Dan Rostenkowski, D-Ill., whose Ways and Means Committee also oversees medicare, had to say about the proposals: "We're not about to ask senior citizens and medicare providers to bear the brunt of deficit reduction responsibility. Those issues were supposedly settled in last year's budget agreement. In any event, when all is said and done, beneficiaries won't be paying any more than they now do for medicare services." House Budget Committee chairman Leon E. Panetta, D-Calif., agreed, calling the proposed medicare cutbacks "an exercise in frustration."

Also controversial, if to a lesser extent, are Bush's ideas about scaling back other benefit programs for the well-to-do.

For instance, Bush would deny farm deficiency payments to those whose nonfarm income exceeds $125,000, redirect higher education Pell grants more to the needy, give smaller school lunch subsidies to children of the nonpoor and restructure veterans' programs so that they no longer discriminate against families of low-ranking military officers.

Democrats may have expected a respite from fights over entitlements—benefits that automatically go to recipients according to age, income and other criteria. If, under the budget deal, Congress no longer must achieve a specific deficit target, why should it mess with these politically popular programs?

But Bush, to find money for some proposed entitlement increases, was required by the budget pact to propose reductions in spending on other entitlements. That agreement forces Congress to offset the costs of new entitlement spending or tax reductions.

Potentially as controversial are some of Bush's ideas for domestic discretionary spending. Here, too, some Democratic criticism of Bush seems misplaced. The President, complying with last year's budget deal, set spending for domestic, defense and international aid programs at agreed-upon levels. Proposals by some Democrats to shift defense funds to domestic programs would violate a key part of the deal. *(For a report on the Pentagon's budget plans, see this issue, p. 326.)*

That domestic programs must compete with each other for funds pleases the White House. At a briefing, Darman cited as an advantage of last year's budget deal that "we can . . . have a competition of ideas."

It's a competition to which Democrats don't look forward. "We're reduced to cannibalizing the budget, sacrificing one program to another, abandoning one needed investment so we can afford the next," Sasser said.

Among other things, Bush wants higher spending for science, space and energy ventures; Democrats suggest they'd shift those funds to beef up some human services programs. That conflict could mean trouble for the Appropriations Committees that draft the 13 spending bills, each requiring the President's signature, that are needed to keep the government running.

TAX AND SPENDING HIGHLIGHTS OF BUSH'S BUDGET

Here are highlights of President Bush's tax and spending proposals for fiscal 1992.

For spending programs, proposed levels for fiscal 1992 are compared with actual levels for the current year. The exception is for medicare; its over-all spending is expected to rise, but proposed controls are intended to limit that rise and save $2.9 billion.

For all spending programs, figures are for budget authority, not outlays. Budget authority is money that can be spent in current or future years; outlays are amounts actually to be spent in a particular year. The single exception in the following list of proposals is for medicare, where proposed savings are in outlays.

For tax proposals, the signs (+) and (−) identify whether the proposals are expected to raise or lower revenues.

SPENDING

ANTIDRUG EFFORTS

THIS YEAR	$10.5 billion
NEXT YEAR	$11.7 billion

Although Bush's proposals represent a healthy 11 per cent increase over 1991, the real story here is how federal spending has skyrocketed over a longer time frame. Antidrug spending was just $1.5 billion in 1981, and stood at only $6.4 billion as late as 1989. But news stories about the drug problem, leading to heightened public concern, prompted Bush and Congress to pour billions more into antidrug efforts. For 1992, program highlights include a $627 million increase in criminal justice activities, a $221 million boost for international and interdiction programs and more funds for prevention, treatment and research efforts.

REVENUE

CAPITAL GAINS

THIS YEAR	N.A.
NEXT YEAR	+$3.0 billion

In a move that could set off another round of partisan warfare, Bush has once again proposed to cut the tax rate on capital gains. When the proposal, designed to encourage long-term investment, is fully phased in in 1993, assets held for more than three years would qualify for a 30 per cent exclusion from taxes; those held more than two years could get a 20 per cent exclusion; those held at least a year could get 10 per cent. For instance, a taxpayer in the 28 per cent income bracket with a capital gain qualifying for a 30 per cent exclusion would pay taxes of 19.6 per cent on the gain. With the question of how much revenue a capital gains tax cut would produce still controversial, Bush proposes that Congress, the executive branch and the Federal Reserve Board look into the subject, with Fed chairman Alan Greenspan to head the study. Because most of the financial benefits from a capital gains tax cut would flow to the wealthy, the proposal is likely to reignite Democratic complaints about its fairness. Bush counters that the tax cut, by spurring economic growth, would produce benefits for every income class.

REVENUE

FAMILY SAVINGS ACCOUNTS

THIS YEAR	N.A.
NEXT YEAR	-$0.3 billion

In another holdover from last year's budget, Bush proposed these accounts to encourage Americans to enhance their personal savings. The U.S. rate of personal savings, which helps determine the amount of capital in the economy available for investment, dropped in the 1980s. Many mainstream economists argue that a low savings rate will cut into future economic growth. Under Bush's plan, individuals would be permitted to contribute up to $2,500 per year to the special accounts, with the number of accounts limited to two per family. The tax benefits would be "back-loaded": Although contributions would not be deductible, individuals would not pay taxes on the earnings for as long as the money remained in the accounts. Nor would they pay taxes on withdrawals, if the money remained in the accounts for at least seven years. Withdrawals within three years would be subject to a 10 per cent excise tax in addition to regular income taxes. Withdrawals after three years but before seven years would be subject only to regular income taxes. To ensure that these accounts are middle-class benefits, eligibility would be limited to individuals earning up to $60,000 a year and families earning up to $120,000.

SPENDING

HEAD START

THIS YEAR	$1.95 billion
NEXT YEAR	$2.05 billion

Bush, who campaigned on a promise to extend this hugely popular preschool program for disadvantaged children to all eligible children, proposes to move further in that direction. Under his proposal, Head Start would provide 58 per cent of eligible 4-year-olds with its menu of developmental, nutritional, immunization and other services. This is just one of numerous Bush proposals to increase spending on early-intervention programs, which supposedly save several dollars in crime, health and other social costs down the road for every $1 invested. Also targeted for increases are the supplemental feeding program for the Women, Infants and Children program; child immunization grants; and compensatory education services for disadvantaged children.

SPENDING

HIGHER EDUCATION

THIS YEAR	$11.97 billion
NEXT YEAR	$13.64 billion

Bush proposes to reshape the Pell grant and Guaranteed Student Loan programs. Bush proposes a $401 million increase in Pell grants to $5.8 billion, by boosting the maximum grant to $3,700, an increase of $1,300. Average awards would go up by $425, to $1,909. Other changes would direct

the grants more to lower-income students. Currently, the grants can meet up to 60 per cent of college costs, regardless of family income. The President wants the grants to cover up to 79 per cent of college costs, minus expected family contributions, for students with family incomes below $10,000, but only 30 per cent of the costs for those with family incomes above $30,000. Bush also proposes various changes in the student loan program to reduce federal risks, stabilize lending agencies, improve the collection of defaulted loans and make other improvements.

SPENDING

INTERNATIONAL AFFAIRS

THIS YEAR	$19.79 billion
NEXT YEAR	$35.68 billion

Consistent with last year's budget agreement, Bush proposes an international aid budget that calls for a sizable increase in developmental and humanitarian assistance and a modest cut in security assistance programs. More specifically, the President would increase Agency for International Development spending to $2.7 billion (from $2.3 billion) and multilateral development bank contributions to $1.5 billion (from $1.3 billion). Included in Bush's program is his "Enterprise for the Americas Initiative," under which Latin American nations can write down their international debt if they adopt economic reforms. The increase in over-all spending for international aid is inflated by a onetime $12.2 billion line of credit deposited by the United States with the International Monetary Fund.

SPENDING

MEDICARE CONTROLS

THIS YEAR	N.A.
NEXT YEAR	-$2.9 billion

In a proposal certain to spur a heated debate, Bush calls for scaling back certain medicare payments and moving the program further in the direction of means-testing. Certain payments to teaching hospitals, home health agencies, skilled nursing facilities and other institutions would be cut back. Other changes would affect hospital outpatient departments, ambulatory surgery centers and physician offices. In the means-testing initiative, Bush wants individuals with adjusted gross incomes of more than $125,000 and couples with incomes above $150,000 to pay higher premiums for physicians' services. The elderly now contribute about 25 per cent of the costs, but Bush wants to boost that to 75 per cent for the well-to-do. The changes would cost these beneficiaries $95 a month, according to the budget.

SPENDING

NATIONAL HIGHWAY SYSTEM

THIS YEAR	N.A.
NEXT YEAR	+$7.7 billion

As part of his national transportation policy, Bush proposes creation of a national highway system of roads "with the greatest significance for interstate travel and commerce." Included would be 150,000 miles of highways, including the 43,000-mile interstate system and other "nationally important highways." With the interstate highway system essentially completed, the new system would focus federal resources on "rehabilitation and improvement." Bush's transportation proposals are sure to spark a major debate in Congress, which must reauthorize highway aid programs by the end of 1991. Other major proposals include an urban-rural program under which states could spend federal funds on "any project currently on the federal-aid urban, primary and secondary highway systems."

REVENUE

RESEARCH TAX BENEFITS

THIS YEAR	N.A.
NEXT YEAR	-$0.8 billion

Bush proposes to extend two popular tax breaks. A 20 per cent tax credit for certain incremental research and experimentation spending, scheduled to expire on Dec. 31, would be made permanent. Bush proposed the same thing last year, but budgetary constraints prompted White House negotiators, in last year's budget summit, to settle for a one-year extension. Bush also proposes a one-year extension on the so-called research and experimentation allocation rules, which instruct companies with foreign operations on how to divide their research and experimentation expenses, for tax purposes, between their domestic and foreign operations.

SPENDING

SUPERCONDUCTING SUPERCOLLIDER

THIS YEAR	$0.24 billion
NEXT YEAR	$0.53 billion

This proposed $291 million increase is intended to spur research and development efforts on a project that, Bush says, "holds the potential for new breakthroughs in science, technology and education." When completed, the atom smasher, expected to cost $8.2 billion by 1999 (two-thirds of it from federal funds), would provide "a collision energy 20 times greater than the current capability," the budget says. A special laboratory is being built in Ellis County, Texas, that will employ about 2,500 scientists, engineers and technicians and play host to 500 visiting scientists.

SPENDING

TENANT OWNERSHIP

THIS YEAR	$0.29 billion
NEXT YEAR	$2.15 billion

These financing figures are, in a sense, deceptively high. Because housing programs take a long time to develop, Bush estimates that only $142 million would be spent next year. The programs, part of last year's National Affordable Housing Act, are intended to "help low-income families become home owners with a stake in their communities." An example the Administration touts is the Kenilworth-Parkside housing project in Washington, D.C., which Bush describes as a "vibrant example" of how a troubled project can be transformed into a "viable, dynamic residential community."

Rx for America: Export-Led Growth

by C. Fred Bergsten

The American economy has experienced exceedingly slow growth since early 1989. For almost two years, it has expanded at annual rates of less than 1.75 percent in every quarter. The current recession is the culmination of that slowdown. The recession need not be prolonged, however, if American companies take a leaf from the book of other countries and — with sharply increased support from their government — shift to export-led growth. Whatever the outcome in the Gulf, export-led growth may be the only feasible strategy for the US in the early 1990s when neither fiscal nor monetary tools will be able to reinvigorate the economy.

Fortunately, there is no world recession. Most of Asia and Continental Europe continue to expand and thus provide growing markets for American products. Moreover, the exchange rate of the dollar is low enough to render industry in the United States price-competitive in most world markets, and to enable it to restore domestic market share against imports in a number of sectors. The internal slowdown should push US companies to look abroad to boost sales and profits.

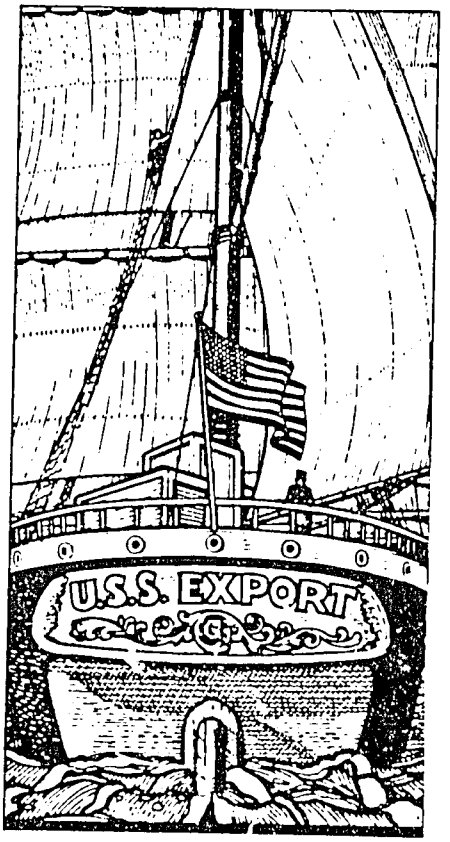
After six years of consistently rapid growth, a pause in the US economy is natural. There are two unique characteristics of the present turndown, however. One is very bad news: the unavailability of either of the usual policy tools, fiscal or monetary, to restart the economy. New fiscal stimulus is obviously out of the question in light of the massive budget deficit. That deficit will rise further for a year or two as lower tax payments and higher welfare spending result from the economic turndown, but fiscal policy is quite properly moving in a contractionary direction as a result of the recent deal between the Administration and Congress.

Export-led growth may be the only feasible strategy for the US in the 1990s, when neither fiscal nor monetary tools will be available.

Hope for a quick recovery thus centers on lower interest rates. The budget deal will produce such a result over time and rates have already come down a bit. However, there are three reasons why monetary policy is unlikely to deliver much economic stimulus in the near term.

First, the underlying rate of "core inflation" remains uncomfortably high and has continued to rise until quite recently. Second, a substantial drop in interest rates could trigger a

products, photographic and optical equipment, computers, and scientific instruments. There have been impressive gains in such "surprise" sectors as furniture, textile yarn, apparel, auto parts, musical instruments and minivans as well as in traditional sources of strength such as aircraft and chemicals.



How much might further trade expansion contribute? Could a trade boom prevent America from sinking into a prolonged slump? What would it take? A sustained trade boom could readily contribute about $50 billion annually in real economic growth for the next three years, boosting total output by about 1.25 percentage points per year. This would provide half or more of the maximum real growth of between 2 and 2.5 percent per year that is attainable for the United States without added inflation, given the anticipated future profile of our labor force and productivity.

Is such trade improvement feasible in domestic terms? The answer is "yes." The US economy generated trade gains of this dimension in 1979–80 and 1988. It has in fact experienced trade swings of this magnitude, both positive and negative, about half the time over the past decade. The posited improvement over the next three years would produce a cumulative net trade contribution of about 6 percent to real GNP from 1987 through 1993, offsetting the similar deterioration that occurred from 1981 through 1986. Such trade improvement in real terms would probably eliminate the US current account deficit in current dollars — and thus halt the buildup of America's foreign debt.

Can the world economy accept such improvement in the US trade balance? From 1987 through 1990, the American share of world exports of manufactured products rose by about 0.6 percentage points annually and its share of world imports of manufactures dropped by about 1 percentage point annually. (Most of the improvement must come from trade in manufactured goods.) The other industrial countries not only survived the shift but experienced a pickup in their economies as they shifted to domestic-led expansion. Three more years of similar recovery of American market share — cumulating to 1.5–2 percentage points per year on the export and import sides taken together — would accommodate the suggested trade gains. Such a trade burst would still leave America's share of world markets for manufactured exports a percentage point or so below the 1980–81 level.

The key to such a outcome is whether firms producing in the United States, including those headquartered abroad, will be sufficiently agile to achieve such a shift. The macroeconomic environment will certainly be propitious for export-led growth: the stagnation of domestic demand should push the firms toward foreign markets, continued growth abroad should pull them in that direction as well, and the competitive exchange rate for the dollar facilitates a trade focus.

American firms did achieve export-led growth in 1979–80. Unfortunately, the soaring dollar and governmental indifference to trade in the first half of the 1980s snuffed out much of this new trade focus. The data for the past

four years, as noted above, suggest that an export orientation is being restored.

But 85 percent of all American exports are still accounted for by only 15 percent of American companies. Half the firms that do export are active in only one market. Only 20 percent of the exporters — three percent of US industry — sell in more than five countries abroad. American business will simply have to intensify its global efforts during a period when foreign competitors are selling aggressively. In particular, they will need to seek maximum expansion in market share by taking advantage of the lower dollar rather than raising prices.

The US government and other key countries can help. First, the United States must take the lead among the G-7 nations to ensure that the dollar does not rebound in the short run and prematurely undermine American price competitiveness. Indeed, a modest further decline in the dollar is likely in view of continuing higher growth, profit opportunities and interest rates abroad. Such a decline should be endorsed by the G-7 as long as it occurs in an orderly manner.

Second, many US firms are reluctant to invest in export capacity due to fears that the dollar might soar again and become uncompetitive by the time their new plants come on stream. Hence the G-7 should elaborate the "reference ranges" installed at the Louvre in 1987 to create a credible system of target zones that will produce a predictable, sustained level for the dollar and other currencies. There must be a clear US commitment to avoid a repeat of the 1981–85 neglect of the dollar which was a disaster for American trade. To support such commitments, the United States must fully implement the new budget deal, and perhaps launch a second major attack on the deficit within the next year, to sustain lower levels for interest rates and the dollar; the large surplus countries, notably Japan and Germany, will have to maintain rapid domestic-led growth through the adjustment period.

On the domestic front, the US government should sharply increase the size and scope of the Export-Import Bank and substantially expand other export-promotion programs. Eximbank support is critical, especially for medium-sized and smaller US firms, as private banks have largely withdrawn from export finance. Yet the Bank literally ran out of funds in mid-1988 and its program is wholly inadequate now. A ten-fold expansion in Exim's direct lending in the late 1970s contributed substantially to the export-led growth of that period, and similar increases are called for now. Such a shift would be greatly facilitated by the Administration's proposed budget reforms, which would count only the modest subsidy element of Exim loans against current expenditures, and could be enhanced still further by placing Exim and related programs in a new "export promotion" function in the budget rather than continuing to group them with unrelated foreign aid activities.

In addition, the Administration and Congress should jointly develop new legislation to eliminate, or at least modify, the numerous policies (including excessive national security controls, foreign policy controls and short supply controls) that block billions of dollars in potential sales abroad. For the longer run, the entire government must place higher priority on improving America's competitiveness in global markets as it addresses all components of economic policy including the budget, taxes, antitrust, education and the whole array of regulatory regimes.

A sustained trade boom could readily contribute about $50 billion annually in real economic growth for the next three years.

Finally, export-led growth should become the focus of US trade policy for the foreseeable future. It is thus essential to conclude a successful Uruguay Round and for the US

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HOW TO MEASURE "EXPORTS"?

The US Government publishes two quite different sets of data on the country's international transactions. The most familiar are the monthly releases on merchandise trade, and the essentially similar quarterly series on both merchandise trade and the entire current account (including services transactions). These numbers are presented in *value* terms and denominated in *current* dollars, which is the relevant concept for appraising the magnitude of the country's external financing requirement. One set of the official GNP data is also presented in value terms, denominated in current dollars, and thus includes a similar component for "net exports of goods and services." The growth of GNP, however, is most frequently viewed in *volume* terms denominated in *constant* (1982) dollars — excluding the impact of price changes. This *real* (as opposed to *nominal*) GNP concept includes changes in the volume (rather than value) of US net exports and is the best guide to the impact of trade on the level of production and employment in the United States.

There are substantial differences between the two data series during particular periods of time. When the price of oil rises, for example, the United States (as a net oil importer) experiences a worsening of its trade balance in nominal terms even with an unchanged volume of imports and thus no change in the real measure. When the exchange rate of the dollar weakens, imports cost more in dollar terms so the nominal trade balance improves less than do net exports in GNP terms.

The focus of the adjacent article is the impact of changes in the trade balance on the real US economy, so real net exports are used throughout (except where indicated to the contrary). It should also be noted that what counts for the growth of the real economy are changes in *net* exports, i.e., the difference between the growth of exports and the growth of imports. Rising imports detract from domestic output as much as falling exports. The term "export-led growth" is used in this article as convenient shorthand for the more precise concept of "expanding domestic output through an improvement in net exports of goods and services."

Administration to maintain its aggressive efforts elsewhere to reduce foreign barriers to US exports. The United States needs increased market access, including zero tariffs wherever possible, in the sectors where it is most competitive: agriculture, many services, high technology goods and capital equipment. A failed Round would unleash protectionist tendencies that would deter corporate efforts to penetrate foreign markets. Indeed, an uncertain outlook for trade policy could prompt American firms to invest abroad to circumvent possible new barriers, rather than build new capacity at home. New bilateral or regional arrangements with Latin America can help exports but are no substitute for global liberalization.

The fundamental requirement is the adoption of a new mindset of export orientation by US industry and government — for both the immediate future and the long term. Such attitudes are second nature in virtually all other countries. The time has come for America to join the world in this critical respect, and the prospect of slack domestic markets for some time to come should spur such a reordering of priorities. If America can successfully focus on selling abroad, economic recovery can come more promptly and smoothly. If it cannot, stagflation may persist and America will fall steadily behind its global competition.

Dr. Bergsten is the Director of the Institute for International Economics. He was Assistant Secretary of the Treasury 1977–81.

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As the US economy deteriorates, the key question for 1991 is how far the downturn will go, writes **Martin Feldstein**

The Fed's battle with recession

After hovering on the verge of a recession for several months the American economy turned decisively downward in October and November. The number of employees on private payrolls fell by nearly 500,000 in those two months and industrial production dropped precipitously.

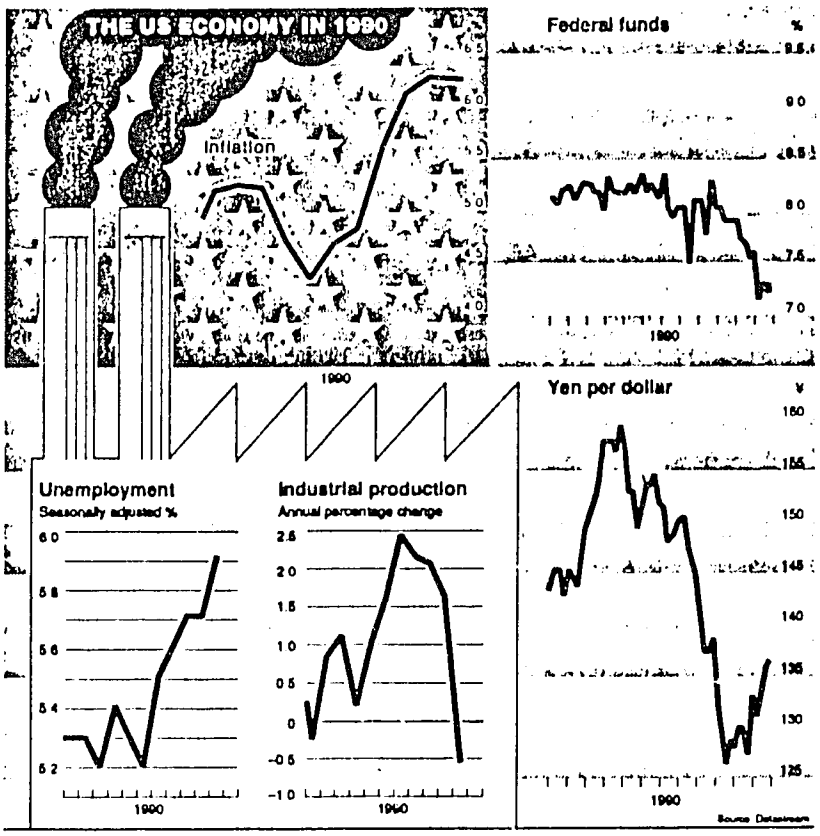
The important questions for 1991 are therefore how long the downturn will last and how far the economy will fall before the turnaround begins. Most US economists are predicting a short and shallow recession with the recovery beginning after less than the 13 month average of all post war recessions and with a smaller than average cumulative decline from peak to trough.

An important reason for believing this rather favourable outlook is the relatively benign posture of the Federal Reserve Board. The Fed did not actively seek a recession at this time and would now like to return to economic expansion. The situation is thus very different from 1981 and earlier recessions when the Federal Reserve pushed interest rates up sharply in order to reverse a sharp rise in inflation.

But the Fed's good intentions may not be enough to ensure a quick reversal of the present decline. In spite of its desire to avoid a recession, the Fed's policy in 1990 did contribute to the current downturn and its actions in the months ahead may not be consistent with the forecast of a rapid rebound. To understand this risk, it is helpful to review the Fed's strategy and its actions in 1990.

For the past two years, the Fed has been seeking to reduce inflation gradually while avoiding an actual recession. In his biannual testimony to the congressional oversight committees, Mr Alan Greenspan, the chairman of the Federal Reserve Board, has repeatedly projected a monetary policy that was expected to be consistent with a gradually declining rate of growth of total nominal spending and therefore of inflation. In the autumn of 1989 he predicted that total spending in 1990 would increase by about 6 per cent, with inflation of roughly 4.5 per cent and real economic growth of 1.5 per cent. In July 1990, he reiterated this outlook for 1990 and projected that 1991 would see a similar rise in nominal gross national product with a slightly more favourable division between inflation and real economic growth. To support this growth of nominal GNP, the Fed projected that the M2 monetary aggregate (currency, checking accounts plus savings and smaller time deposit accounts) would increase at a rate of approximately 4 per cent and explained why it anticipated the implied rise in velocity.

Iraq's invasion of Kuwait and the consequent rise in the price of oil inevitably made this outlook impossible. A direct pass through of the higher oil price would raise the US price level by approximately 1 per cent. An unchanged growth of nominal GNP would, therefore, cut real GNP growth over the following year by approximately 1 per cent to only slightly more than zero. A more expansionary monetary policy might have sustained a faster rate of economic growth but only by accepting a greater increase in inflation and therefore risking a sharp rise in inflationary expectations.



Alternatively, a tighter monetary policy could have reduced the inflationary aftermath of the oil price rise, but only by pushing the economy into a deeper downturn. The Fed appears to have rejected both alternatives, accepting instead the temporary rise in inflation and decline in real growth that would accompany a steady as you go approach to nominal GNP.

But even without the rise in the price of oil, the actual execution of monetary policy in 1990 was likely to have led to a downturn in real GNP by the end of the year. Perhaps because of its focus on short term interest rates rather than monetary aggregates, the Fed kept the growth of M2 to less than 4 per cent. There has been no increase in the observed velocity link between M2 and subsequent nominal GNP. In the absence of such an increase, nominal GNP would expand at an annual rate of less than 4 per cent in the final quarter of 1990 and the first quarter of 1991 and therefore real GNP would decline.

The outlook for economic activity in 1991 depends critically on both the price of oil and the Federal Reserve's monetary policy. The optimistic case for a short and shallow downturn assumes that oil prices do not increase further and that the Fed pursues a monetary policy that is sufficiently accommodative. If the price of oil remains at its current level and the Federal Reserve provides enough credit to support 6 per cent growth of nominal GNP, the economy is likely to begin expanding by the summer and to enjoy a real growth rate of more than 2 per cent in the second half of the year.

The uncertainty over oil prices imparts a corresponding uncertainty to the pace of real economic growth. Stable oil prices at even the current elevated level would allow the economy to return to the mix of real growth and inflation that the Fed had projected before the initial jump in oil prices. Although the high level of energy prices does depress the purchasing power of US households and may reduce output in some manufacturing industries (because of the higher cost of energy inputs), a stable, high price of energy will not diminish the rate of economic growth.

A fall in the price of oil along the path implied by the futures market would depress inflation further, bringing the rate of inflation to 3 per cent or less by the middle of 1991. The resulting rise in purchasing power would induce increased consumer spending and a faster rise in real GNP. Conversely, a sharp jump in the price of oil caused by an Iraqi attack on Saudi oilfields would exacerbate the current inflation and cause a longer and deeper decline of economic activity.

The slow rate of expansion of the monetary aggregates in 1990 and the debates within the Federal Reserve now raise doubts about whether the Fed will provide enough credit to achieve its target of 6 per cent nominal GNP growth in 1991. There are four distinct reasons for concern.

- First, the Federal Reserve's use of the federal funds interest rate as a measure of monetary policy may inhibit the expansion of money and credit. Short term interest rates are a poor guide to the adequacy of monetary expansion when the demand for money is changing. A decline in economic activity can cause interest rates to fall because the demand for funds declines rather than because the supply is increasing. If the Fed judges the extent by which it eases in 1991 by the decline of the Fed funds' rate, it may be misled into an overly tight monetary policy. Although the Fed funds rate and other short term rates have declined in recent months, the money supply at the start of December was actually lower than it had been three months earlier.
- Second, a failure to distinguish the temporary price surge caused by the rise in oil prices from a sustained rise in the rate of inflation may shift the focus from nominal GNP growth to inflation. Although the Fed has a primary responsibility to fight inflation, its strategy of reducing inflation gradually by slowing the expansion of nominal GNP remains appropriate. If members of the Fed's open market committee misinterpret the recent price rise as evidence that their strategy is not working, monetary policy may be inappropriately tight.
- Third, a desire to prevent the further decline of the dollar relative to the D Mark and the yen could lead to an explicit decision to keep monetary policy tighter than it would otherwise have been. Although the dollar's decline during the past year has been substantial, a further permanent decline in the real value of the dollar is needed if the US is to shrink the trade and current account deficits that still exceed $100bn a year.

There are, nevertheless, Americans who resist a further fall of the dollar because they fear that a lower dollar will induce more foreign purchases of US assets. And the French government and some foreign individuals are calling for dollar stability to prevent a deterioration of their own international competitiveness.

Most American economists are predicting a short and shallow recession with the recovery beginning after less than the 13-month average of all post-war recessions

A tight money strategy aimed at propping up the dollar would not only weaken domestic demand but, by arresting or reversing the dollar's decline, would prevent the substantial boost to GNP in 1991 that is expected to follow from the improvement in net exports caused by the dollar's continuing decline.

- Finally, there are the reductions in bank lending caused by the conflict between the decline in the banks' capital and the increase in both official capital requirements and regulatory stringency. Although open market operations may increase the ability of some banks to make additional loans, other banks may be unable or reluctant to do so. At a minimum, the uneven distribution of increased bank lending - with some banks not doing any at all - may weaken the impact of the Fed's expansionary policy. The Fed may, therefore, have to increase reserves and money faster in order to achieve expansion of nominal GNP.

The Federal Reserve's recent decisions to lower the Fed funds rate, to reduce reserve requirements and to cut the discount rate, all indicate that the Fed wants to reverse the current downturn. The big question for 1991 is whether it will actually pursue that fight aggressively enough to succeed.

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FORECAST 1991 US

Bush Banking Plan Faces Obstacles

On Feb. 6, 1989, President Bush unveiled a sweeping initiative to address the growing crisis in the savings and loan industry. For the most part, the administration's proposal was met with praise on Capitol Hill, and Congress cleared the landmark legislation six months later.

Two years later, almost to the day, the administration has proposed an even more far-reaching plan to overhaul the U.S. financial services industry.

The proposals were included in a report, mandated by the 1989 thrift bailout law, on the state of the deposit insurance system. The plan would sweep away banking laws in place since the 1930s and allow institutions the freedom to determine where they operate and what financial services they offer.

"If we expect to exert as a country world economic leadership in the 21st century, we must have a modern world-class financial services system inside the United States," Treasury Secretary Nicholas F. Brady said Tuesday.

But the administration cannot expect to pull the same kind of weight in the battle over the future of the financial services industry as it did in the S&L debate.

No Consensus

Lawmakers were glad that the administration took the lead in 1989, and openly deferred to its judgment. During the House Banking Committee markup of the legislation that year, lawmakers often scurried to a back room to confer with administration officials before agreeing to a provision.

Things are different this year. There is no consensus on how to overhaul the U.S. banking system, and based on early comments, lawmakers won't be as willing to follow the administration's lead.

Of the proposals put forth by the administration on Tuesday, only two — deposit insurance and an infusion of money for the bank deposit insurance fund — are considered by most lawmakers to be must-pass legislation this year.

Key lawmakers, including House and Senate Banking Committee Chairmen Henry B. Gonzalez, D-Texas, and Donald W. Riegle Jr., D-Mich., respectively, want to focus first on revising the deposit insurance system. But the Bush administration wants Congress to consider a comprehensive package of proposals.

Rep. Charles E. Schumer, D-N.Y., says the Treasury plan "has a lot of problems. In short, the proposal shouldn't be thrown on the scrap heap, but it's far from ready to roll off the assembly line without real significant modifications."

Banking, securities and insurance groups will also have to be convinced that reworking the financial services system is in their interest, which could prove a difficult task. In 1988, legislation that would have given banks expanded powers died because of industry infighting and jurisdictional battles between the House Banking and Energy and Commerce panels.

Troubled Industry

A depressed real estate market and the recession have caused hundreds of bank failures and have drained the bank deposit insurance fund. Federal Deposit Insurance Corporation (FDIC) Chairman L. William Seidman has said that the fund would need $10 billion by midyear to remain solvent.

In the past 20 years, U.S. banks have also lost their standing in the world. In 1970, nine U.S. banks were among the top 30 banks in the world holding the most in deposits. In 1991, only one U.S. bank — Citicorp at No. 27 — remains in the top 30.

The list is now dominated by Japanese banks, which are not prohibited from interstate banking or securities activities.

The banking woes come right on the heels of the S&L crisis. The administration has estimated that thrifts losses will cost taxpayers between $90 billion and $130 billion.

The perilous financial condition of banks and thrifts is one of the main reasons members are uneasy about making radical changes. Lawmakers are wary of rekindling voter anger ignited by the S&L bailout.

The administration wants Congress to repeal the 1933 Glass-Steagall Act that placed barriers between commercial and investment banking. Recent legal changes and decisions by the Federal Reserve Board have breached the barrier, but the administration wants it knocked down completely.

Restrictions on interstate banking would also be removed under the administration's plan. Brady said such a move was essential to get U.S. banking regulations up to speed with developments in Europe.

For example, in 1992 German and British banks will be able to move freely within the European market, while U.S. banks are restricted from opening up branches in other states, he said. "A California bank can open a branch in Birmingham, England, but not in Birmingham, Alabama," Brady said.

Banking panel Chairman Gonzalez said it would be a mistake to allow banks into new fields before changes were made to strengthen the deposit insurance system. "This is the same cart-before-the-horse mentality which plagued the deregulation of the savings and loan industry in the early 1980s."

Limiting Potential Losses

Not all of the administration's requests are expected to be met with opposition.

The S&L mess and the threat of a crisis in the bank insurance fund have convinced most lawmakers that the government must limit its liability for bank and thrift losses. The government insures about $3 trillion in deposits in the nation's banks, thrifts and credit unions.

Under current law, the government will back each account held by a depositor up to $100,000. But to maintain depositor confidence in banks, the government has often paid off losses in excess of $100,000.

The administration wants to limit its potential liability per depositor to $200,000 per institution — half for retirement accounts and half for all other accounts.

More importantly, the administration wants to end the FDIC's authority to pay off uninsured deposits. Under its plan, the Treasury secretary and chairman of the Federal Reserve Board would make that decision.

Schumer said the administration proposal did not go far enough, and he called for a limit on overall deposit insurance per family. "They're virtually doing nothing because a well-to-do individual can have his or her money in 20 different institutions and get $2 million of deposit insurance right away," he continued.

The administration has called for significant changes in the government's supervision of the banking industry. The plan proposes to cut the number of regulators from four to two. The Office of Thrift Supervision and Office of Comptroller of the Currency (OCC) would be merged within the Treasury Department to supervise all national banks and thrifts.

The Federal Reserve System would take on the added responsibility of regulating state-chartered banks. The FDIC — which currently supervises the banks — would continue to insure deposits. Oversight of bank holding companies would be shared by the Federal Reserve and the OCC.

Some lawmakers disagree with the administration's approach. Gonzalez wants one agency to supervise all financial institutions.

--By Thomas Galvin

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EDITORIAL/OPINION

Scrap Bank Deposit Insurance

By JOHN T. BENNETT

The Treasury Department's master plan for bolstering the nation's banking system would not do nearly enough to make these institutions sound and secure. Inadequate federal regulation, poor business judgment and volatile interest rates have created problems for banks, yet the one reform that might address these issues — a reduction in deposit insurance coverage — barely appears in Treasury's proposals. Such a step should be considered seriously.

Treasury's plan, released in early February, would greatly expand banks' powers, make the department their regulator and start reducing deposit insurance coverage.

Treasury wants to have bigger banks that do more things. Financial institutions would be permitted to sell insurance, stocks and mutual funds, operate across state boundaries and merge with non-financial firms. Treasury's proposals imply that banks will continue to lose money on banking functions and will not survive unless they can profit from other business lines or by monopoly pricing from their big.

The department, as the planned regulatory agency, would protect the public from abuses by giving these new commercial powers only to sound banks. Yet, regulation hasn't worked very well. The Keating Five provide an object lesson that regulation can be neutralized through political pressure.

Self-dealing has been widespread in the financial industry. Neil Bush, the president's son, is only the most obvious example. Each day, real estate developers are resigning from bank boards of directors.

Gold-plated hotels that will never make a profit and developments with big infrastructure investments but no chance of completion escaped the regulator's eye. They also escaped the scrutiny of accountants, who are hired to check for fraud but somehow couldn't see it when their employers were the perpetrators.

It has been clear for several years that houses and commercial real estate were overbuilt in many areas. The banks had already been stung with Third World loans that were never repaid, and their real estate lending compounded that lapse in judgment. Banks provided the funds that drove up prices, which then justified further lending.

Banks' other problems are not addressed by the Treasury proposals. Banks borrow on a short-term basis and lend long-term. They then get into trouble when volatile interest rates rise and depositors search for higher earnings. Moreover, the United States has too many banks.

Reducing deposit insurance coverage might help. The current limit on deposit insurance is $100,000 per account. Treasury is proposing to reduce it to $100,000 a person per institution. Eventually, it would be cut to $100,000 a person. The General Accounting Office already has attacked even this first small step as "unwise" at a time when many banks are in trouble and depositors are nervous.

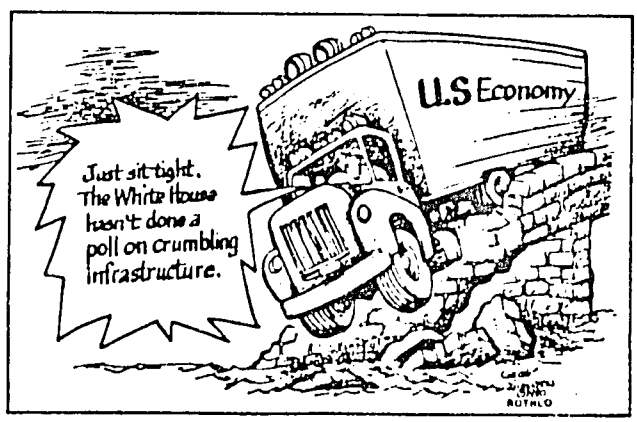
Deposit insurance is sold to the public as protection for small savers. But few need $100,000 in coverage. Most consumers can put enough money in a checking account to pay current bills. Any additional cash can earn more from a money market fund with almost equal safety.

The funds' safety comes from diversification and the short term of the commercial paper in which they invest. But if that is not safe enough, a saver can buy into a fund that invests solely in government securities.

The experience of the money market funds so far reinforces their good reputation. Only two have had losses, and their owners have covered them. Even if there were losses, diversification would limit them for most depositors.

The current argument for lowering bank deposit insurance coverage misses the point. The conventional wisdom holds that depositors with funds above the insured levels will not put that money in a weak bank. Depositors, therefore, would impose some discipline on banks. But few depositors look at their bank's balance sheet and most would find it impossible to judge its loan portfolio.

If the United States reduced deposit insurance substantially, discipline would develop, but for a different reason. Depositors would see the banks as much riskier than money market funds and keep most of their savings in these funds, earning more in the process. The question, then, is whether any deposit insurance is warranted.



To be competitive when there is no deposit insurance, most bank mortgages and loans would either have to be short-term or charge a variable rate. Alternatively, the banks could make the loan or write the mortgage, collect the interest and keep the accounts, but the security would be repackaged for resale so that the buyer was committed for the same term as the borrower.

Another way to judge Treasury's reforms is to consider whether they are either necessary or desirable for banking to survive. Banks provide a number of services, the two most important being a safe place to keep one's money and a source of capital for borrowers.

Big companies now sell bonds or commercial paper rather than borrowing from banks. Since small companies are riskier borrowers, banks need to charge them higher rates and, more important, keep their exposure strictly limited.

If banks cannot earn enough from their loans, depositors may have to pay more to keep their money safe and to write checks. But there is little logic in using deposit insurance as a subsidy to keep banking services low-priced.

Money market funds today account for almost $500 million in deposits, banks total four or five times that amount in insured accounts. An end to deposit insurance would cause a large share of banks' deposits to be shifted to money market funds. Would that be such a bad thing? Long- and short-term maturities would match. Businesses and other borrowers still would get their loans. Many weak banks would disappear, but the survivors would be strong.

Industry consolidation would mean big losses for some banks and their owners. The Treasury Department's proposals, because they avoid such a scenario, are good for bankers. They are not so good for the public.

John T. Bennett is an economist who lives in Alexandria, Va.

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THE WALL STREET JOURNAL TUESDAY, FEBRUARY 5, 1991

The Dangers of Letting Banks Own Everything

By Robert E. Litan

With our banking system in so much trouble and many of our large banks losing market share here and around the world, it is tempting to agree that some European countries, and to a lesser extent Japan, have a much better model for banking regulation than we have. If so, Europe and Japan will continue to enjoy that advantage. The Treasury Department is not going to propose a universal banking model for the U.S. And it's well that it won't, because universal banking poses significant risks for our deposit insurance system and eventually for taxpayers.

In a system of universal banking, as practiced in Germany and perhaps eventually throughout Europe, banks are permitted directly to take unlimited equity positions in other companies. Japanese banks are allowed only 5% equity stakes.

Treasury's Plan

The Treasury's plan, in contrast, is likely to permit banks only to be affiliated with or owned by non-banking (including commercial) concerns. Banks would be prohibited from directly engaging in any other non-banking activity. This seemingly technical distinction between affiliation and direct activity is critically important. Indeed, it underscores the major drawback to the universal banking model.

Universal banking would stretch the federal safety net—deposit insurance and access to the Fed's discount window—under not just banks but much of the rest of the economy as well. Although no one there may admit it, this has already happened in both Germany and Japan, where it is widely understood that the central banks would never permit depositors at any large bank to take a loss. America, too, has its "too big to fail" policy—witness the recent protection of all depositors of the Bank of New England—but at least it doesn't (yet) apply to bank investments in the auto, steel and computer industries.

SAVING THE BANKS

Of course, advocates of universal banking might answer by saying, get rid of "too big to fail." That way, when a large bank is threatened by losses in its securities, insurance or commercial business, the deposit insurer won't bear the whole loss. Indeed, there is growing support in Congress even among those who don't like universal banking for ending "too big to fail."

But this is not realistic. Even if Congress were to restrict or prevent the Federal Deposit Insurance Corp. from fully protecting uninsured depositors, the Federal Reserve would still come to their rescue by providing sufficient liquidity to troubled banks to meet any run.

Advocates of universal banking might reply instead that because universal banks should be safer than ordinary banks, the FDIC and the Fed would be less likely to be called upon than now. Critics will scoff, and point to the claims in the early 1980s that "broader powers" would save the thrift industry.

The problems with universal banking run even deeper, however. Because their deposits are insured by the federal government, banks are able to raise funds more cheaply than other companies. If the law were to allow banks to engage directly in other activities (rather than through affiliates financed by uninsured funds), then bank-operated financial and commercial enterprises would have an advantage over independently operated (that is, non-bank owned) companies. Accordingly, the market would eventually drive companies into the arms of commercial banks.

Universal banking would stretch the federal safety net under not just banks, but much of the rest of the economy as well.

Universal banking advocates, of course, see nothing wrong in this; to the contrary, they believe that bank-controlled capitalism is better than the current stock market controlled system. But even if that theory is correct in Germany and Japan, where commercial banks historically have attracted the cream of managerial talent, it is questionable at best for the U.S., where the best talent has flowed into other sectors of the economy. To be sure, the best and the brightest of our managers might begin moving into banks if universal banking were to become the norm, but the transition period would be long—certainly long enough for many banks to make more mistakes at the FDIC's expense.

If the universal banking model contains such risks, is Treasury's likely model of bank "affiliation" with non-banks (under the roof of a common holding company) any better? In principle, the answer is "yes" because the plan would not permit banks directly to fund other businesses with insured deposits. But even this approach is hardly risk-free.

Without offsetting measures, commercial conglomerates can use insured bank deposits to subsidize loans to customers of their non-banking operations. After all, wouldn't GM or Ford rather extend cut rate car loans through an affiliated bank funded with insured deposits than through their finance companies funded with uninsured commercial paper? In addition, conglomerates would have incentives to use insured deposits to pay for common overhead costs.

More troubling, even though a bank may be healthy, the failure of the non-banking arm of a bank could easily trigger a run among the bank's depositors. To be sure, such runs are irrational. But so were the runs by insured depositors on the Bank of New England.

Three methods have been advanced for insulating banks from their non-bank affiliates. So far, the option that appears to be preferred in Congress (among those at least willing to contemplate financial modernization) is to raise even higher "firewalls" than those that Treasury probably will propose, that banks and their affiliates be required to maintain separate employees, officers, directors, places of business and names. John Dingell, the chairman of the key House Energy and Commerce Committee has insisted in the past that banks and their affiliates be prohibited from "cross marketing" their services. With such firewalls, no one from outside the banking industry will be interested in getting in.

A second option, advanced at least once by FDIC Chairman William Seidman, would order banks to narrow their investments (over some reasonable transition period) to "safe assets"—government securities and highly rated corporate, municipal and asset backed instruments—as the price for affiliating with other enterprises. Banks in such conglomerates would have to transfer their direct lending business to separate finance company affiliates, funded by uninsured sources. As a carrot for limiting their investments to safe assets, conglomerate banks could be charged lower deposit insurance premiums than other non-affiliated banks (with broader investment powers) while being permitted to abide by lower capital requirements.

Finally, Federal Reserve Chairman Alan Greenspan (and conceivably the Treasury plan itself) proposes that banks desiring to belong to financial or commercial conglomerates maintain higher capital ratios than other banks. This proposal could have the opposite effect of the "narrow" or "safe" banking option: To meet return-on-equity targets, banks owned by conglomerates might shift their portfolios to even riskier assets. On the other hand, a higher capital threshold might deter non-banks from entering banking less than strict investment limits would.

It will be said, of course, that imposing either higher capital requirements or narrow banking will scare off just those commercial giants whose interest in banking and willingness to supply capital are so sorely needed. There is no easy way to resolve this tradeoff. Some believe that the cost savings to the FDIC and to consumers from one-stop shopping justify the gamble on less intrusive insulation requirements. Others (like me) are less willing to risk stretching the federal safety net, and so want stronger insulation.

S&L Scars

The scars of the S&L debacle are so painfully felt in Congress that it is unlikely that banks will be permitted to affiliate with non-banks, even with substantial insulation provisions. Congressional inaction, however, will not end the debate. During the 1980s, various states have effectively endorsed the universal banking model by allowing the banks they charter to expand their product offerings. If Congress continues to sit on its hands, this trend should continue into the 1990s.

So those in Congress and the country who wish to prevent the federal safety net from overstretch would be wise to face the question now.

Mr. Litan, a fellow at the Brookings Institution, recently co-authored a report on the banking industry for the Financial Institutions Subcommittee of the House Banking Committee.

This is the second of two articles presenting the arguments for and against breaking the barriers between banking and commerce. The first article appeared yesterday.

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ECONOMIC VIEWPOINT

A shortage postponed

By Samuel Brittan

Whenever a view becomes conventional wisdom it is time to question it. An example is the supposed world capital shortage.

There have indeed been changes which will tend to increase the demand for new capital relative to the supply of savings. There are the needs of reconstruction both in eastern Germany and the rest of the former communist world. In the former case this will reduce to vanishing point the savings surpluses a united Germany can make available to the rest of the world. Japanese growth and Japanese savings are also under pressure. Yet there have been no compensating structural rises in savings propensities in the rest of the western world.

This diagnosis overlooks, however, short-term forces making for world recession. These arise partly from the earlier tightening of monetary policies in many countries to counter the re-emergence of inflation. They have been powerfully reinforced by the so-called "credit crunch", that is, the bad debts and corporate insolvencies which have made banks and other financial institutions more reluctant to lend at any given rate of interest. Moreover the *need* for capital reconstruction in eastern Europe, and even more the Soviet Union, is proving slower to materialise in the form of viable investment opportunities than the optimists supposed.

In any case the predominant worldwide trend is towards recession, and in a recession interest rates fall. Thus, while the received wisdom is that German interest rates will increase and pull up those of the rest of the world and especially Europe, this is no more than a temporary possibility for the early part of this year. The pattern would then be "First a rise, and then a fall" to a rhythm from a Strauss operetta. For, as Tim Congdon, with whom I am happy for once to agree, remarks in the Gerrard & National Review, recessionary forces in the rest of the world are likely to slow down the boom in Germany, which has a smaller weight in the global economy than its influence in Europe suggests.

The much-vaunted international payments imbalances are disappearing

One would not expect signs of falling European interest rates while Gulf tensions are at their present level. But oil prices have been far below those of last autumn, when they touched $40 per barrel. Their tendency to plunge at the slightest whiff of a peace rumour shows how far they are above any normal market equilibrium. Even before such rumours the level of oil prices signified a market belief that any conflict would fail to knock out the main Saudi oil installations.

Meanwhile the combination of Middle Eastern tensions and the threatened crumbling of President Gorbachev's USSR has made the D-Mark slightly less attractive, as well as increasing the attraction of the dollar as a safe haven. These external forces plus endless British official repetitions of the no-devaluation theme have strengthened sterling a little, and it is no longer the weakest currency in the ERM. The relief is only short term, but it will at least buy a little time for the chancellor, and brings in sight the prospect of modest interest rate cuts by around Budget time with larger ones later if ERM credibility can be maintained.

What would we expect to see in the world's main financial markets if a recession takes place in the context of a longer run shortage of savings relative to investment opportunities? Surely a fall in short term interest rates, with long term interest rates remaining fairly sticky and falling only modestly.

The drop in short term interest rates is still to come out side the US. But at the long term end we have already seen bond rates in the US and Germany converging towards the 8 per cent to 9 per cent band, while Japanese rates, at about 7 per cent are a couple of percentage points above 1989 levels. A jump was especially noticeable in Germany, where long term rates rose by 1½ percentage points around the time of the breach of the Berlin Wall. The more policy influenced short term rates rose much later, and, in envisaging lower rates later in 1991, I am several steps ahead of anything the Bundesbank cares yet to contemplate.

The Bundesbank president Karl Otto Pohl stuck firmly in Basle this week to the line "There is no room for lower interest rates in Germany because of the huge budget deficit." The debate in the Bundesbank is between those who expect interest rates to increase and those who believe they might remain approximately stable. A supposedly technical problem is the "Lombard trap" created by the tendency of the normal gap between the Bundesbank's Lombard lending rate and market rates to disappear as market rates rise. This might be resolved by a floating Lombard rate combined with lower reserve requirements for the banks – technical devices which will not resolve the policy problem of how much liquidity to put into the market.

In general, I found the atmosphere on a stopover in Frankfurt much less hawkish than I expected from the mood of the financial markets. One of the most zealously anti inflationary figures in the Bundesbank envisaged that German wage increases would not go above an effective 6 per cent per head in 1991. Productivity might rise by 2½ per cent, and there could be some squeeze on margins. He therefore did not expect underlying inflation to rise much above 3 per cent. Moreover the recession in Germany's partners is proving positively helpful in dampening demand, releasing resources for reconstruction in the east, and boosting the D-Mark.

The proclaimed key to Bundesbank actions is the national budget, and the Bundesbank is happy to line up with Germany's EC partners in calling for a tighter fiscal policy, as the Bundesbank president did in Basle. But again this has to be interpreted with a pinch of salt.

If the German government – which will not be finally formed before next week – can make a half-convincing stab at the chancellor's promises of DM35bn of budget cuts, the Bundesbank will just about accept the resulting 1991 deficit as a temporary unification expedient without saying so, even though it will amount to some 4 to 5 per cent of GDP, or higher than that of the US at its worst. Contrary to widespread belief the Bundesbank is not pressing for tax increases, which it fears will be spent by the Länder, and much prefers expenditure cuts.

One definite change is that the Bundesbank is no longer pressing for an ERM realignment. It accepts that the French have set their faces against any further franc devaluation and that even the UK has a strong commitment to its present parity. It is also influenced by the dwindling of the German current payments surplus from DM104bn in 1989 to a projected DM40bn-50bn in 1991 and to less than DM30bn in 1992. This is part of the general process by which the much vaunted international payments imbalances are disappearing.

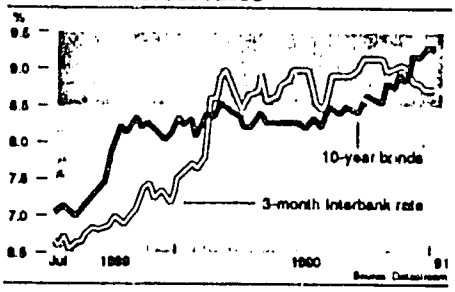
The subtext in Frankfurt is that a strong D-Mark is the key to curbing inflation

About half the envisaged contraction in the German surplus is with other Community countries. This movement has nothing to do with the incorporation of the eastern Länder. In the German payment accounts in the middle of 1990. For, as west German experts were amazed to discover, the former German Democratic Republic was running a current payment surplus on the basis of soft currency contracts with its Comecon neighbours.

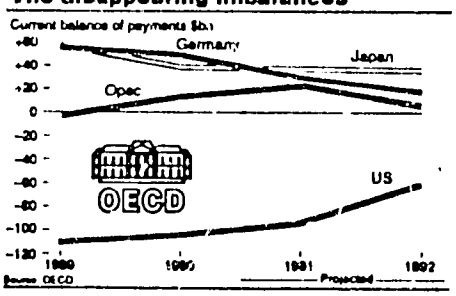
The unspoken subtext in Frankfurt is that the inflationary effect of reunification can be held in check so long as the D-Mark remains strong – not so much against ERM currencies, as against the dollar. The Bundesbank does not want any further appreciation against the US currency. But nor does it want to see the D-Mark appreciably lower. The best hope for the EC countries worrying about interest rate prospects is that the inevitable relapse of the D-Mark, following the failure of the Baker-Aziz talks, will not go too far or last too long.

Of course, if there were a lengthy Gulf conflagration and a soaring oil price, all bets would be off. Far more would then be at stake that the course of German interest rates.

German interest rates



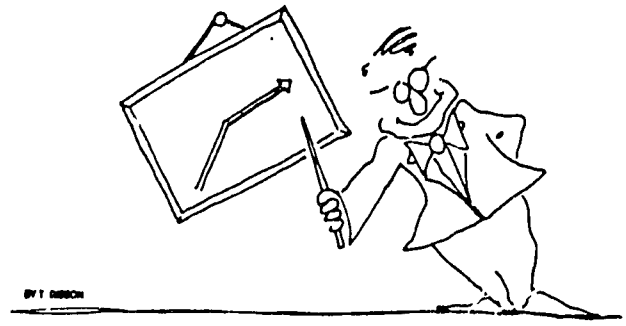
The disappearing imbalances



WASHINGTON POST, January 10, 1991

Hobart Rowen

A Near-Depression . . .



Shades of the Depression! When the federal government has to stop a run on a $13 billion bank by taking it over, you know that the nation's economy is in real trouble. But despite the Bank of New England failure (it should have been closed a year ago), a series of interviews reveals widespread disagreement among experts on just how bad a recession we face.

"I find the decline to date is about average. I would call it a typical, garden variety of recession," says former Federal Reserve Board governor Lyle Gramley. "Still, I have to say that the risks are on the downside." A deep recession, federal bank regulator L. William Seidman admits, would accelerate the pace of bank failures.

Investment banker Felix Rohatyn of Lazard Freres is a pessimist: "I have never been as uneasy about the outlook in 40 years. Everywhere you look, you see red lights blinking. I see something beyond recession, but short of depression."

But some experts are convinced that the anecdotal evidence of recession—the horror stories of individual, company or regional problems—is worse than the actual numbers. At the end of November, Federal Reserve Board Chairman Alan Greenspan said that "the world out there, whenever you look at the hard data, is not in as bad a shape as it feels."

The Brookings Institution's Charles Schultze says that "these anecdotes cause us to examine our position with more care, but having done so, our conclusion is that we face a moderate recession, a lot less than the one we had in 1981-82, with recovery getting underway [later] in 1991."

With the caveat that no single month's statistics is a sure guide, George Perry of Brookings points to the December labor force data as an indication that "the falling-off-the-cliff school doesn't look too good." Although the jobless rate jumped to 6.1 percent, total hours worked in December actually topped November's.

"What we've had is an economy where certain sectors were at a depression level, so the anecdotes [of major trouble] were quite real," Perry said. "Yet, they didn't add up to a lot of GNP."

Gramley cites credit as one area where the actual statistics don't look as bad as the anecdotal evidence. But even so, he admits, "This [credit situation] is different. We've never lived through a period [like this]. We look at it and wonder what it means." Rohatyn broods over the depletion of the domestic credit system, exacerbated now by Japan's and Germany's need to keep at home more of their capital "that we have been living off."

There are some positive elements in the economy that could lead to a turnaround. Business inventories are lean instead of fat, mortgage and other interest rates have come down (with the probability that the Federal Reserve can be expected to push them even lower) and a cheaper dollar helps make exports of American goods attractive. Economic Council Chairman Michael J. Boskin guesses that the worst of the decline has already been registered in 1990's final quarter.

Yet it is difficult for anyone, including those who see only a moderate recession, to build a scenario that restores the economy quickly to a sustained period of vigorous economic growth. The federal budget deficit is huge, and a future tax increase to pay for the costs of Desert Shield and the S&L/bank bailouts looms on the not-so-distant horizon.

There is no blinking the reality of an overbuilt real estate market that helped precipitate the crisis among financial institutions. Even relative optimist Perry grants that commercial real estate is in its own depression: "It'll be a long time before anyone builds a commercial building again." Lenders are super-cautious in extending new credit for any purpose. And state and local governments are being forced to cut services and lay off workers.

What's more, although the rise in unemployment during the past year has primarily hit production workers, a severe crisis in the financial and business-services industries has had an early impact on white-collar jobs for the first time.

The showdown with Saddam Hussein further clouds the outlook. If there is no war—or, at worst, only a short one—most anticipate a revival of consumer and business confidence. If there is a protracted war, all bets are off.

But even a quick end to the Gulf crisis won't end the troubles of the economy. Lee Price of the Joint Economic Committee staff says, "We can't get back to 3 to 4 percent real growth until we write off some of the debt overload—junk bonds, real estate and so on. We can have a short, shallow recession, but we can stay at a sluggish level for a long time."

So how will the recession of 1990-91 wind up? Better not to ask. John Kenneth Galbraith, testifying Monday before a Senate Labor subcommittee, said that in forecasting recession, there are two kinds of economists. "There's the kind that doesn't know, and then there's the kind that doesn't know that it doesn't know."

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STATEMENT OF
WILLIAM K. REILLY
ADMINISTRATOR
U.S. ENVIRONMENTAL PROTECTION AGENCY
BEFORE THE
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

March 12, 1991

Good morning, Mr. Chairman and members of the Committee. I welcome the opportunity to be here today, the first time an Administrator of the Environmental Protection Agency has appeared before the Committee on Foreign Affairs.

As is becoming clearer every month, the task of protecting our national environment has growing global dimensions. Whether it is the prospect of global climate change, depletion of the stratospheric ozone layer, or issues relating to our border environment with Canada or Mexico, environmental problems respect no borders.

The Department of State, of course, is charged with the development and implementation of United States foreign policy. In that environmental issues are increasingly being recognized as integral to our foreign policy, EPA provides valid assistance in implementing these policies, and through development assistance projects under the Foreign Assistance Act.

International environmental activities also have an important foreign relations dimension, as when we help the countries of Eastern Europe launch their environmental cleanup, give technical assistance that will help developing countries come into compliance with the Montreal Protocol, or help

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implement the innovative debt-for-environment provisions you are considering in the Enterprise for the Americas legislation. In performing these activities, EPA coordinates closely with the foreign affairs agencies, particularly State and the Agency for International Development (AID).

Congressional concern for the global environment has historic roots that date back to or precede the creation of EPA. The National Environmental Policy Act of 1969 (NEPA) directs Federal agencies "to recognize the worldwide and long-range character of environmental problems ..." and, where consistent with our foreign policy, to use their programs and resources to support "international cooperation in anticipating and preventing a decline in the quality of mankind's world environment."

Congress subsequently included many international mandates in EPA-administered statutes. For example, the Clean Air Act, the Resource Conservation and Recovery Act (RCRA), the Federal Insecticide, Fungicide and Rodenticide Act (FIFRA), and the Toxic Substances Control Act (TSCA) all have specific international provisions.

In general, EPA's international activities, carried out in cooperation with the Department of State, are driven by the following: the ability to derive direct benefit to EPA's domestic programs, the opportunity to acquire knowledge or data useful to EPA, or an advance in building international cooperation on environmental problems. The Great Lakes, the Caribbean, and the Mexican border are some of the areas which

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provide opportunities for EPA, in conjunction with the State Department, to address international environmental problems that have a direct effect on the U.S.

EPA has agreements with technical agencies in over 20 nations. In addition, cooperation with international organizations like the Organization for Economic Cooperation and Development (OECD) and the United Nations Environment Program (UNEP) provide EPA with valuable opportunities to develop, test, and disseminate environmental technologies and information.

Increasingly, EPA's international activities involve areas of common jurisdiction between your Committee and other committees as EPA is called upon to work with the foreign affairs agencies on programs such as environmental assistance for Eastern Europe under the SEED program, debt-for-nature linked to debt reduction in the Enterprise for the Americas, implementation of the Montreal Protocol, acid rain, and global climate change.

These issues have become EPA priorities not only because they directly affect domestic EPA programs, but because our functional environmental expertise is inherently suited to contributing to meeting these most pressing environmental challenges. The United States is increasingly called upon to provide leadership, and EPA is increasingly called upon to provide technical expertise to tackle global environmental issues. I am pleased to say that EPA is committed to responding, along with other relevant agencies.

At the start of my tenure in 1989, we established a new, Presidentially-appointed Assistant Administrator for International Activities (OIA) and brought "international activities" into EPA's strategic planning and budget process. I directed OIA to convene regular meetings of an Agency-wide Task Force on International Activities to review issues and coordinate our international efforts. My subsequent strategy for EPA's International Activities was outlined in an internal document issued last May, the "International Strategy for the Environment," and I would be happy to provide a copy for the record.

To focus EPA's international efforts, our international office is leading an effort to develop EPA's strategic plan on international activities, which is under review within the Agency. I would like to take this opportunity to summarize the plan's broad, long-term, and inter-related goals, which cover the full range of EPA's international activities and programs.

First, the **protection of the global atmosphere** encompasses international cooperation on global climate change and stratospheric ozone depletion, as well as local and regional air pollution, acid rain, airborne toxics, and other transboundary air pollution issues.

Second, the **protection of marine and polar environments** focuses on coastal environments where development and population pressures are the greatest, and includes issues such as dumping

waste at sea, oil and chemical spill prevention and response, land-based sources of marine pollution, and mineral exploration.

Third, the **conservation of species, habitats, and ecosystems** aims at the prevention of habitat destruction, species extinction, and the overall loss of biodiversity, and includes such issues as deforestation, especially in tropical areas, and the preservation of freshwater bodies and ecosystems such as the Great Lakes.

Other elements in EPA's strategic plan include **sustainable development** and the **protection of human and environmental health.** These objectives include international standards development, shared testing, and cooperative programs to reduce risks from goods moving in international commerce, as well as a recognition of the principle that economic and environmental decisions need to be integrated.

We have developed several strategies to further these five goals, for example:

Strengthen bilateral programs: Working with other pertinent agencies, we tackle common environmental problems with Canada and Mexico, and we conduct cooperative research and development programs with Japan, Germany, and other industrialized countries. These activities also support the broader political goal of improved bilateral relations with strategically important countries, such as the Soviet Union and the Peoples Republic of China.

Improve cooperation with international organizations: Many international financial and development organizations are engaged in numerous efforts to provide technical and financial assistance to developing countries as they address environmental problems. The U.S., therefore, should coordinate its activities to avoid redundant programs and to reduce the costs of administrative overhead. Earlier this year, I attended a conference of OECD environment ministers for just this purpose.

Enhance technical assistance and technology transfer: One of the important issues I raised with my counterparts at the OECD was the question of technical assistance and technology transfer. It is essential that EPA, along with the Agency for International Development (AID) and other Federal agencies, encourage cooperation among donor and recipient countries to promote demand for environmentally sound technologies, training and research, information on and access to appropriate technologies, infrastructure to support these technologies, financial planning to make the cost of implementing these technologies feasible, and the protection of intellectual property rights.

Through our development assistance projects in particular, we underscore approaches that emphasize pollution prevention, risk assessment and risk management, assessment of environmental impacts, cross-media and regional approaches, and market mechanisms.

By pollution prevention, I mean using resources more efficiently to generate less waste in the first place, the reuse

of materials, and the substitution of non-toxic materials for toxic ones. EPA is currently working with AID, OECD, and UNEP on environmental technologies and a clearinghouse for pollution prevention. EPA is also working with AID to develop an inventory of mechanisms, approaches, and interventions aimed at reducing greenhouse gases that contribute to climate alteration.

The use of market mechanisms and economic incentives is illustrated best in the 1990 Clean Air Act, which includes an innovative emissions allowance trading system for sulfur dioxide. In the international arena, the Montreal Protocol on Substances that Deplete the Ozone Layer also includes a limited emission trading system, and our implementing legislation contains a tax to hasten the phase-out of CFC's. Such measures need to be encouraged.

Environmental assessment is a key component of United States domestic environmental programs, and many other countries are interested in developing legislation and procedures similar to ours under the National Environmental Policy Act (NEPA). Along with the Council on Environmental Quality, we have been actively assisting in the development of such approaches.

Regional approaches often provide the best return on our investment in environmental protection. While obviously appropriate to the preservation of marine environments like the Caribbean, regional approaches can be successful in areas with common environmental and social conditions.

Eastern Europe is a case in point. Last September, I was in Budapest, Hungary, to participate in the opening of the Regional Environmental Center for Central and Eastern Europe. The Center was founded, as you know, by contributions from the United States, Hungary, the European Community, and several other countries to strengthen environmental policies and build institutions.

After only six months, the Center already has become a focal point for environmental groups, governments, and citizens of the region. They look to the Center for leadership, expertise, and resources to redress forty years of environmental neglect. The Regional Environmental Center is one of the early successes of the Support for East European Democracy (SEED) Act of 1989.

Latin America is another example: the Enterprise for the Americas Initiative, announced last June by President Bush, will allow for the renegotiation of debt owed to the U.S. Government and application of the interest to environmental protection and conservation.

EPA's international activities include expanded cooperation with other Federal agencies. For example, the two programs that I just mentioned, in Eastern Europe and in Latin America, involve substantial cooperation among EPA, the State Department, AID, the Department of Treasury, the Peace Corps, and other agencies.

The funds for EPA's activities under SEED are appropriated to AID and then transferred to EPA. The coordinating process for these activities, under the overall direction of Deputy Secretary

of State Lawrence Eagleburger, has enabled EPA, AID, and DOE to develop jointly an Environment and Energy Strategy for Central and Eastern Europe, collaborate on program development in the region, and combine our considerable mutually reinforcing expertise to assist our colleagues in Eastern Europe to solve their most pressing environmental problems. We will continue to work together to develop a highly effective program for the future.

Mr. Chairman, we are aware that during this Congress the Committee on Foreign Affairs will direct its efforts toward the reauthorization of the Foreign Aid Assistance Act. We are encouraged that the Committee recognizes the role of the environment in foreign assistance decision-making. We urge the Committee to consider EPA's international strategy for the environment and our inherent environmental expertise as you take up this legislation.

For the past decade, the U.S. has been called upon and responded to the need to provide international environmental leadership. I hope that EPA can expand its collaboration with foreign assistance agencies and the multilateral donors and play a larger role in international assistance programs. EPA is recognized to have expertise in many key areas, and we have much to offer to the development and implementation of environmental programs.

At EPA, we plan to build upon our successes in bilateral and multilateral cooperation, foster regional approaches to

common national problems, and help build the necessary international responses to global environmental challenges. We will work closely with the State Department and AID to ensure our efforts are consistent with and support foreign policy and development assistance objectives. In all these efforts, we value your help very much.

This concludes my prepared statement, Mr. Chairman. I will be happy to answer any questions you may have, either now or later in writing for the record.

Congressional Research Service
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The Environment as a Foreign Policy Issue

by Curt Tarnoff
Foreign Affairs and National Defense Division, January 31, 1991

SUMMARY

Environmental issues have become a significant factor in U.S. foreign policy. Several developments explain their growing prominence. The nature of environmental problems increasingly involves cross-border issues and, in the form of ozone depletion and potential climate change, they are perceived as global threats. Scientific findings indicating an environmental threat have led to growing media attention, public concern, and entry of the issue to the political agenda. Finally, many believe that the dominant security agenda of the cold war is being replaced by other issues, such as economics and the environment. Most recently, the Persian Gulf crisis has demonstrated the use of the environment as a weapon of war.

Many question whether the United States is equipped institutionally to deal with issues that encompass both domestic and international concerns. At this time, decisionmaking appears to be *ad hoc* in nature. Others believe that, in the on-going race between heads of state to be the "greenest," the Administration is not doing enough to sustain the United States as a leader on environmental issues internationally.

Most environmental relations between the United States and other industrial countries have been conducted in the form of friendly competition for leadership and in terms of seeking cooperative measures to resolve problems. However, there is growing friction between the United States and its allies over specific agreements on pollution controls. Environmental assistance to Eastern Europe and the Soviet Union is viewed by many as a way to facilitate political stability and increased trade opportunities.

Environmental issues are likely to have an impact on U.S. relations with developing countries. The United States may increase its attempts to influence the environmental policies of developing countries through the use of aid conditionality and sanctions. Developing countries, sensitive to intrusions on their sovereignty, have begun to ask for increased economic assistance in return for adoption of conservation policies and programs. They may also demand that the United States alter its own domestic environmental policies before attempting to constrain their economies with environmental restrictions.

The following questions arise concerning U.S. foreign environmental policy. What kind of multilateral environmental institutions should the United States support, and how much funding should the United States provide to such organizations? What kind of bilateral economic assistance program would respond best to developing-country environmental problems, and what funding can the United States provide? What priority should environmental concerns have *vis-a-vis* other important policies regarding Third World development, international narcotics, and domestic concerns? The Congress is currently seeking to address these and related issues.

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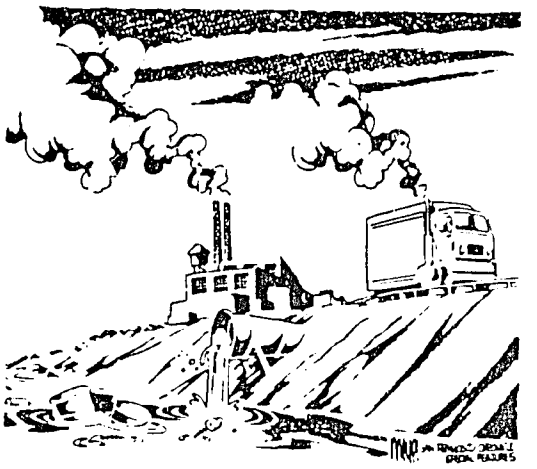
BRUCE STOKES

'GREEN PROTECTIONISM'

Environmental issues and trade issues are on a collision course. The insular world of trade policy making may never again be the same.



For years, trade negotiators cut their deals with no direct concern for the environmental consequences. But now, an increasingly interdependent global economy is emerging against a backdrop of rising environmental consciousness. Neat separation of policy making, with the U.S. Trade Representative's Office (USTR) handling some issues and the Environmental Protection Agency handling others, is no longer politically feasible.

Congressionally mandated environmental goals are likely to be part of the price the Bush Administration pays for authority to negotiate a free-trade agreement with Mexico. And differences over what is a permissible environmental subsidy are dogging the current international steel negotiations and the multilateral trade talks now winding down in Geneva.

How these conflicts are resolved may determine whether Congress ultimately approves a Mexican trade deal and whether U.S. companies will face new overseas competition that has been subsidized for ostensibly environmental reasons. More broadly, the new climate signals that trade policy must now reflect a broader set of social and political concerns.

Environmental groups, among them Friends of the Earth Inc., the National Wildlife Federation and the Natural Resources Defense Council Inc., have an ecological agenda for the Mexico talks, which are slated to begin this summer. Citing the air and water pollution created by the burgeoning number of factories that have already sprung up on the Mexican side of the border, U.S. environmentalists want some assurance that the Mexican government will enforce its antipollution regulations when new investment floods into Mexico following a free-trade accord. To ensure that American companies won't flee to Mexico after the deal is done just to avoid U.S. cleanup efforts, the groups also want Mexico to hold any new U.S. investors to Washington's higher environmental standards.

"We are not against a trade agreement with Mexico," said Stewart J. Hudson, legislative representative for international programs of the National Wildlife Federation. "What we are against is one that is not structured properly to take into account the problems it would exacerbate."

Environmental groups, having allied themselves with labor, industry and farm interests (which have their own wish lists for the talks), stand a great chance of success. The Democratic leadership in Congress is already toying with different schemes to force USTR to include environmental objectives in the package it brings back from the negotiations with Mexico.

In the steel talks and in the General Agreement on Tariffs and Trade (GATT) talks, some European and Asian governments want to legalize subsidies for industry investment in new technologies to help them cut their plants' air and water pollution or to improve their energy efficiency. This does not sit well with the Bush Administration or with U.S. industry. "We don't want people getting subsidies just to modernize their plants," a U.S. trade official said.

"You can design a reason to subsidize whatever industry you want to promote," said Thomas R. Howell, a partner in the Washington office of the New York City law firm of Dewey Ballantine, which represents U.S. steelmakers. "It's a loophole you can drive a steel mill through. The way you clean up the environment is through regulation of pollution. Subsidies affect the competitiveness of companies, not necessarily the environment."

"We've advocated the polluter-pays approach to the issue," said Eric I. Garfinkel, assistant Commerce secretary for import administration, explaining the official U.S. negotiating stance. "Therefore, it would be inconsistent to support the creation of a permissible category of subsidies."

U.S. negotiators think that the coming steel and GATT agreements will ultimately avoid providing a back door for trade-distorting government aid.

But the issue is unlikely to go away. Green protectionism has become a new rallying cry for the European environmental movement, which is increasingly interested in economic self-reliance as a means of minimizing global ecological degradation. "The first thing which would be required would be protection for threatened, fledgling or, at present, absent sections of the economy necessary to ensure increased self-reliance," wrote Colin Hines in a recent study, "Green Protectionism," for Earth Resources Research in London. "To be sustainable, such protection must have environmental goals at its heart."

Under such political pressure, Howell said, "it's clear the Europeans contemplate a greater amount of spending in this area in the coming decade and want to do it in a GATT-consistent way" to avoid being subject to countervailing duties imposed by the United States on subsidized imports.

It is clear that these issues are here to stay. "The question is how do you protect the environment and structure the system for ferreting out protectionism," Eric L. Christensen, a project attorney for the Natural Resources Defense Council, said.

Whether that will be possible may depend on whether the U.S. environmental community can bridge the division that has emerged in its own ranks. On one side are those who are convinced that increased international trade will necessarily lead to greater damage to the environment. They have willingly made alliances with labor and industry forces that want to stop the Mexico deal and the GATT agreement for protectionist reasons. At the other end of the spectrum are groups that worry about environmental destruction but who also believe that freer trade can stimulate the economy, creating more resources to help protect the environment.

Narrowing that divide will not be easy. But if environmental groups don't find some middle ground, their newly minted coalition with labor, industry and farmers may prove ephemeral. And an opportunity to permanently alter the way trade experts formulate policy may be missed. ■

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The Trilateral Commission, April 1990

TASK FORCE REPORT

Beyond Interdependence: The Meshing of the World's Economy and the Earth's Ecology

JIM MACNEILL

PIETER WINSEMIUS

TAIZO YAKUSHIJI

"Beyond Interdependence: The Meshing of the World's Economy and the Earth's Ecology" is the title of one of three task force reports to the Trilateral Commission discussed in draft form in Washington, D.C. The report was prepared by Jim MacNeill, Pieter Winsemius and Taizo Yakushiji. MacNeill is a Senior Fellow at the Institute for Research on Public Policy in Ottawa and Secretary General of the World Commission on Environment and Development (Brundtland Commission). Winsemius, former Dutch Minister of Housing, Physical Planning and Environment, is a Director of McKinsey & Company in Amsterdam. Yakushiji is a Professor of Technology and International Relations at the Graduate School of Policy Science of Saitama University in Japan.

The following are excerpts from the concluding chapter of the report:

The OECD nations bear a special responsibility to lead initiatives to reduce rates of climate change, to reverse deforestation and soil and species loss, and to modify ecologically perverse behavior. But what initiatives appear to hold the most promise for real action? Current efforts to strengthen and reform existing institutions and to negotiate major new conventions must be supported but, given the time frames involved, we favor a parallel pluralistic approach that would seize opportunities for concrete action as they arise—unilateral national action, bilateral action, action by small self-selected groups of nations, regional and global deals. This approach would take advantage of differences between nations and target groups to effect bargains that could improve the situation of all the parties involved....

OECD nations should substantially increase R&D and program funding for energy efficiency and renewable energy resources. Putting such measures into an international agreement, enacted by each nation conditionally on all (or nearly all) others doing the same, would remove the competitiveness obstacle associated with any producing nation moving first....

OECD nations should move quickly to marshal sufficient investment for bargains on global warming. The most frequently proposed mechanism is an international fund. A large number of proposals have been made to finance the fund through various taxes or levies, including a "climate protection tax" related to the carbon content of fuels, levies on a mix of pollutants, on the value of international trade, on international passenger and freight transport, and on carbon, sulphur, nitrous oxides and other air pollutants. Several proposals have been made to create an international regime within which shares or permits to emit carbon would be granted to national governments and could be marketed freely between them. The "simplest" solution for politicians in the OECD nations is undoubtedly to channel a fixed percentage of GNP into a fund....

The greatest weakness in the existing institutional framework for environment and development exists at the national and local levels, especially in developing countries. There is an urgent need to build viable domestic institutions for sustainable development. The most pressing need in the areas of environmental protection and resource management is to

strengthen the scientific capacity needed to assess changes in the environment. Scientists are on the front line in the battle for a sustainable planet. The most pressing need to ensure that future development is sustainable is to increase the capacity of central economic, trade and sectoral agencies to assess the impact of their policies and budgets on the resource base for development, and to act on those assessments.

Developing this institutional capacity should be the subject of priority bargains between OECD bilateral development assistance agencies and institutions in selected developing countries....

[N]ations should continue negotiations on an international agreement to cap and reduce CO^2 emissions. The goal should be a substantive (i.e., not an empty) "framework convention," which would be negotiated in parallel with, and signed at the same time as, action protocols. The convention should contain a clear commitment to the goal of stabilizing GHG [greenhouse gases] concentrations in the atmosphere, and a set of phased targets to achieve that goal. The protocols would pick up the agreed targets and set out the agreed means to achieve them. The convention should not be signed unless and until at least a protocol on energy emissions and one on deforestation could be signed with it. The existing Montreal Protocol (strengthened by the June, 1990 meeting in London) could also be folded under the convention. Later protocols should provide for appropriate measures concerning the hitherto uncharted territory of methane and nitrous-oxide emissions.

The convention should also lay out the foundations for a simple but effective mechanism to provide leadership, overall political direction and broad coordination of work under the convention. It might be called a World Forum on Environment and Development (WEDF). It would bring together ministers representing the signatories to the convention at least once a year to evaluate progress and decide on necessary actions. This could take the form of a "summit" of Ministers of Resources, Environment, Energy, and Finance, from North and South, to discuss progress toward global sustainability. The WEDF would need to be supported by a small permanent bureau. A group of senior officials would also be essential to prepare policy recommendations and to set up channels for the implementation of its decisions. UNEP and the WMO might perform these roles. The intergovernmental Panel on Climate Change (IPCC), which involves senior officials from participating governments, could undertake scientific assessments and analysis of policy options on a continuing basis. After completing its original mandate, the IPCC could also be retained as a body for developing and funding joint research projects on climate and the environment. We also see a larger role for a redirected World Bank as the pre-eminent institution for collecting and distributing large funds and for preparing and managing multilateral bargains. With a modified charter, the World Bank could perhaps grow into the role of serving as the international clearinghouse.

OECD nations should attempt to achieve a substantive framework convention of this type by the time of the 1992 World Conference on Sustainable Development. But the prospects for this at the moment seem very unlikely. If negotiations through 1992 do not produce a framework convention with goals, targets and a few key action protocols that can be signed at the same time, it would be better in our view to opt for no convention than to settle for an empty framework. A political "success" purchased at the price of an empty framework would reduce pressure for real action, perhaps for years to come. The chastening experience of a political "failure" could sharpen the pressure and maintain the momentum of the negotiations until real success is achieved. The worst thing that the world community could do is to let governments "off the hook." Rather, it should increase societal pressure to "make them sweat it out" until such pressure has been translated into a political willingness to act.

The full published report is available from the New York, Paris and Tokyo offices of the Trilateral Commission.

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Jessica Mathews

The New Dogma of Environmentalism

It is the kind, not the amount, of economic growth that makes the difference.

Some years ago, biologists coined a phrase they called the Central Dogma. Its few words (which describe the flow of genetic information inside a cell) became the indispensable mental map by which a torrent of new information was organized and understood. In the 1980s the study of environmental trends went through a period of similar ferment and acquired a central dogma of its own. It holds that the solution to the planet's environmental problems lies in something called sustainable development.

The phrase was popularized by a United Nations commission whose 1987 report "Our Common Future" was a surprise international bestseller, though not in the United States. The Brundtland Report, as it is also known, changed the terms of international debate by persuasively demonstrating to a broad audience that environmental degradation is not merely a consequence of industrialization but a "survival issue," especially for developing countries. Although individuals and commissions had been making the same case for years, "Our Common Future" succeeded where others had failed in illuminating the environmental aspects of poverty, hunger, disease, debt and economic growth.

The report provided a bare-bones definition of sustainable development as economic activity that "meets the needs of the present without compromising the ability of future generations to meet their own needs." While that is accurate as far as it goes, it has proven to be surprisingly difficult to expand the definition in terms useful to policy makers.

Sustainable development assumes that economic growth is essential to environmental solutions. Thus it leaves behind sterile growth/no growth debates. It also implies that there are limits to economic growth. The general view today, however, is that these are not the absolute limits whose existence was so hotly debated in the 1970s. Nor are the limits likely to be imposed by a dwindling, finite supply of resources. Instead, the limiting factor is likely to be, as the report put it, "the ability of the biosphere to absorb the effects of human activities." While these effects are obviously related to the number of people on the planet and to aggregate economic activity, the limits are highly elastic. They are determined by the state of technology and social organization, by political will and capital investment. It is the kind, not the amount, of economic growth that determines environmental stress.

In practice, the difficulty lies in distinguishing growth that is sustainable from growth that is not. Doing so requires a long time frame, detailed knowledge of subtle biological relationships and a broad geographic view. Growth that depends, for example, on the export of pollution may look sustainable as long as only the exporters are considered. Growth that rains acid precipitation on Swedish forests may look fine to the Poles, the Czechs or the Germans, but not to the Swedes.

Finding the appropriate time scale is much harder. It turns up, for example, in the controversy about Northern Pacific old-growth forests and the spotted owl. It is possible to grow old trees in these forests in 200 years. But more than old trees are necessary for sustainable old-growth forests. They also require large, hollow logs on the forest floor. Why? Because the trees depend on fungi that live in their roots, the fungi depend on rodents for their reproduction and the rodents need the logs to survive. It takes much longer than 200 years for a tree to grow old enough to fall, and so a sustainable cutting cycle in these forests must also be much longer than 200 years.

While societies wrestle with these sorts of problems, environmental historians are confirming that the choices are not merely theoretical. The evidence extends back to the beginning of literate civilization. For 1,200 years the history of ancient Sumer hinged on its ability to produce an agricultural surplus, which, in the Mesopotamian valley, meant irrigation. Over time, irrigation caused salinization, as it does today. After 600 years, as the soil grew saltier and the supply of fresh land was exhausted, Sumer's crop yields, and its fortunes, began to fall. By the time of the Babylonian conquest, yields had dropped to one-third what they had once been.

The same story is being pieced together in Mexican jungles where Mayan civilization flourished for 400 years and then collapsed. There deforestation and soil erosion, rather than salinization, apparently did the damage.

The beginning of the last decade of the millennium is a natural moment to glance backward. Clive Ponting, a British environmental historian, points out that an accurate account of human history in 30 minutes would devote 29 minutes and 51 seconds to hunter-gatherers, more than 8 seconds to settled agricultural society and a fraction of the last second to the modern, fossil fuel-fired industrial world. "Viewed over the long term," Ponting writes, "human history has been a story of rising numbers and greater pressures on the environment." A crucial difference is that what were once local pressures are now global ones. "Is humanity too confident about its ability to avoid ecological disaster?"

The Brundtland Commission thought it saw an answer. "We came to see that a new development path was required, one that sustained human progress not just in a few places for a few years, but for the entire planet into the distant future." The notion of sustainable development has defined the goal. Figuring out how to achieve it remains a monumental task.

The writer, a vice president of the World Resources Institute, writes this column independently for The Post

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THE OECD OBSERVER, February/March 1991

Managing the Environment

by Bill L. Long

It is a time for 'stock taking' by the international environmental community. Preparations are underway for a major United Nations Conference on Environment and Development in Brazil in 1992 which will, in part, commemorate the launching of the 'era of the environment' twenty years ago at the UN Conference on the Human Environment in Stockholm, Sweden. And the twentieth-birthday year of the OECD Environment Committee culminates early in 1991 with a meeting of the OECD Environment Ministers.

In each case the meeting organisers are pondering what they should report to heads of state and ministers on how far the nations of the world have come since the 1970s in managing the environment.

My own view is that the OECD countries have, in general, come a considerable distance, and are today poised on the threshold of significant breakthroughs in protecting and enhancing their environmental resources in the years immediately ahead. On the other hand, when one looks beyond the OECD region, to eastern Europe and the developing world, environmental performance in the 1970s and '80s was dismal, alarmingly so.

It is, I believe, both interesting and instructive to look back twenty years and compare environmental attitudes and approaches then with the situation today.

In 1970, the Stockholm Environment Conference was being planned as an event that would raise awareness, to make world leaders sensitive to environmental threats and the importance of a common approach. During a recent visit to the OECD, the Secretary-General for the 1992 Brazil Conference, Maurice Strong (who also headed the Conference in Stockholm twenty years ago), emphasised that deliberations in Brazil will be about the economics of environmental management.

This is consistent with one of the principal trends in international environmental affairs, captured neatly by a speaker at an OECD workshop early last year that 'one can track the evolution of environmental concern over twenty years by watching it move from the back page of major newspapers to the front page, and now to the financial page'.

It is consistent also with OECD's approach, which emphasises the imperative of integrating economic and environmental decision-making if goals in either sector are to be achieved.

A second notable change involves the sources of concern. In 1970, the principal worry, expressed mostly locally, was pollution which could be seen, smelled or heard. Today, concern has spread to include pollution by chemicals and radionuclides at micro-levels of concentration – threats to human health and well-being which citizens cannot detect with the unaided senses. Further, environmental risks have broadened spatially to encompass transborder air and water pollution on a regional scale, and also problems of ozone depletion, climate change, deforestation and ocean pollution on a global one.

The environmental 'renaissance' in the second half of the 1980s, which has since engulfed the highest political levels in OECD and other countries, was in fact triggered by public concern that human activity had reached the point where it was beginning to affect adversely the basic life-support systems of the Earth.

From Regulation to Market

In 1970 technology and industry were perceived as the villains. The evolution of attitude here was characterised by Gustave Speth, President of the World Resources Institute in Washington, who recently confessed to being a 'reformed Luddite'. He associated himself with a growing number of converts who now see technology – in the form of a new generation of 'clean' technology – as the key to an environmentally sustainable future, with private industry an essential part of the solution, rather than the problem.

Clearly industry – or parts of it, at least – is earning much more public tolerance, even respect, by demonstrating that it can make a profit while reducing waste generation, pollution emissions and raw material consumption. But while success breeds success, it also heightens expectations. Thus industry is being confronted with a

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Kaku Kurita/Gamma

One of the direct results of tropical deforestation (left) is catastrophic flooding (below), often in areas considerable distances away.

new challenge as government officials and the public, extrapolating from individual success stories, seem increasingly to believe that, with enough pressure, industry will perform environmental miracles while maintaining profitability.

The President of the International Chamber of Commerce, Peter Wallenberg, noted in a recent speech that 'the withering away of the Marxist challenge to the free enterprise system leaves the environmental challenge as the most fundamental one that businessmen all over the world are going to face in the foreseeable future'.

The evolution of environmental management is also reflected in the policy instruments governments have employed to achieve environmental objectives. In the early 1970s, 'command and control' regulatory approaches were adopted in an effort to bring a quick halt to major pollution problems. Subsequently, the expanding costs of pollution control, the increasing complexity of regulatory regimes, and the failure of regulation to force technology innovation beyond what was required by law caused governments to look for new policy tools.

OECD countries, in particular, turned increasingly to the 'market'. Environmental taxes and charges, deposit-refund schemes and – most recently – the use of tradable emission permits were introduced. Within the last two years there has been an explosion of interest in the use of such market-based instruments with the intensification of the search for increased efficiency in environmental management.

What is emerging appears to be a *de facto* 'hybrid' system, with governments using command and control regulation to fix long-term performance standards and targets, while looking to market instruments to find the most cost-effective pathways.

Governmental policy-making in the environmental field has also moved sharply in the direction of more comprehensive approaches. Early attempts to protect the environment were based on the management of one pollutant at a time and one medium at a time. This strategy failed to take into account the fact that the pollution is often just moved from one medium to another (e.g., if controlled as a solid waste and incinerated, any toxic material can end up in the air), or that regulation of one chemical can give rise to more hazardous substitute products. At the beginning of the 1990s, governments are now adopting much broader strategic approaches, captured in such policy slogans as 'multimedia management', 'integrated pollution prevention and control' and 'cradle-to-grave management'.

From Adversity to Co-operation

The changes taking place in Eastern Europe are also of striking importance in international environmental affairs. The 'cold war' mentality of the early 1970s spilled into the UN Environment Conference in Stockholm as the East and West competed to convince other nations of the merits of their respective economic systems for protecting the environment. Two decades later, the importance of open societies, pluralistic institutions and market-based economies for effective environmental management stands unchallenged.

Haldevi/Sygma

ENVIRONMENT AT THE OECD

Work on environment questions in the OECD has, not surprisingly, mirrored international trends. In the Organisation's first decade, a number of environmental projects were undertaken, principally related to the science of air and water pollution. In 1970, as environmental concerns moved up the political agendas of member countries, an OECD Environment Committee and Environment Directorate were established. A major concern was the economics of environmental protection: who pays, and how much? This was answered in part in 1972 with the adoption by the OECD of the 'Polluter Pays Principle', one of the basic tenets of environmental management today.

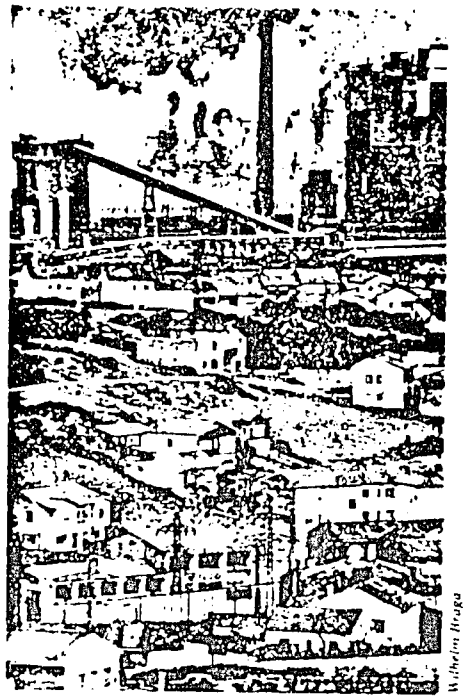
During the 1970s, the OECD's environmental work expanded well beyond environmental economics to include new programmes on chemical safety, pollution control (encompassing air and water pollution and waste management), natural resources management, and sector studies focused on agriculture, transportation, energy, coastal zones and urban areas.

It is noteworthy that, until the latter years of the 1980s, the OECD's environmental work was carried out almost exclusively by the Environment Directorate and the associated Committee. Now the situation is markedly different. Reflecting national trends, environmental work in the OECD is virtually everyone's business as national delegations raise environmental concerns and proposals in the Organisation's committees on, for example, economic policy, trade, science and technology, and agriculture and fisheries.

Twenty years ago, furthermore, the OECD was the principal forum that Western industrialised nations turned to for international environmental work. Today, the field is crowded. Active and influential environmental programmes are in place in the European Communities, Economic Commission for Europe, European Free Trade Association, Council of Europe, Nordic Council, United Nations Environment Programme and an array of other UN specialised agencies. The Conference on Security and Co-operation in Europe (CSCE) is leading to an expansion of international work on the environment, and the new European Bank for Reconstruction and Development (BERD) has environment specifically included in its mandate.

In view of the changing priorities in environmental management and the increasing competition among multinational organisations for the time and support of member states, the OECD Council, meeting at Ministerial level in 1989, decided on a 'next generation' approach. The idea is to focus a broad spectrum of the Organisation's capabilities on five central issues where it seems to have a comparative advantage:

- the relationship between the economy and the environment
- energy and the environment
- 'clean' technology
- environmental health and safety
- co-operation with non-member countries.



Wilhelm Hrugo

Concern for the environment now involves forms of pollution beyond those that can be seen or smelt.

Today, the extent and severity of environmental degradation in eastern and central Europe pose a special challenge to economic reform in that region. At the same time, East-West co-operation in the reform process provides new hope for improving the health and welfare of hundreds of millions of people and for protecting and rehabilitating the natural environment. It also affords former adversaries the opportunity and motivation to address 'spill-over' transboundary environmental problems in Europe, as well as to join forces in confronting global environmental problems and assisting developing nations.

At the 1972 Stockholm Conference, a developing-country spokesman remarked that 'Industrial smoke looks like money to me'. Unfortunately, he might well resurrect it for his speech at the 1992 UN Conference in Brazil since little has been accomplished in the developing world in the intervening years to demonstrate the fallacy of the remark. In spite of the considerable efforts by many nations to establish environmental infrastructure and to mount remedial programmes, and the provision of substantial financial and technical assistance by the external donor community, the environment continues to be degraded in most of the developing world. Population growth and debt problems have conspired to overwhelm efforts to improve the environment, and in the process to maintain near-term economic growth as the over-riding national priority.

A. Baranyi/Jerrican

But there has been a major change in the North-South environmental relationship. For most of the last two decades, assistance to the South for environmental protection was largely based on humanitarian concerns. With the discovery of the hole in the ozone layer over Antarctica in the mid-1980s, this situation changed radically. It quickly became obvious that, unless the developing world is willing and able to co-operate in confronting global environment threats, efforts by the developed nations acting alone will be grossly inadequate.

Today, issues involving the possible creation of new international environmental funds to assist developing countries, and ways of facilitating technology transfer to them, dominate at international conferences and negotiations on, for example, ozone depletion, climate change and tropical deforestation.

Finally, the mental and conceptual model for addressing the environmental problems has been radically transformed. In the early 1970s, the 'Limits to Growth' approach of the Club of Rome was in vogue, projecting collapses of ecological systems from the onslaught of population growth, pollution and exhaustion of natural resources. With the report by the World Commission on Environment and Development in 1987, a new growth-oriented 'sustainable development' model has emerged to capture widespread attention and support.

Its proponents agree, however, that this requires a new kind of economic growth, one concerned as much with quality as with absolute quantity. One of the virtues of sustainable development, beyond replacing a 'gloom and doom' scenario with one of hope, is that it forces planners and decision-makers into a more strategic approach to environmental management. It extends the time-horizon for planning and analysis, and forces consideration of longer-range objectives and targets.

□ □

The only type of development which is sustainable over the long term is one which integrates environmental concerns, and the only environmental policy sustainable over the long term is one that is in harmony with economic objectives. The challenge is to define the ways and means to achieve this so that nations do not have to choose between a healthy environment and a healthy economy.

William Mansfield, Deputy Executive Director of the United Nations Environment Programme, observed that 'economics' and 'ecology' both have the same Greek root, 'oikos', meaning 'household' and 'everything in its proper place'. The challenge, he said, is 'to put these back together again'.

Integration of economics and environmental decision-making – involving such issues as trade, pricing policy, development assistance strategy, and government intervention in the marketplace – clearly will be the dominant concern of environmental policy-makers, and their colleagues in other government ministries and departments, in the 1990s. The OECD, given its orientation, experience and capabilities, should – and must – play a central role in international efforts to confront this challenge. ■

OTA Report Brief

February 1991

Changing by Degrees: Steps To Reduce Greenhouse Gases

The United States can decrease its emissions of carbon dioxide (CO_2) to as much as 35 percent *below* 1987 levels within the next 25 years by adopting an aggressive package of policies crossing all sectors of the economy. Such emissions reductions will be difficult to achieve and may be costly, but no major technological breakthroughs are needed. OTA identified a "Tough" package of energy conservation, energy supply, and forest management practices to accomplish this level of emissions reductions.

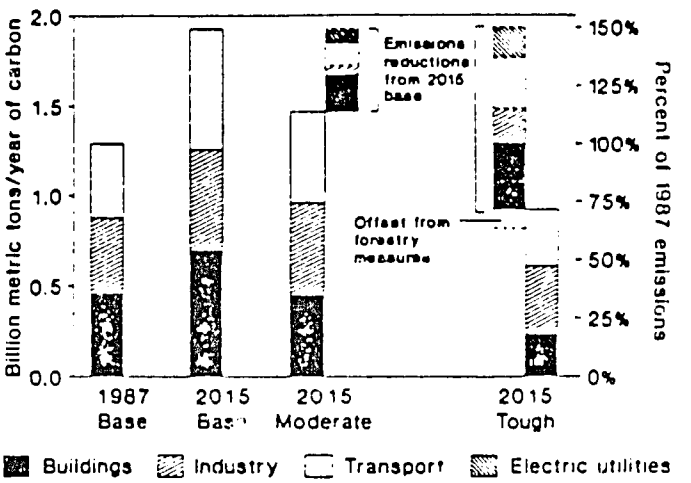
OTA also presents a package of cost-effective, "Moderate" technical options, which if adopted, would hold CO_2 emissions to about a 15-percent increase over 1987 levels by 2015. In contrast, if the United States takes no new actions to curb energy use, CO_2 emissions will likely rise another 50 percent during that time.

CO_2—the major "greenhouse gas"—accounted for an estimated 55 percent of the global warming commitment caused by human activities over the last decade. Greenhouse gases trap much of the heat from sunlight, potentially leading to significant changes in the Earth's climate. The United States is the single largest contributor of greenhouse gases. With only 5 percent of the world's population, the United States accounts for 20 percent of the world's warming commitment.

OTA examined a suite of technical and policy measures that could be adopted in four sectors of the U.S. economy—buildings (commercial and residential), manufacturing, transportation, and energy supply. We modeled about 100 discrete, energy-related technical options—including relatively quick retrofits to existing equipment and, in the long term, introduction of more efficient technologies to replace worn out equipment and satisfy a growing economy's needs. OTA also identified steps to increase carbon uptake by U.S. forests and thereby offset CO_2 emissions, as well as methods to control emissions of other greenhouse gases, primarily from the food sector.

No single option, nor focus on a single sector of the economy, can achieve major emissions reductions alone. Of the CO_2 reductions possible under OTA's Tough scenario, about 30 percent would come from commercial and residential buildings; about 25 percent from manufacturing; between 15 and 20 percent each from transportation and electric utilities; and about 10 percent from forestry.

Carbon Emissions Under the Base Case, Moderate, and Tough Scenarios



NOTE: The boxes outlined with dashed lines represent the *reductions* in carbon emissions associated with control measures applied in each of the three demand-side sectors (i.e., buildings, industry, and transportation) and electricity supply (electric utilities); additional carbon *offsets* afforded by forestry measures are also shown. The boxes outlined with solid lines represent *total emissions* from each demand-side sector. Emissions associated with electricity generation have been allocated to the three demand-side sectors.

SOURCE: Office of Technology Assessment, 1991.

A variety of Federal policy initiatives will be required to achieve large reductions in U.S. CO_2 emissions. Such policy actions will have to include both regulatory "push" and market "pull" mechanisms—including performance standards, tax incentive programs, carbon-emission or energy taxes, labeling and efficiency ratings, and research, development, and demonstration activities. To achieve lasting reductions, government signals (e.g., pricing and regulatory policies) need to be consistent and reinforcing. Otherwise, we are likely to see reversals—as in the 1980s, when energy prices decreased, Federal attention lapsed, and U.S. fossil-fuel consumption started climbing again.

A 35-percent reduction in U.S. CO_2 emissions during the next 25 years would not, by itself, stop global warming. The Intergovernmental Panel on Climate Change and the U.S. Environmental Protec-

The Office of Technology Assessment (OTA) is an analytical arm of the U.S. Congress. OTA's basic function is to help legislators anticipate and plan for the positive and negative impacts of technological changes.

Selected Options To Lower U.S. Carbon Dioxide Emissions

Measures that affect all sectors:

Promising policy options:

- carbon emission tax
- marketable permits for carbon emissions
- RD&D for noncarbon energy sources and energy-efficient technologies

Buildings:

Technical options:

- Better insulation, windows, and improved construction methods to lower heating and cooling needs
- more efficient furnaces, air conditioners, and appliances
- improved lighting, especially in commercial buildings

Promising policy options:

- efficiency standards such as tighter appliance standards and building energy codes for new construction
- "demand-side management" programs by electric and gas utilities to facilitate improvements in existing buildings
- information programs such as energy audits and home energy ratings as a requirement for mortgages

Transportation:

Technical options:

- fuel efficiency improvements
- increased use of mass transit, vanpools, and carpools
- more efficient vehicle operation through measures to reduce congestion, reinstate 55-mph speed limit

Promising policy options:

- tighter fuel efficiency standards for cars and trucks
- gasoline tax
- transportation control measures (e.g., high-occupancy vehicle lanes and parking management), better mass transit, and improved urban design

Manufacturing:

Technical options:

- continuing process improvements—especially for iron and steel, chemicals, paper, and petroleum
- increased cogeneration of electricity and heat
- improved electric motors
- fuel switching from coal to gas

Promising policy options:

- carbon emission tax
- joint industry/utility programs for "demand-side management"
- marketable carbon emission permits

Electricity generation:

Technical options:

- increased use of nonfossil sources (e.g., hydro, wind, solar, nuclear)
- co-firing existing coal-fired plants with natural gas
- retiring existing fossil-fuel-fired plants after 40 years

Promising policy options:

- marketable carbon emission permits
- carbon emission tax
- efficiency standards, carbon emission limits, and/or moratorium on new coal-fired powerplants
- RD&D for noncarbon energy sources

Forestry:

Technical options:

- increasing productivity of forests
- planting trees on marginal croplands, other nonforested rural lands, and in urban areas
- growing short-rotation woody crops for use as biomass fuels

Promising policy options:

- increase existing Federal forestry assistance programs
- expand Conservation Reserve Program
- tax incentives for forest management, tree planting

Food:

Technical options:

- decrease livestock methane emissions
- increase efficiency of nitrogen fertilizer use to reduce nitrous oxide emissions
- take marginal croplands out of production and rotate crops

Promising policy options:

- increase research funding to evaluate efficacy of methane-reducing practices
- require farmers to adopt environmentally sound agricultural practices as a prerequisite for receiving Federal price and income supports
- continue to remove disincentives to crop rotations

tion Agency suggest that stabilizing the *concentration* of greenhouse gases in the atmosphere will require a 50- to 80-percent reduction in CO_2 emissions from current levels *worldwide*, as well as significant reductions in the other greenhouse gases—chlorofluorocarbons (CFCs), methane, and nitrous oxides. Thus, a global effort would be needed.

Internationally, the United States could work towards a worldwide agreement to reduce greenhouse gas emissions, similar to the Montreal Protocol that phases out CFCs, the second largest contributor to global warming. Several other industrialized countries have called for either a freeze or 20-percent reduction in CO_2 emissions by 2000 or shortly thereafter. All industrialized countries currently account for about two-thirds of the greenhouse gases.

Also, the United States could help developing countries control their greenhouse gas emissions while maintaining needed economic growth. A similar goal is appropriate for the U.S.S.R. and Eastern Europe, where institutional obstacles such as centralized planning and highly subsidized energy resources have led to energy-inefficient societies. The United States could encourage emissions reductions in all of these countries by placing more emphasis in its foreign aid policies on, for example, switching to nonfossil fuels, developing energy-efficient technologies, sustainable use of forest and agricultural resources, and adopting international forestry protocols. For developing countries, moreover, the United States must also consider population growth and foreign debt issues.

Ultimately, nonfossil energy sources such as solar technologies and/or a new generation of nuclear power must replace fossil fuels if the world hopes to keep emissions from rising under continued economic growth. The Tough options identified by OTA not only can reduce emissions in the short term, they can also help the U.S. economy (as well as others) make the transition to a nonfossil fuel future. To be poised for this transition, increased funding for research, development, and demonstration is needed to help bring the non-greenhouse gas emitting technologies on line.

Copies of the report for congressional use are available by calling 4-9241.

Copies of the report and summary for non-congressional use can be ordered from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402-9325 (202) 783-3238. The GPO stock number for the OTA report, "Changing by Degrees: Steps To Reduce Greenhouse Gases," is 052-003-01223-5. The price is $16.00. The GPO stock number for the summary is 052-003-01224-3. The price is $2.75.

For further information contact OTA's Publications Office. Address: OTA, U.S. Congress, Washington, DC 20510-8025 (202) 224-8996.

WASHINGTON POST, February 26, 1991

ALSTON CHASE

Into the sunshine at climate confab

Think of it as shifting gears on a steamroller.

A U.N. conference on global warming — "the Intergovernmental Negotiation Committee for a Framework Convention on Climate Change" — recently concluded a stormy session in Washington.

Even as U.N. meetings go, this one, which became deadlocked over some crucial issues, was underwhelming. Yet despite accomplishing little, it was significant for what it revealed: that politics, not science, drives the global-warming debate.

Even before scientists pronounced warming a threat, the United Nations had created a mechanism for addressing it. This machinery is propelled by private agendas that have nothing to do with the issue. And despite its momentary glitches, the U.N. effort is a bandwagon gathering momentum that may be far more dangerous than the peril it pretends to avert.

According to some theories, so-called "greenhouse gases," such as carbon dioxide (CO_2) — produced by burning fuels such as wood, coal, gas and oil), chlorofluorocarbons (CFCs — used as refrigerants) and methane, are building up in the atmosphere, where, by trapping solar heat, they could cause catastrophic rises in worldwide temperature. The U.N. meeting, which included representatives from 130 countries, was intended as a step toward developing a global agreement on reducing these emissions.

Yet the conference split on two issues. First, Europe wanted specific reductions in carbon dioxide, but the Bush administration sought to build a negotiating framework that would include all greenhouse gases. Second, Third World countries, particularly India, desired free technology transfers to aid them in reducing greenhouse gases, while industrial nations wanted the nature of compensation left for later discussions.

Europeans have done less to clean up their own air than Americans, and they are under political pressure from green parties to do more. They rely more on natural-gas generation (which produces 20 percent less carbon dioxide) and nuclear power than the United States does. So, seeking a painless way to look like good environmentalists, they proposed a worldwide freeze of CO_2 emissions at 1990 levels by the year 2000, while ignoring other greenhouse gases, such as CFCs and methane.

By contrast, CO_2 reductions would have a severe impact on America. Our country emits 30 percent more carbon dioxide, per unit of gross domestic product, than Europe. This is not all due to extravagance. A higher proportion of U.S. energy is produced by coal because the environmental lobby has been so effective in closing the nuclear option. In addition, America needs more energy for heating and cooling because it is colder in winter and hotter in summer than Europe. It needs more fuel for transportation because it is a bigger country.

Meanwhile, the United States has already done more than any nation to reduce CFCs. So not surprisingly, the Bush administration sought an agreement that, rather than focusing on CO_2 alone, addressed all greenhouse gases, including CFCs.

Third World delegates saw a global-warming agreement as a giant income redistribution scheme — just like the recently signed U.N. protocol to limit CFCs, which included payments from industrial countries to poorer nations as compensation.

Delegates privately pushed selfish agendas while simultaneously trying to perch, publicly, on the moral high ground. What the debate lacked was the voice of scientists, for an increasing number of scholars wonder: Is global warming a threat at all?

So throughout the conference, delegates privately pushed selfish agendas while simultaneously trying to perch, publicly, on the moral high ground. What the debate lacked was the voice of scientists, for an increasing number of scholars wonder: Is global warming a threat at all?

In a meeting held in Arizona last fall, 30 climatologists expressed great skepticism about global warming. They concluded that it would be far less than predicted and that increased levels of carbon dioxide, rather than a threat, could actually be beneficial, stimulating crop growth.

There are perhaps 100 climatologists in the United States doing empirical studies on global warming. So this meeting by no means represented a lunatic fringe. Indeed, scientists worldwide are expressing doubts about the greenhouse hypothesis. But while scholars raise critical questions about warming, bureaucrats and environmental lobbyists hold meetings to keep it on the front burner.

A prime example of how this political bandwagon rides roughshod over scientific integrity was last year's assessment from the United Nation's Intergovernmental Panel on Climate Change. The document had two parts, a short, snappy "Policy-makers' Summary" and the report itself — a long, thoughtful scientific review. But whereas the full report expressed doubts about global warming, the policy-makers' summary was a classic scare scenario. MIT professor of meteorology Richard S. Lindzen called it "sophistry."

Such sophistry drives the global-warming debate because it serves the economic interests of some nations. Eventually, these interests will agree on how to divide the pork, and an agreement will be reached. The next U.N. climate meeting, in Nairobi this June, could produce a hasty and ill-conceived treaty with disastrous economic consequences.

If so, then the United Nations, rather than building institutional machinery that identifies real environmental threats and that formulates appropriate responses to them, will have fashioned an instrument that actually hurts the chances of human survival.

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Environmental-Economic Evaluation of Projects and Policies for Sustainable Development

By Mohan Munasinghe
and Ernst Lutz

The World Bank Environment Department, January 1991

ABSTRACT

The efficient use of natural resources (both mineral and biological), as well as manmade capital and human resources, are a vital prerequisite for sustainable development. One key role of environmental economics is to help value environmental and natural resources more precisely, and internalize the costs and benefits of using such resources into the conventional calculus of economic decision-making.

The environment provides essentially three main types of services to human society -- and the consequences of damage to all these aspects must be incorporated into the decision-making process. First, the environment is a source of essential raw materials and inputs that support human activities. Second, the environment serves as a sink which absorbs and recycles the waste products of economic activity. Finally, the environment provides irreplaceable life support functions (like the stratospheric ozone layer that filters out harmful ultraviolet rays), without which many living organisms would cease to exist.

This paper reviews current economic approaches to the analysis of projects and policies and discusses possibilities for better integrating environmental concerns into public decisionmaking. In Part I, current practices are briefly reviewed as they relate to project analysis, to public expenditure and investment reviews, and to the analysis of economic policies.

Part II deals with four key issues: Physical impacts of projects and policies; valuing these in monetary terms; the discount rate and issues of risk and uncertainty. The main emphasis is given to methods of valuing environmental impacts. Where possible, practical examples are given that should be useful for "broad-based" analyses, which better deal with what hitherto has often been referred to as "externalities".

The principles of valuing environmental costs and benefits discussed in the paper have only been applied in a limited number of actual situations. Therefore, the major need at present, is not for more theory or techniques, but for application of existing methodology and approaches to concrete problems, particularly in developing countries. More such work could be carried out as part of project preparation. A major purpose of this endeavor is not to provide fine-tuned numbers but to indicate orders of magnitude. Some project alternatives can be ruled out in this fashion. Also, one can often identify the key estimates to which the decision is sensitive and focus more refined analyses on them.

The best one can do is to use cost-benefit analysis to the extent possible and push it to its acceptable limits. Alongside, one needs to consider and, to the extent possible, rigorously analyze consequences and risks that cannot be measured in monetary terms (such as with multi-criteria analysis). The two things, together with sound judgement, are at present the best inputs into decision-making.

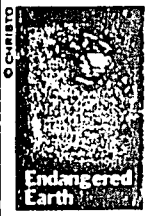
TIME, April 1, 1991

FOREIGN AID

Good Intentions, Woeful Results

How an ambitious environmental program ended up damaging the tropical rain forests

By EUGENE LINDEN



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A new threat to the world's fast-diminishing rain forests has united the normally fractious environmental community. The organizations arrayed against this peril constitute a Who's Who of the environmental movement: the Sierra Club, Friends of the Earth, the World Wildlife Fund, the National Wildlife Federation and the Natural Resources Defense Council. Testifying before Congress, Bruce Rich, chairman of the Environmental Defense Fund's International Program, said none of these groups were "exaggerating when they say they fear that an environmental Frankenstein has been unleashed."

And just what is this monster? Sadly, it is a program originally intended to save the world's remaining rain forests. The Tropical Forestry Action Plan, or T.F.A.P., was perhaps the most ambitious environmental aid program ever conceived. Sponsored in 1985 by the World Bank, the U.N. and other groups, the initiative was designed to help the world's tropical countries come to grips with deforestation. With the help of international agencies, each nation would come up with a formal proposal for managing and protecting its forests. T.F.A.P. would channel $8 billion in aid over the next five years to implement those programs.

By now, efforts to slow tropical deforestation should have been in effect for years. Instead, sponsors had to convene in Geneva last month for what James D. Barnes of Friends of the Earth described as a "make or break" meeting to see whether the foundering plan could even be saved.

Few would deny the seriousness of the crisis that prompted T.F.A.P. Moist tropical forests cover just 6% of the earth's terrestrial surface but contain at least 50% of the world's variety of insects, plants and animals. Throughout the world the forests are chopped to clear land, provide firewood or supply the timber market. A report issued in 1990 by the U.N.'s Food and Agricultural Organization shows that the rate of deforestation in the tropical world has accelerated 80% since 1980.

T.F.A.P. was the industrial world's largest collective effort to help address the developing world's environmental problems. It was launched with assurances that the program would not repeat the mistakes of past development efforts, which included duplication of effort; rip-offs by contractors, consultants and corrupt officials; and a tendency to promote the donor's priorities at the expense of the Third World's. Unfortunately, the forestry plan ended up repeating many of these failings.

From the outset, T.F.A.P. seemed to have more to do with expert opinion in industrial-world think tanks than with actual situations in tropical nations. Perplexed critics asked why India, with few remaining tropical forests, was targeted to receive $1.2 billion, while Indonesia and Zaire, with huge forests, were to receive $193 million and $34 million apiece.

It turned out that the authors of the original T.F.A.P. had chosen spending targets not by the size of their uncut tropical forests but by their ability to digest large amounts of money. Says Bruce Rich: "It was a plan that was really devised according to the needs of the aid agencies rather than the needs of the countries."

Embarrassed by such missteps, the sponsoring organizations made the first of several attempts to fix T.F.A.P. Be patient, they advised waiting aid recipients; the plan was still evolving, and its shortcomings would be addressed. Despite reservations increasingly being voiced by sponsoring organizations, however, the program seemed to take on a life of its own.

In country after country, proposed action plans stressed such projects as the opening of previously pristine forests for exploitation. Noting that Cameroon could become the "most important African producer and exporter of forestry-based products from the start of the 21st century," T.F.A.P. proposed construction of a 370-mile road through virgin rain forest that is home to 50,000 Pygmies. Many environmentalists wondered, By what logic do building roads into pristine areas and financing logging operations help preserve uncut forests?

The logic of self-interest, as it turns out: the sponsors of T.F.A.P. created a plan that promised benefits to rich and poor nations alike if they adopted programs stressing forestry over conservation. By making the forestry department of the U.N.'s Rome-based

Food and Agriculture Organization principally responsible for administering the overall plan, moreover, the sponsors made it likely that cutting trees would have high priority.

But the organizations also made the mistake of selling the program in different ways to the rich nations and the Third World. Although touted to environmentalists in the industrial nations as a plan to save the forests, T.F.A.P. was sold to the Third World as one more source of funding for traditional forestry projects. Little wonder that the plans tended to be short on ways to slow deforestation. Said a development expert: "For officials in the Third World, environmental aid has become a new form of cargo cult: Go through the motions of doing these assessments, and cargo will come."

The most serious problem, however, is that T.F.A.P. may be based on a flawed premise. Thomas Fox of the World Resources Institute doubts there is evidence to support the assumption that tropical forests can be harvested and managed without damaging the ecosystem. So little is known about the intricate codependencies that tie the myriad species of plants, animals and insects of these forests into a working system that some biologists wonder whether tropical forestry is sustainable at any commercial level.

The plan has been all but disavowed by some of its original sponsors. James G. Speth, who as president of the World Resources Institute was instrumental in creating T.F.A.P., has described the plan as the "biggest disappointment of my six years at W.R.I."

FAO director general Edouard Saouma, an autocratic executive who likes to run his own show, has fought to keep control. Under threat of a funding cutoff from the sponsoring organizations, however, the U.N. organization agreed in Geneva earlier this month to cede control of the program to an outside governing council and to participate in the program's redesign. For the moment, these decisions have partially mollified critics, who are willing to wait to see whether these actions will produce meaningful reform.

So far, T.F.A.P. has not fulfilled the most dire predictions of environmentalists, but only because very little of the $8 billion intended for the Third World has actually been spent. Moreover, the plan has not been all bad. It offered a framework that brought rich nations together with Third World countries to begin dealing with tropical deforestation. "There are benefits to having global, one-stop shopping for the basic principles of forestry lending," says Barnes of Friends of the Earth.

Nor can it be said those criticizing T.F.A.P. are without sin. Tropical nations today find themselves besieged by international environmental groups, each promoting its own approach to conservation and planning. Some African nations are dutifully undertaking as many as seven different types of assessments, often with little coordination between the ministries involved. It was the fear of this type of scattershot approach that inspired creation of T.F.A.P. in the first place.

Perhaps the best thing to come out of the T.F.A.P. disaster is that the furor it triggered has forced major international organizations to pay attention to the complexities surrounding tropical deforestation. The World Bank has been harshly criticized for promoting development projects that lead to the destruction of tropical forests. But the bank's vast influence in poorer nations gives it the potential to be a major force in plans to save the forests.

There is little time to spare. An estimated 210 million acres (85 million hectares) of tropical forests have been burned, cut or flooded in the five years since T.F.A.P. was conceived. It is not too late for the world to act to save these intricate green engines of life, but efforts to help will come to naught if the rich nations do not first absorb the failings of the world's most ambitious environmental program to date. ■

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Expanded statement for the record

Mr. Chairman and Members of the Sub-committee:

It is a pleasure to appear before you as we mark the beginning of a new era in American foreign policy. Areas of historical international tension have diminished. The opportunity to promote the universal goals of peace, prosperity, democracy and human rights has not been greater in living memory.

Far from self-marginalization on the periphery of world events, African countries are asserting themselves on the world stage in positive, productive ways. There is no better example of Africa's determination in this regard than its performance in the events of the recent Gulf crisis. African countries, almost without exception, joined wholeheartedly in the worldwide chorus condemning Iraqi aggression. The four African members of the UN Security Council during Operations Desert Shield and Storm -- Zimbabwe, Ivory Coast, Zaire and Ethiopia -- stood firmly and decisively with us and other Security Council members to take forceful UN-mandated action in the Gulf. Three countries -- Senegal, Niger, and Sierra Leone -- contributed contingents to the coalition forces.

The Administration believes that Africa must take part fully in realization of our historic opportunity. To help Sub-Saharan Africa realize its potential, the Administration is requesting $828 million in economic assistance, $147 million in food assistance, and some $33 million in military assistance for FY 92. In all, our request for Africa totals just over one billion dollars.

THE DEVELOPMENT FUND FOR AFRICA

Congress created the Development Fund for Africa (DFA) in FY 88, in explicit recognition of the region's special needs. There was a desire, which we fully support, to move beyond relief of disasters like famine to supporting sustained development. Last year the Congress appropriated the DFA at a level greater than our request. This year I am pleased that in spite of global budget constraints, our request for the DFA maintains that increased level of support.

We're especially pleased because this shows that there is an Administration-Congressional consensus for support of Africa. It also sends a clear signal that events in Eastern Europe and elsewhere notwithstanding, we will not forget our African friends.

The State Department welcomes AID Administrator Roskens emphasis on democracy because economic and political pluralism cannot be reserved for the United States and a few other already developed countries. These two complementary elements represent not only the only socio-political order that permits individuals and nations to realize their full potential, but they also provide the only environment responsive to universal human aspirations.

While our economic and political development objectives rightly hold first priority, many parts of Africa will have a desperate need for humanitarian relief assistance as well. Food aid and emergency aid from AID's Office of Foreign Disaster Assistance (OFDA) are key to meeting these needs.

We are all painfully aware that Africa's onerous external debt burden is an enormous impediment to economic growth, draining away limited resources from development activities. In 1989, we initiated a program to forgive development assistance and ESF debt to reforming African countries. To date, $590 million of such debt has been forgiven. In addition, the Agriculture and Trade Act of 1990 includes a provision for generous waiver of PL 480 food aid debt. Although implementation procedures have not yet been completely worked out, we are pleased that Africa will be a major beneficiary.

THE NEW ERA IN AMERICAN FOREIGN POLICY

Secretary Baker has articulated five key foreign policy objectives for the decade before us -- democracy, market economies, meeting transnational challenges, conflict resolution, and relief of human suffering. Our FY 92 request for Africa addresses forcefully each of these objectives.

For several years, African countries have been rejecting the false promises of Marxism and other state-interventionist economic systems on the evidence of their utter failure. At this point, almost three-quarters of the countries of Africa have embarked on economic reform, directed at reducing the role of the state and according a greater role for private initiative and market dynamics.

Africans throughout the continent have increasingly joined the positive trend towards insistence on greater participation in their political systems -- they want and deserve democracy as much as everyone else. Africans are also succeeding in creating democracies in places that may not have appeared promising just a short time ago. Newly independent, democratic Namibia is perhaps the most dramatic example of this movement. But in addition to established democratic societies in The Gambia, Senegal, Botswana, and Mauritius, within just the past year Benin, Mozambique, Cape Verde, Sao Tome & Principe and

Gabon have made enormous progress toward democracy. Many other African countries have begun the process of liberalizing their political systems. As Freedom House put it, Africa is experiencing "a sweep of multipartyism that presents the most significant phenomenon since decolonization three decades ago." Today, in many areas of Africa, domestic debate is lively and less controlled or indeed controllable; free elections have been held; political opposition is recognized as legitimate; people are successfully insisting they determine their political destinies for themselves.

THE SPECIAL ROLE OF ESF

Mr. Chairman, I have discussed the importance of the Development Fund for Africa, our chief tool for directing foreign assistance to Africa. I want to use the opportunity of this hearing today to also discuss two other forms of assistance we are directing to Africa: Economic Support Funds (ESF) and Military Assistance.

Like DFA, ESF has been used for economic purposes. In Chad, for example, ESF has been used to help with budget support for the economic ministries with which AID conducted its DFA activities. In this case, DFA and ESF were complementary and mutually reinforcing. But, whereas DFA is our best instrument for responding to traditional development and humanitarian concerns, ESF has a flexibility that makes it our best instrument for supporting growing positive trends toward democracy and human rights in Africa.

Our ESF request for Africa is $28.3 million. Our request reflects special political, economic and security concerns on the continent, as mandated by the FAA. The five countries intended to receive $18.3 million of these funds - Namibia, Cote d'Ivoire, Djibouti, Senegal and the Seychelles - have been carefully selected on the basis of one or more of the criteria I have already referred to - sound economic reform, democracy, and responsible participation in world events.

For FY 92, we request a $10 million ESF fund for an entirely new initiative, a regional account solely for the purpose of supporting democracy in Africa. Africa's established democracies and those countries newly embarked on a democratic course will need, and certainly merit, supplemental assistance, particularly in the event of destabilizing economic emergencies. A part of the fund could be used for this purpose. Another part would be used to assist reforming countries in their transition to democracy by providing technical and material support for constitutional development, the holding of elections, establishment of representative

regional governments and other aspects of the democratization process. Finally, a part of the fund would be used to strengthen those institutions and values on which democracy rests -- a free press, an independent judiciary, the rule of law -- throughout the continent.

While we have indicated five specific countries we are persuaded merit ESF in FY 92, we very deliberately have not indicated which countries might be chosen to receive funds from our proposed new regional democracy fund. Our intention is to be able to respond quickly and substantively to sudden, unanticipated domestic political developments deserving US support.

For example, who could have imagined only one year ago that Benin would utterly reject Marxism-Leninism in favor of a market economy and freely contested elections? Benin's leaders and people made this courageous decision and proceeded to implement it very quickly; and their country is now completing a series of free and democratic elections which have totally transformed the political landscape. At the time that Benin undertook its peaceful political and economic revolution, we had great difficulty finding new resources to assist that country and demonstrate support for reform. Ultimately, we were able to identify a small sum of $1.3 million in ESF that we could transfer to Benin. I should add that this money will be used to help Benin meet its pressing balance of payments needs, freeing other resources to finance the country's elections and development. I am convinced that in at least the near term, only ESF, from our proposed regional fund for democracy, will permit us to respond to what are sure to be a number of rapidly developing opportunities to support directly and quickly the progress of democratization in Africa.

THE MILITARY ASSISTANCE REQUEST

There is also an important role for military assistance. Our approach is intended to be consistent with the many recent changes we have seen in the world, including in Africa. We do not see our military assistance supporting the kinds of strategic objectives which were a concern in past years, but rather as another form of contribution to development and stability. Our proposed military assistance would also provide a measure of additional security for a selected group of countries.

As this is a period of considerable change, we have designed our military assistance for FY 92 to be as responsive as possible. Several states with which we have had a substantial relationship are no longer eligible for military assistance, but we might want to be in a position to help them

again if they are able to set their houses in order. We are also mindful of the constructive role a timely amount of military assistance might play in helping to consolidate resolutions of any of Africa's devastating internal conflicts.

In this setting, we are proposing a military assistance program that consists of the following elements:

We want to continue with IMET at roughly this year's level. IMET is our primary means of training junior and mid-level officers in their professional military specialties while giving them an opportunity to experience the American way of life. It is our expectation that IMET graduates will return to their countries with a proper perspective of the role of the military in society, particularly non-involvement in politics. This will be especially important in this period of democratic ferment.

Our FY 92 request for Foreign Military Financing (FMF) is also in line with recent requests, but with a greater emphasis on regional programs and less bilateral activity. On the bilateral side, we want to maintain our support for a few countries which have made good use of our assistance in the past, which need help in maintaining equipment which we provided in previous years, or which face an external threat, principally from Libya. The bulk of the proposed bilateral assistance is non-lethal, and typically helps the recipients meet their needs in maintenance, transportation, engineering and military construction.

For the first time we have included a request for an Africa Regional Military Assistance Program. This includes the Africa Civic Action Program, and I want to say a few words about that before describing the proposed new elements of the Regional Program. Under the heading, Africa Civic Action, the U.S., for several years has assisted African militaries with construction projects which benefit civilian populations. Bridges, schools and health clinics are among the types of construction projects which have been undertaken, enabling African militaries to play a direct role in national development. More recently a Military Health Affairs component was added to enable us to assist with health equipment, supplies and training for military health personnel for the benefit of both military personnel and civilians. A third civic action element, the African Coastal Security program, has been successful in helping African countries, especially in West Africa, to protect fisheries resources against unlicensed depredations by outsiders. Our assistance typically increases the ability of such states to patrol their exclusive economic zones and enforce their laws. The fisheries resources are then available to meet Africa's nutritional needs or to produce income for development.

The Regional Military Assistance program we propose would cover these activities while also enabling us to lend a hand in helping with resolutions to Africa's internal conflicts. We currently have requirements to support peacekeeping activities in Liberia and Mozambique, and foresee requirements in Angola, among other disputes where we consider we have an interest in a peaceful resolution. We want to see Africans assume responsibility for African disputes, and plan to use this regional program in part to train key African militaries in peacekeeping.

Mr. Chairman, I appreciate the opportunity to testify before your Subcommittee on the crucial issues of funding for Africa. As you know, TransAfrica, an interest group dedicated to promoting more progressive American foreign policy toward Africa, has been quite vocal in its support of increased aid.

In my brief testimony this morning, I want to not only to recommend an increase in Africa's development aid level to $1 billion in fiscal year 1992, but also to highlight the inconsistencies in American foreign policy toward the continent. U.S. foreign aid to Africa must be made contingent on respect for human rights and progress toward political and economic reform.

Africa is undergoing a whirlwind of political and economic change that predates and, in many respects, surpasses developments in Eastern Europe. Reform is a serious enterprise. It is imperative that the Congress and the Administration make a strong commitment to assisting the growth of freedom in Africa, and to helping African countries achieve and sustain the kind of economic progress necessary for the nurturing of a free society.

The Administration's response to events in Africa has been inconsistent and ambivalent. Clear and consistent foreign policy toward Africa based on respect for human rights and support for

political and economic reform, will promote development and stability in Africa, and serve the foreign policy interests of this country.

There are no easy solutions. The beautiful and varied landscape of Africa reflects a complex variety of problems and opportunities which will require distinct responses from the United States. But we must also be aware of how the various economies and political systems in Africa interact and affect each other.

An obvious example is South Africa. South Africa's system of apartheid and its policies of regional destabilization harm not only the disenfranchised black majority in South Africa, but also the frontline states of Southern Africa.

Consistent foreign policy must include an increase in assistance for SADCC, the regional grouping that has made considerable progress toward infrastructural development and economic growth. But we must also do all that is within our power to eradicate apartheid. TransAfrica recently published a report which concluded that it is both premature and illegal to consider lifting sanctions at this time. Continued violence in South Africa and delays in reaching a negotiated settlement will have disastrous consequences for the whole Southern African region. Increased aid to the frontline states and the pursuit of a nonracial democracy in South Africa go hand in hand.

Angola is another nation where the adverse effects of inconsistent and wrong-headed U.S. policy is particularly obvious. While the U.S. funnels military aid to the UNITA rebels, Angola remains the United State's second largest trading partner in SubSaharan Africa. I respectfully ask the committee to use the authorization bill and all other mechanisms available to it to stop funding this bloody civil war and move the Administration toward meaningful dialogue and support for economic development in Angola.

For too many Americans, Africa raises images of swollen bellies and drought stricken lands. Famine and drought are indeed serious problems and I urge the committee to advise, guide and monitor the Administration so that this nation does all it can to prevent the devastation that is looming in Angola, Sudan, Liberia, Somalia and Ethiopia.

But there is another, more positive story to be told. Africans themselves are demanding change. United Nations Undersecretary General Adebayo Adedeji captured the spirit that is sweeping Africa very well at the International Conference on Popular Participation in Arusha, Tanzania last year. Mr. Adedeji told the gathering that

> Africa needs fundamental change and transformation, not just adjustment. The change and transformation required are not just narrow, economistic and mechanical ones. They are the broader and fundamental changes that will bring about, over time, the new Africa of our vision where there is

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> development and economic justice not just growth; where there is democracy and accountability not despotism, authoritarianism and kleptocracy; and where the governed and their governments are moving hand-in-hand in the promotion of the common good, and where it is the will of people rather than the wishes of one person or group of persons, however powerful, that prevails.

Many African countries, often in response to popular pressures, are moving toward or have established multi-party systems. Other countries, where progress is not so marked, have nevertheless taken concrete steps to encourage popular participation and make governance less inflexible. These countries deserve our special financial support. Just as Poland and Hungary were able to garner over $900 million in emergency foreign aid, African countries that are democratizing also merit special consideration well above the normal levels of aid allocations as circumstances dictate.

Newly independent Namibia holds the promise and potential for democratic development in Africa. After a long struggle for independence, Namibia has instituted a multiparty democracy rooted in the rule of law and the practice of social justice. Their solid Constitution guarantees a separation of powers, allows for freedom of speech and association, and protects fundamental human rights. Most notably, this Constitution establishes an independent judiciary and limits a President to two terms of office.

However, the legacy of apartheid has left significant obstacles to Namibia's socio-political development and economic growth. New institutions and policies must be developed to address the issues of education, housing, food production, health care, infrastructure and unemployment. Substantial aid is needed here to restructure this nation and ensure its longevity as a democratic society.

Botswana has been a shining light of democracy in Africa since its independence in 1966. Protection of human rights and the structure of democratic institutions are guaranteed by the Constitution, making Botswana one of the most democratic nation on the continent. However, this multi-party state needs greater foreign assistance and investment to expand its production in agriculture and industry and to address a growing income disparity between rural and urban areas. If the U.S. supports democratization in Africa, it must provide more financial support for a leading model of African democracy: Botswana.

There have been remarkable shifts towards multi-party democracy in Benin. A seventeen year dictatorship ended without violence after a severe economic crisis motivated the call for political change. Benin's new Constitution limits a president to two terms and provided for last month's election of a new Parliament. While these political changes are encouraging, economic problems threaten their success. The shift from a state controlled economy to a free market system will not ease the economic crisis until

privatization and diversification can succeed. Increased foreign assistance will help Benin survive this economic and political transition.

Positive changes toward multiparty democracy and political accountability are also underway in Nigeria, Mozambique, Zambia, Sao Tome and Principe and Cape Verde. These developments deserve more than just moral support; they need our concrete assistance not only to entrench democracy, but also to serve as an example to those few countries that are resisting similar demands for change.

While several countries have responded to their citizens' demands for reform, others have tried to circumvent them or have rejected them outright. U.S. policy should not reward such countries. Primary among these are Zaire, Kenya and Malawi.

President Mobutu, while promising reform in one breath, has proceeded to harass and intimidate those who want to take advantage of the so-called reform. We must not be fooled by this wily behavior and should instead send a strong message that any reforms must be total and unconditional.

Kenya's President Moi has been as aggressive in his resistance to change. Prominent personalities including the winner of the 1991 Golden Pen Award, Mr. Gitobu Imanyara, are in jail either without charge or on dubious charges. President Moi is indeed living up

to his promise to critics that he would "hunt them down like rats." We fully support the conditions passed by the Congress last year and would suggest that they be maintained. Additionally, with corruption reaching alarming proportions in Kenya, we advise that any development assistance be channelled through proven non-governmental organizations.

For many years, Malawi has been able to quietly avoid international attention to its very poor human rights record. This is true, despite the fact that there may be no other African country that suffers under such repressive authoritarian control. The United States has long supported a regime that not only has a President-for-Life, but a regime which has detained hundreds of critics--real and imaginary. I urge the Congress to impose conditions similar to those placed on Kenya, before releasing any further assistance to Malawi.

Mr. Chairman, it is TransAfrica's firm belief that military assistance, particularly in the form of materials and arms, should cease immediately. The last several years have shown that these arms are hardly used for the defense of countries against outside aggressors. Indeed, it is significant that some of the latest and fiercest civil wars in Africa have occurred in countries to which we have provided military assistance--Liberia and Somalia. It is imperative that the U.S. not contribute to this death and destruction by providing such military aid.

Before I end, I want to commend the Committee on the passage of the new permanent authorization language for the Development Fund for Africa. The new language will hopefully foster more effective, equitable and participatory usage of monies destined for Africa. I encourage AID to strongly enforce and implement this language which requires close consultation with the poor, the expansion of the participation of women and is protective of environmental interests.

Mr. Chairman, thank you for inviting me this morning to remark for the record on the proposals before us. I do hope that the United States as part of a new world order will begin to see the intrinsic value of enhanced long term development programs over the use of patriotic missiles and armed forces. If the Persian Gulf War warrants the spending of up to $1 billion a day, surely the countries of SubSaharan Africa deserve to share a sum equal to that amount for a single fiscal year. Thank you.

IMF ACTIVITIES

Some African Countries Have Made Enviable Economic Progress, Says Camdessus

Following are excerpts from remarks by IMF Managing Director Michel Camdessus to the IMF/AACB Symposium in Gaborone, Botswana, on February 25:

After some twenty years of disappointing performance in much of Africa, resulting in lower real per capita incomes, it is easy to understand why many feel tempted to despair about the prospects. Moreover, the global economic environment is worsening, with . . . slowdown[s] in some industrial countries, while the suspension of the Uruguay Round raises questions about the prospects for world trade. These setbacks compound the existing external difficulties, including the shortage of external financing and slow progress toward resolving the debt problem.

But in contrast to all this, we also see the encouraging achievements of those countries that have prudently managed their resources and/or steadfastly pursued their reform programs. Consider the encouraging recent record of the nearly thirty African countries that have been persevering with growth-oriented adjustment programs. The programs are producing results—positive real growth, the steady transformation and improvement of their economic structures and systems, and, in particular, an improvement in the living standards of the rural population.

More solid economic progress is achievable, but only if we reinforce what I call the unwritten law of international cooperation: that countries should implement appropriate policies to the best of their ability and that these policies should be supported by creditors and donors.

It is true that structural reforms do not produce their full results quickly. One cannot expect to correct in a few years what have sometimes been decades of structural misadjustment. The results so far have been modest in some cases, at least partly because of the legacy of mistaken investment priorities and development strategies that were for too long inward-looking and based excessively on state interventionism. It is taking time to rectify these policies and to move toward a more productive economic system—in which private entrepreneurship is encouraged, given sufficient scope, and allowed to flourish. It is also taking time to adjust the role of the public sector to its proper function in a modern, market-based economy.

It is not surprising that those African countries that were quick to deal with their economic problems and have shown firm economic management (such as Botswana and Mauritius) have achieved an enviable economic performance. Equally important, a significant number of African countries . . . have been implementing far-reaching structural reforms for several years. These reforms are yielding encouraging results, and their long-term benefits will be reaped increasingly in the period ahead. Certain countries—including Mozambique, Tanzania, and Uganda—that are still experiencing severe economic difficulties are already seeing significant results from their commitment to effective adjustment programs, including a revival of economic growth and/or slower domestic inflation.

> *"Nearly thirty African countries . . . have been persevering with growth-oriented adjustment programs."*

Truly, in many countries, we see encouraging signs. Clearly, there is a definite need for further structural improvements. In each country there are sectors where progress has been inadequate. One of these is of particular concern to the central bankers gathered for this symposium; I refer to the urgent need to reform and strengthen the commercial banking sectors in several countries. This is particularly important where we see insolvent banks, an overhang of nonperforming loans, a banking structure that does not promote competition, and the persistence of negative real interest rates. These weaknesses in banking systems hamper the development of competitive and productive economies and render more difficult the conduct of sound policies. And in most countries, I believe, there is scope for more vigorous

measures to promote private sector activity, decentralize decision making, and reduce the stifling impact of excessive state intervention and unnecessary bureaucracy. All this simply underlines the need for persistence in forcing through the structural and systemic changes that are a necessary condition—though never sufficient in themselves—for the creation of a more productive and viable economy.

So far I have stressed the responsibility of the Africans themselves. They know that the primary task rests with them, with their governments, and with their people, to forge their own destiny. Help from outside is indispensable. But it can only supplement these countries' own efforts. The experience of the IMF in recent years has been that governments are more likely to find success if their programs are both well designed technically and broadly supported by the public. This implies, in particular, that these programs ensure that the vulnerable members of society are cushioned from the most severe transitional consequences of necessary adjustment. This is not only compatible with, but effectively supportive of, the process of adjustment for growth.

"A meaningful reduction of trade barriers, in the context of the Uruguay Round, is essential."

Increasingly, we are seeing that effective political leadership involves a complex process to marshal a consensus behind a coherent medium-term strategy. Hence the increased emphasis in Africa on improving the "qualitative" design of economic programs. This is reflected in a greater concern to ensure that revenue systems are efficient and fair, and public expenditure is channeled in accordance with economic and social priorities. In many countries we hear loud and really justified criticism of expensive—if not extravagant—projects or excessive military spending. In times of such scarce saving and such pressing basic needs this has got to be corrected. I do hope that the relaxation of regional tensions, particularly in southern Africa, will be seen by the governments of this area as a favorable occasion to demonstrate their commitment to reduce such expenditures to a minimum. Acting simultaneously and . . . in a coordinated fashion could allow them to be bolder than acting on their own. Let us hope that this could enable all countries of southern Africa to use the resulting "peace dividend" to meet pressing needs, and to pay greater attention to the development of human capital.

These are only a few aspects of the growing demand in Africa for "good governance," meaning more responsive and accountable governments, and for more pluralistic systems of political representation. These trends are improving the chances for economic and systemic reforms to be better understood, better accepted and so more successful. That is why they are particularly welcomed by Africa's friends.

In discharging these demanding responsibilities governments can be most effectively supported by bold regional cooperation as underscored in the Lagos Plan of action. If anything, my recent stay in southern Africa has further brought to my attention the formidable potential for additional economic efficiency your countries could release in forging closer regional ties. There is no need to tell you that we, in the IMF, look forward to strengthening our relationships with key regional organizations in Africa and particularly with SADCC [Southern African Development Coordination Conference].

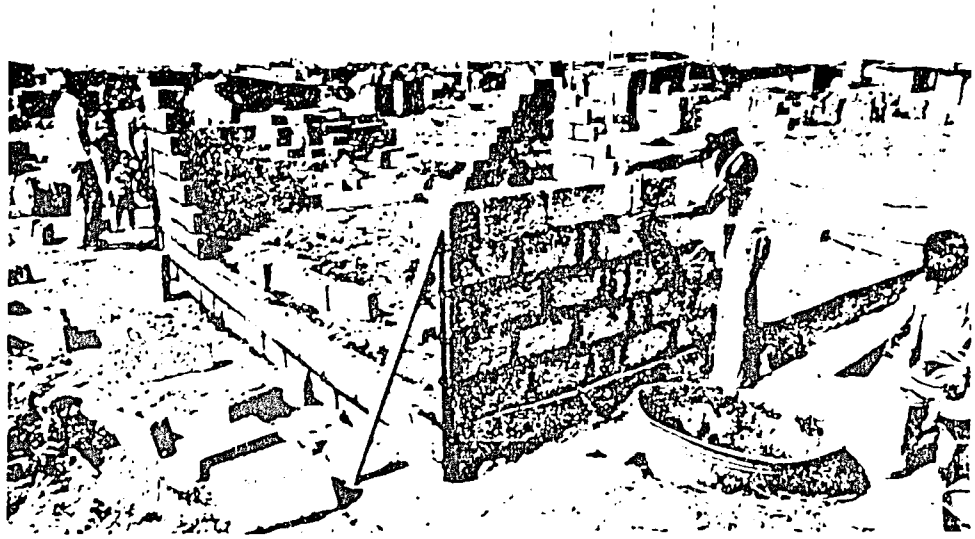
In retrospect, the experience of Africa with regional cooperation offers some useful lessons. First, it may be helpful to start with modest but feasible programs of cooperation, by focusing on selected areas where the prospects for mutual benefit are largest. Cooperation along this line, as exemplified by SADCC, can concentrate on specific areas, such as transportation, energy, industry, and banking. Second, efforts at economic integration stand a better chance of succeeding if they are also outward-looking. Economic integration at the regional level and in the world economy are not incompatible. It is important that a reduction of trade barriers within any region be accompanied by measures to reduce domestic distortions, liberalize markets, and improve competitiveness.

Regional cooperation is most effective if it is accompanied by careful harmonization by the cooperating countries of their policies in key areas; in particular to increase the scope for trade with the outside world. The ultimate aim must be to ensure that African exports are competitive in the industrial countries. And here also, how could I refrain from mentioning that seeing key countries in the area now implementing economic policies inspired by the same principles, I do believe that prospects for fruitful regional cooperation are made even more promising and could at the appropriate time culminate in various forms of monetary arrangements.

More effective policies in African countries will not succeed, however—and this is my second main proposition—unless their reform programs are adequately supported by the rest of the world. I repeat, *the responsibility for development and for economic adjustment is a shared one.* The industrial countries, in particular, have a special duty to Africa. In the more difficult global economic environment of today, I would like to

focus on three main areas: the level of activity in the industrial countries, finance, and trade.

First, the long expansionary phase in the industrial countries has recently faltered, with slowdowns in some major countries. It will be important for Africa that the industrial countries, which are the major market for its exports, resume growth at sustainable rates. The IMF expects that the present slowdown will be relatively shallow and short. Because any artificial boost to their activity would be self-defeating, the IMF is recommending a cautious fiscal and monetary policy stance for the industrial countries. We think that policies should be geared mainly to ensuring that the next expansionary phase will be healthy.



Low-income housing construction in Zambia: meeting urgent basic needs is a priority.

Second, finance. The prospects for some of the traditional sources of external finance are not encouraging. It would be unwise to expect a buoyant provision of bilateral or multilateral development assistance in the period immediately ahead. The most recent DAC [Development Assistance Committee] projections point to only a modest nominal rise. The commercial banks are showing a reluctance to extend new finance to developing countries on the scale of a few years back . . . . [M]uch of Africa will clearly need to rely heavily in the period ahead on domestic sources of finance (including the return of flight capital) and on nonbank types of private foreign capital.

In my view, the industrial countries can improve their provision of finance to Africa in three ways. First, even if their provision of ODA [official development assistance] is not expected to grow substantially in the years immediately ahead, they can do much to ensure that these scarce resources are channeled in ways that contribute to development in direct and productive ways. I am encouraged by the growing evidence that donors are working to enhance the usefulness of their assistance, while streamlining their procedures for approval and disbursement. Second, they could increase the proportion of grants in total ODA. And a third avenue is in the area of debt relief; much progress has already been achieved, in the cooperative framework of the Paris Club . . . .

Trade is the third area where the industrial countries need to act soon, and forcefully, to improve the global economic environment. A meaningful reduction of trade barriers, in the context of the Uruguay Round, is essential. It will reinvigorate the expansion of the industrial countries themselves and create the prospects for stronger trade for all countries. The importance of this open door policy for Africa, and in particular for those African countries that are implementing outward-looking reform programs, is self-evident. *The present opportunity should not be missed.*

Last, let me add a brief word on the IMF's own contribution. The IMF also shares the responsibility for Africa's future . . . . We now have concessional facilities, the SAF [structural adjustment facility] and the ESAF [enhanced structural adjustment facility] . . . which are tailor-made mechanisms for helping any low-income African country that seeks to achieve long-term and sustained growth through structural reforms. We are ready . . . as we have shown with our response to the recent oil shock, to adapt as needed our instruments to the emerging problems. The IMF, as I noted, is currently supporting the programs of nearly thirty African countries. The IMF stands ready to help all others, . . . both with technical assistance and with financial support, as soon as they are ready to embark on sound programs.

I should like to end by mentioning something that has come up in each of the African countries that I have visited in the last week. Everywhere I have been asked if the large amounts of assistance that the IMF is extending to others, including Eastern Europe, will oblige it to shortchange Africa. My answer is a definite "no." No IMF resources will be shifted. The IMF will support good economic programs in all member countries and, with the same heartfelt commitment, [will] continue to help to catalyze support from other sources. That is our basic mandate.

From the Executive Board . . .

Jamaica: Compensatory and Contingency Financing Facility. The IMF has approved a request by the Government of Jamaica for a drawing of SDR 19.9 million (about US$28.5 million) under the Compensatory and Contingency Financing Facility (CCFF) to cover the additional cost of oil imports in the period of October 1990–September 1991. An additional SDR 10.7 million (about US$15 million) could be disbursed at a later date, provided the necessary conditions have been met.

The excess in oil import costs is almost entirely attributable to movements in the world prices of oil rather than increases in volume. Jamaica has taken measures to adjust energy prices in line with international prices.

Jamaica's external payments position has come under increased pressure since September 1990 and this has reduced its capacity to pay for needed imports and meet debt-service obligations. Crude petroleum and petroleum products account for nearly 90 percent of Jamaica's total energy supply, and all petroleum consumed in Jamaica is imported. The largest petroleum consumer is the bauxite/alumina sector, which is also the main export earner, accounting for about 30 percent of total consumption.

The decision on Jamaica's use of CCFF resources has been accompanied by an Executive Board review and approval of a disbursement of SDR 20.5 million (about US$29.4 million) under a 14-month stand-by arrangement approved in March 1990 for SDR 82 million (about US$ 117.6 million). Jamaica's quota in the IMF is SDR 145.5 million (about US$208.7 million), and its current outstanding financial obligations to the IMF resulting from past transactions amount to SDR 246.7 million (about US$353.9 million).

Press Release No. 91/10, February 22

Bulgaria: Compensatory and Contingency Financing Facility. The IMF has approved a drawing by Bulgaria equivalent to SDR 60.6 million (about US$87 million) under the IMF's Compensatory and Contingency Financing Facility (CCFF) to help meet an increase in the cost of oil imports anticipated in 1991. Bulgaria has taken a number of energy-related and other economic policy measures in recent weeks, and an additional disbursement under the CCFF, which on present assumptions would be SDR 32.6 million (about US$47 million), would be made available later, provided the relevant conditions have been met.

The expected increase the cost of oil imports during 1991 is partly related to the low level of shipments received by Bulgaria during the second half of 1990. Until 1990, most of its oil came from the Soviet Union or in triangular deals involving Iraq. But in the second half of that year, supplies from the Soviet Union were disrupted and deliveries cut by one third, imports from Iraq were terminated, and, because of the low level of its international reserves, Bulgaria was unable to replace these lost supplies with imports from other sources.

This is the first use of IMF financing by Bulgaria, which joined the institution on September 25, 1990. Its IMF quota is SDR 310 million (about US$446 million).

Press Release No. 91/11, February 25

Ghana: Enhanced Structural Adjustment Facility. The IMF has approved a credit equivalent to SDR 116.45 million (about $165 million) for Ghana under its enhanced structural adjustment facility (ESAF) to support the third annual financial program under Ghana's ESAF arrangement. [The ESAF is the IMF's concessional lending window for assisting its poorest members that are undertaking structural economic programs to strengthen substantially, and in a sustainable manner, their balance of payments position.] The credit is available in two semiannual installments. The first disbursement would amount to SDR 68.45 million (about $97 million) and the second to SDR 48 million (about $68 million).

Ghana has already drawn a total of SDR 272.1 million (about $389 million) under its first and second annual ESAF programs. Although the three-year ESAF arrangement, which was approved in November 1988, was originally for a total of SDR 368.1 million (about $526 million), the amount available under the third annual program includes an augmentation of SDR 20.45 million (about $29 million). The augmentation is designed to partly cover some of the increase in the cost of Ghana's oil imports (see Press Release No. 90/57 on the IMF's response to the Middle East crisis), in view of the strengthening of Ghana's policy package.

The Ghanaian authorities have updated their economic program for 1991–93 to reinforce the momentum of the reform efforts, sharply reduce inflationary pressures, and adjust to the deterioration in the external economic environment without unduly restraining the rate of economic output or creating an unsustainable dependence on foreign aid.

Since 1983, Ghana has been implementing extensive and broad-based structural and financial reforms designed to liberalize the economy, shifting from a centralized system with pervasive government controls, to a market-determined environment.

The key elements of this process have been the successful completion of a comprehensive liberalization of the exchange system, accompanied by an appropriate exchange rate policy and the elimination of external payments arrears; the lifting of most price controls; the liberalization of interest rates and removal of sectoral credit controls; significant increases in real producer prices; institutional and financial reforms to strengthen the domestic banking system; the initiation of state enterprise reform; the strong mobilization of resources coupled with the strengthening of incentives through tax reform and improved tax administration; and substantial increases in government expenditure for the rehabilitation of the economic and social infrastructure.

Despite the very notable progress that has been made, the overall economic situation remains fragile. Because of poor weather in 1990, real economic growth slowed sharply, disruptions in food supplies caused the rate of inflation to accelerate, and the slowdown in economic activity affected the budgetary position. These trends

were aggravated by the increase in world oil prices that occurred in the second half of the year.

The basic objectives of the updated program for 1991–93 are to achieve a real economic growth rate of about 5 percent, reduce the average rate of inflation from about 37 percent in 1990 to 5 percent in 1993, and to generate sizable surpluses in the overall balance of payments.

To achieve these aims, budgetary and monetary policies will be tightened, with special emphasis being placed on quickly restoring and maintaining positive real interest rates; major tax reforms have been introduced; and flexible pricing policies will be maintained. Among structural policies, state enterprise reform will be accelerated, particularly the privatization program; efforts to improve the monitoring and control of government expenditure will be intensified; and public sector management will be strengthened.

These policies will be complemented by appropriate sectoral strategies in agriculture, industry, health, education, and by efforts to protect the environment.

Within this framework, the program for 1991, which is supported by the third annual arrangement under the ESAF, aims at achieving a real rate of economic growth of at least 4 percent; sharply lowering inflation (to 10 percent); and generating a sizable overall balance of payments surplus.

Ghana joined the IMF on September 25, 1957, and its quota is SDR 204.5 million (about $290 million). [A member's quota in the IMF determines the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs.] Ghana's outstanding financial obligations to the IMF currently total SDR 523 million (about $743 million).

Press Release No 91/12, March 6

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1991 HUMANITARIAN RELIEF NEEDS IN AFRICA

Agency for International Development

Mr. Scott Spangler
Assistant Administrator, Bureau for Africa, A.I.D.

PRESS BRIEFING

MARCH 15, 1991 10:00 AM

OPENING STATEMENT

I AM PLEASED TO SEE BY YOUR PRESENCE HERE TODAY THAT THE NEWS MEDIA CONTINUE TO BE INTERESTED IN AFRICA. THE CONFLICT IN THE GULF HAS UNDERSTANDABLY OVERSHADOWED EVENTS IN SUB-SAHARAN AFRICA. BUT WE BELIEVE THE CRISIS OVERTAKING MANY COUNTRIES ON THAT CONTINENT WARRANTS OUR MEETING HERE TODAY.

THE PROBLEMS WE ARE FACING ARE DUE IN PART TO DROUGHT AND IN LARGER MEASURE TO CIVIL STRIFE. WE BELIEVE THAT THE HUMAN SUFFERING CAUSED BY MAN-MADE EVENTS COULD BE SIGNIFICANTLY REDUCED IF THE POLITICAL WILL EXISTED TO DO SO. IN SPITE OF OUR BEST EFFORTS, WE ARE AFRAID THAT MILLIONS OF AFRICANS -- PARTICULARLY SUDANESE -- ARE AT RISK OF STARVATION.

I WOULD LIKE TO PROVIDE A SUMMARY FOR YOU OF THE STATUS OF THE COUNTRIES AFFECTED:

SPNG2:3/14/91

IN SUDAN THE SITUATION IS THE MOST SERIOUS OF ALL THE COUNTRIES WE WILL TALK ABOUT TODAY AND IT CAN ONLY WORSEN. SOME NINE MILLION SUDANESE ARE ESTIMATED TO BE AT RISK OF HUNGER. DONORS ESTIMATE THAT OVER ONE MILLION TONS OF FOOD AID WILL BE NEEDED TO AVERT STARVATION FOR THESE PEOPLE. AS IN EARLIER DROUGHTS, MOVEMENT OF FOOD IN SUDAN IS DIFFICULT. WE CANNOT ASSURE THAT THE NEEDED FOOD WILL GET TO ALL OF THE NEEDY IN TIME.

IN ETHIOPIA, UNTIL THIS WEEK WHEN FIGHTING BEGAN AGAIN, WE BELIEVED WE WERE BEGINNING TO GET ON TOP OF THE SITUATION. A COMBINATION OF DROUGHT AND TEN YEARS OF CIVIL WAR HAVE LED TO SERIOUS FOOD SHORTAGES IN ETHIOPIA. DONORS ESTIMATE THAT SOME 750,000 METRIC TONS OF FOOD AID ARE NEEDED TO FEED FIVE TO SIX MILLION AFFECTED PEOPLE; THE U.S. IS PLANNING TO PROVIDE AS MUCH AS ONE-THIRD OF THIS AMOUNT. MR. WILLARD PEARSON, THE A.I.D. MISSION DIRECTOR IS HERE TODAY TO ANSWER MORE SPECIFIC QUESTIONS YOU MAY HAVE ON ETHIOPIA AND CAN COMMENT ON THE EFFECT OF FIGHTING THERE ON OUR RELIEF EFFORTS.

ANGOLA, IS FACING A FOOD EMERGENCY WHICH MAY AFFECT 1.9 MILLION PEOPLE. THE EMERGENCY STEMS FROM THE CUMULATIVE EFFECTS OF FOUR

YEARS OF DROUGHT, CIVIL WAR AND 15 YEARS OF ECONOMIC STAGNATION. IN OCTOBER, THE UNITED NATIONS NEGOTIATED AN AGREEMENT WITH WARRING FACTIONS TO PROVIDE SAFE PASSAGE OF RELIEF SUPPLIES. THIS AGREEMENT BROKE DOWN IN DECEMBER.

I AM HAPPY TO REPORT THAT AS OF MONDAY, MARCH 11, THE AGREEMENT HAS BEEN REACHED TO RESTART RELIEF OPERATIONS.

IN LIBERIA, AN ESTIMATED 1.35 MILLION PEOPLE -- MORE THAN HALF OF THE POPULATION -- HAVE BEEN AFFECTED BY CIVIL UNREST IN THAT COUNTRY. SOME 750,000 HAVE FLED AS REFUGEES TO NEIGHBORING COUNTRIES. IN SPITE OF THE POLITICAL ANARCHY, WE HAVE BEEN ABLE TO PROVIDE NEARLY 100,000 TONS OF FOOD SUPPLIES TO DATE. AN ADDITIONAL 90,000 TONS ARE AUTHORIZED AND WILL BE SHIPPED THIS YEAR.

UNTIL NOW, IT HAS BEEN OUR BRAVE COLLEAGUES IN THE PRIVATE VOLUNTARY COMMUNITY (PARTICULARLY THE CATHOLIC RELIEF SERVICES) AND INDIGENOUS LIBERIAN GROUPS WHO HAVE MADE OUR RELIEF EFFORTS SUCCESSFUL ON THE GROUND.

SPMG2:3/14/91

IN MOZAMBIQUE, CONDITIONS ARE NOT AS BAD AS ELSEWHERE. HOWEVER, RECENT EFFORTS TO REACH A PEACEFUL SOLUTION TO THE ONGOING CIVIL WAR HAVE ENCOUNTERED DIFFICULTIES. WITHOUT A SOLUTION, WE ARE NOW CONCERNED THAT FOOD AVAILABILITY MAY CONTINUE TO DETERIORATE THERE.

LASTLY, WE ARE VERY CONCERNED ABOUT CONDITIONS IN SOMALIA, WHERE RECENT AND CONTINUING CIVIL STRIFE HAS DESTROYED MUCH OF THE COUNTRY'S PRODUCTIVE ASSETS AND INFRASTRUCTURE. UNFORTUNATELY, THE SECURITY SITUATION IS SO UNSETTLED THAT IT IS DIFFICULT TO ASSESS NEEDS OR PROVIDE ASSISTANCE.

THE INTERNAL POLITICS IN EACH OF THESE AFRICAN COUNTRIES HAVE MADE EFFECTIVE RESPONSE DIFFICULT AND, IN SOME COUNTRIES, IMPOSSIBLE. IN SUDAN, WE WERE FORCED TO EVACUATE OUR EMBASSY AND A.I.D. STAFF BECAUSE OF CONCERNS ABOUT TERRORISM AS A RESULT OF THE GULF CONFLICT. IN SOMALIA, EMBASSY PERSONNEL AND PRIVATE U.S. CITIZENS HAD TO FLEE NEAR ANARCHY RESULTING FORM CIVIL STRIFE. AS FOOD EMERGENCY EFFORTS ARE VERY PERSONNEL-INTENSIVE, THIS HAS HAMPERED OUR EMERGENCY RESPONSE CAPABILITY.

SOME HAVE ASKED IF THE U.S. RESPONSE TO THE NEEDS IN SUDAN HAS BEEN

AFFECTED BY THAT COUNTRY'S STANCE IN THE RECENT GULF CONFLICT. I WOULD LIKE TO MAKE IT VERY CLEAR THAT OUR POLICY AND INVOLVEMENT IN SUDAN IS CLEARLY DIRECTED TOWARD PREVENTING STARVATION AMONG THE PEOPLE OF THAT COUNTRY, WITHOUT REGARD TO POLICIES OF THEIR GOVERNMENT.

HAVING DESCRIBED THE SEVERITY OF THE SITUATION, I WOULD LIKE TO ADD HERE THAT THERE ARE SOME BRIGHT SPOTS IN THIS GRIM PICTURE.

- THE U.S. AMBASSADOR TO SUDAN AND THE A.I.D. MISSION DIRECTOR HAVE JUST RETURNED TO KHARTOUM JUST AS THIS YEAR'S FIRST FOOD AID SHIPMENT IS BEGINNING TO ARRIVE.

- AS I MENTIONED EARLIER, THE SPECIAL PROGRAM FOR ANGOLA IS BACK ON TRACK. WE ARE NOW WAITING FOR FOOD AID MOVEMENT TO RESUME. IN FACT, WE HAVE NEARLY 4000 METRIC TONS OF FOOD DUE TO ARRIVE SATURDAY.

- THE VITAL NORTHERN ETHIOPIAN PORT OF MASSAWA HAS BEEN RE-OPENED UP TO FOOD AID SHIPMENTS.

SPNG2:3/14/91

- THERE IS A MEETING OF ALL PARTIES IN THE LIBERIAN CONFLICT BEING HELD IN MONROVIA, TODAY. WE HOPE THAT CONSENSUS CAN BE REACHED ON A POLITICAL SETTLEMENT AND THAT LIBERIANS CAN RETURN TO THEIR HOMES AND FARMS.

WHILE FACED WITH DIFFICULT POLITICAL AND LOGISTICAL SITUATIONS, WE HAVE MADE EVERY EFFORT TO IMPROVE OUR RESPONSE TO DROUGHT AND FOOD EMERGENCIES IN AFRICA.

- WE HAVE IMPROVED OUR FAMINE EARLY WARNING SYSTEM (FEWS). IN ETHIOPIA AND SUDAN, OUR SATELLITE IMAGERY PROVIDED EARLY WARNING OF CROP SHORTFALLS AS EARLY AS LAST AUGUST. YOU CAN SEE HERE THE DIFFERENCES IN RAINFALL COMPARED TO PAST YEARS. (POINT TO THE FEWS MAP).

- IN ADDITION, WE ARE PURSUING A POLICY OF PRE-POSITIONING FOOD AID TO MEET EMERGENCY NEEDS. THIS MEANS GETTING U.S. FOOD AID ON THE HIGH SEAS AS EARLY AS POSSIBLE -- EVEN BEFORE WE KNOW THE TOTAL NEEDED OR MEANS OF DISTRIBUTION.

I WOULD LIKE TO ADD A FEW WORDS ON WHAT OTHER ACTIONS WE SEE NEED

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TO BE TAKEN TO MITIGATE THE GROWING TRAGEDY IN AFRICA.

- WE WILL BE LOOKING TO OTHER DONORS TO JOIN WITH US TO MEET THE BALANCE OF THESE RELIEF NEEDS IN THESE COUNTRIES. WE UNDERSTAND THAT THE EEC AND OTHERS ARE MOVING TO DO SO, PARTICULARLY GREAT BRITAIN, GERMANY AND JAPAN.

- IT IS ALSO IMPORTANT THAT ALL PARTIES TO THESE CONFLICTS DO ALL THEY CAN TO PREVENT NEEDLESS SUFFERING AMONG THE CIVILIAN POPULATIONS THEY CLAIM TO REPRESENT.

AND OF COURSE, THE GREATEST BOON TO OUR EFFORTS AT THIS TIME IS SOMETHING THAT ALL OF US HAVE LITTLE CONTROL OVER -- PEACE IN THE REGION.

THIS IS AN EVOLVING SITUATION AND AT THIS TIME, WE CANNOT TELL YOU DEFINITIVELY THE NUMBER OF PEOPLE WHO WILL DIE OF STARVATION, THE NUMBERS WE WILL BE ABLE TO REACH AND POSSIBLY SAVE, OR THE AMOUNT OF FOOD WHICH WILL ARRIVE AND BE SUCCESSFULLY DISTRIBUTED. WE HOPE OUR ESTIMATES OF RELIEF NEEDS ARE OVERESTIMATED AND THAT THE

NUMBERS OF PEOPLE WHO SUFFER WILL BE AT THE LOWER END OF OUR ESTIMATES.

PLEASE LOOK AT THE PACKAGE WE HAVE PROVIDED WHICH HAS A SUMMARY OF OUR ASSESSMENT OF NEEDS FOR THE COUNTRIES WE HAVE HIGHLIGHTED. THIS INDICATES THAT TO DATE WE HAVE MADE PLANS TO PROVIDE 965,375 METRIC TONS OF FOOD ASSISTANCE TO THESE COUNTRIES. WHILE WE HAVE NOT OUTLINED THE NON-FOOD NEEDS, THE FOOD AID LEVELS ARE INDICATIVE OF THE SCALE OF NON-FOOD RELIEF NEEDS SUCH AS MEDICINE, WATER, SEEDS AND TOOLS, WHICH WILL BE NEEDED AND WHICH WE WILL BE HELPING TO MEET.

WE PLAN TO CONTINUE TO INVITE YOU TO THIS TYPE OF INFORMAL PRESS BRIEFINGS AS EVENTS UNFOLD. AND NOW, I INVITE YOU TO ASK ADDITIONAL QUESTIONS OF EITHER ME OR MY COLLEAGUES. THANK YOU.

SPNG2:3/14/91

AFRICA
EMERGENCY FOOD NEEDS

PLANNED U.S. GOVERNMENT CONTRIBUTIONS IN FISCAL YEAR 1991

	ANGOLA	ETHIOPIA	LIBERIA (& ITS NEIGHBORS)	MOZAMBIQUE	SOMALIA	SUDAN
NUMBER AT RISK	1,900,000	4,600,000	1,950,000	4,500,000	N/A	up to 9,000,000
FOOD REQUIRED (MT)	102,210	750,000	189,705	973,000	N/A	1,200,000
PLANNED USG FOOD CONTRIBUTION (MT)	40,515	250,000	136,600	191,650	15,610	331,000
VALUE	$20,000,000	$121,238,000	$81,942,000	$39,500,000	$5,800,000	$126,200,000

TOTAL VALUE OF USG EMERGENCY FOOD CONTRIBUTION FOR FY 1991: $394,680,400

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Congressional Research Service
IB90152 02-12-91

Kenya: Political Unrest and U.S. Policy

by Theodore S. Dagne
Foreign Affairs and National Defense Division, February 12, 1991

SUMMARY

In early 1990, the Kenya government of Daniel arap Moi launched a campaign to discredit multiparty democracy advocates by arguing that the status quo was ideal for Kenya. President Moi lambasted multiparty proponents as tribalists and troublemakers. The murder of the Foreign Minister, Dr. Robert Ouko, in February heated the already tense political atmosphere, sparking a series of protests in the streets of Nairobi and Kisumu.

By mid-1990, against a backdrop of growing pro-democracy movements in most of Africa, political tensions mounted in Kenya. In July 1990, the peaceful debate turned into violent confrontation between pro-democracy groups and the Kenyan government. Shortly after the government ordered the use of force to crush the pro-democracy movement in July, security forces killed 23, wounded several others, and detained over 1,000 people, including several leading multiparty advocates.

The current political turmoil in Kenya challenges a concentration of powers in the hands of the President at the expense of Parliament and the Judiciary. Human rights abuses, growing economic problems, lack of political tolerance, tribal politics, and increased Church activism in politics have also been contributing factors.

The continued crackdown on opposition has not totally crushed the pro-democracy movement. The political movement against the Moi government, however, is neither well organized nor unified, and does not have a well-defined strategy. The demands articulated by opposition groups are often conflicting, but the quest for change is clear. President Moi seems bent on crushing proponents of multiparty democracy, fearing a loss of national cohesion in tribal strife, and appears unswayed by international pressure to improve human rights and political conditions in Kenya.

Relations between Washington and Nairobi have been strained, especially since the violent crackdown on anti-government protestors in July 1990. The United States had long considered Kenya a politically stable country with shared democratic values. Kenya was also considered by Washington to be a strategic asset in Africa. During the Cold War years, against the backdrop of intense rivalry between the United States and the Soviet Union in Africa, Kenya's unwavering anti-communist stance led to close strategic relations between Washington and Nairobi.

The end of the Cold War, access to better ports and airfields in the Middle East since the Iraqi invasion of Kuwait, and growing abuses by the government of Kenya have reduced Nairobi's strategic significance. Deteriorating human rights and political conditions in the summer of 1990 led to a freeze on U.S. military aid to Kenya. The Bush Administration and Congress agree that President Moi must take measures to improve conditions in Kenya, but disagree on tactics.

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Issues in U.S.-Kenyan Relations

Overview

Against the backdrop of intense rivalry between the United States and the Soviet Union in the 1960s, Kenya's unwavering anti-communist stance in Africa led to a close strategic relationship between Washington and Nairobi. In 1980, the United States signed a military agreement with Kenya similar to those signed with Somalia and Oman. The agreements were considered essential to America's Indian Ocean Strategy. The invasion of Afghanistan by the Soviet Union, the Iranian revolution, and the spread of communist influence in Africa in the 1970s and early 1980s threatened U.S. strategic interests in the Gulf and the Indian Ocean region. The military agreements with the three countries were considered important to U.S. interests because none of the Gulf and Arab states were willing to enter into similar agreements with Washington. Two principal objectives of U.S. strategy were to contain the Soviets and ensure the flow of Persian Gulf oil.

There were no specific commitments by the United States to provide Kenya with monetary compensation for the agreement, but it was reportedly understood that Kenya would get some sort of military assistance. The United States spent $57 million to improve Kenya's ports and airfields, and American warships have visited Kenyan ports 110 times over the past 10 years. In FY1988, U.S. military aid to Kenya was $5 million, and in FY1989 $15 million. In response to a government crackdown on pro-democracy advocates, Washington froze $9.9 million in military aid approved for FY1990. Under the International Military Training Program (IMET), between 90 and 100 Kenyans come for training to the United States each year. The United States also has been providing $250,000 annually to maintain the Moi airport since 1985. The agreement could come up for review in 1990, although it will continue if neither party requests review. After 1990, either party can terminate the agreement after a one-year notice. Thus far, neither party appears interested in bringing the access agreement up for review.

U.S. political interests in Kenya, at least until recently, were significant. Washington had considered Kenya a model developing country with shared democratic values. Kenya's political stability and relatively open political system were of pivotal interest to Washington, particularly in the late 1960s and 1970s, when several African countries were swayed by the Soviets and a tide of anti-American sentiment swept most of Africa. In a continent where civil wars raged and military dictatorships and authoritarian governments reigned, Kenya's parliamentary system stood out as an exceptional model. In international politics, Kenya's moderate foreign policy approach was seen in Washington as a gesture of good friendship and civilized behavior. Kenya's anti-communist stance was rewarded by Washington. Because of close relations with Kenya, Washington and Nairobi often consulted each other on most African issues.

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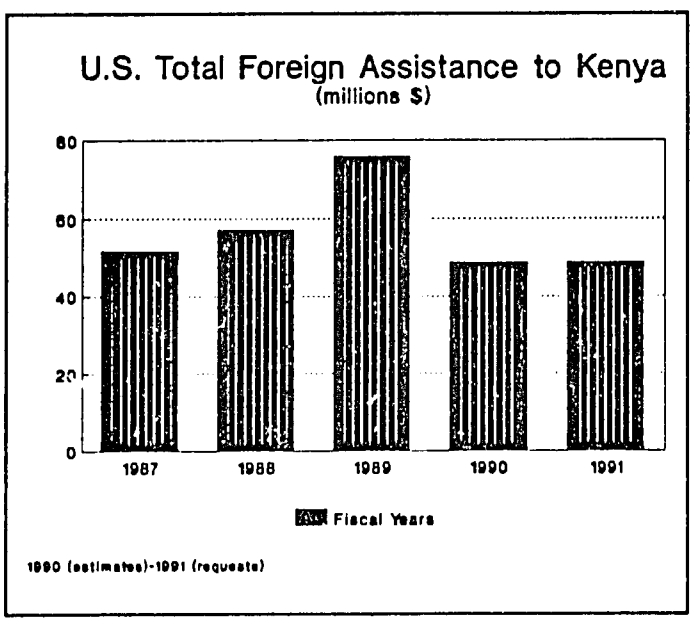
TABLE 1. U.S. Foreign Assistance (millions $)*

	FY1987	FY1988	FY1989	FY1990 (est.)	FY1991 (req.)
Development aid	20	31.1	44.3	30	26
(loans)					
(grants)	20				
Economic aid	15	10	10		7
(loans)					
(grants)	15	10	10		7
Food aid	9.2	11.1	6.7	8.8	77
Military aid	7.5	5	15	9.9	8
(loans)					
(grants)	7.7	5	15	9.9	8
Total	51.7	57.2	76	48.7	487



U.S. Foreign assistance data were taken from the Agency for International Development (AID) and from the Congressional Presentation for Security Assistance Programs.

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Economically, Washington had long considered Kenya as a locomotive for Africa. Several development programs have been undertaken by Washington, and Kenya is the largest recipient of U.S. aid in Africa. For FY1989 the United States provided Kenya $54.7 million, and $30 million for FY1990. The Administration has requested $33 million for FY1991. Over 100 American companies operate in Kenya, and American investment is one of the largest in the country. American tourists also contribute to the economy of Kenya significantly. In 1988, for example, 78,000 Americans visited Kenya. The volume of trade between Washington and Nairobi, however, is insignificant. In 1988, the United States imported $69 million in goods from Kenya, and total U.S. exports for the same period totaled $91 million. In recent years, officials in Washington have been increasingly concerned about the economic conditions in Kenya.

U.S. Concerns

The end of tensions between the United States and the Soviet Union has shifted American foreign policy priorities not only in Kenya, but in the rest of Africa as well. In the years ahead, U.S. Africa policy in the post Cold War era may focus much more on human rights, political pluralism, and economic improvement.

Human Rights

Since the late 1980s, human rights issues have emerged as one of the leading U.S. foreign policy concerns in Kenya. Moi's human rights record has been steadily deteriorating, particularly since the mid-1980s. Though the State Department has been consistently reporting human rights violations by the government of Kenya over the years, the United States has steadily provided the Moi administration with economic and military assistance. Notwithstanding international pressures, including that of Washington, the Moi administration did not make any significant effort to improve human rights conditions in Kenya. President Moi has been hostile to U.S. human rights efforts, often telling American officials, in effect, to mind their own business. In January 1987, Representative Wolpe was lambasted by Kenyan officials and the Kenyan press for stating that there was a growing concentration of executive powers and a decline in human rights conditions. President Moi also accused Wolpe of "bankrolling dissidents, crooks, and swindlers".

In the past several months human rights conditions further deteriorated, and the Moi government appears unswayed by the barrage of warnings coming from Washington. In late September, the government banned the *Nairobi Law Monthly*, a popular law journal, two months after security forces detained the editor of the journal. In October, the High Court of Kenya reversed the ban, pending the outcome of a suit filed by the editor of the *Nairobi Law Monthly*. Notwithstanding international calls for the Moi government to respect human rights, President Moi vows to crush multiparty proponents, whom he considers to be drug addicts and criminals.

Democratization

Democratization has also surfaced as an important interest of U.S. Africa policy. Relations were strained between Washington and Nairobi in May 1990 when the U.S. Ambassador to Kenya, Smith Hempstone, remarked in a speech that there was a strong

tide in Congress that favors granting assistance to those countries with good human rights records and multiparty systems. The ambassador was scolded by Kenyan officials and accused of interfering in the internal affairs of Kenya. U.S. officials agree that political reform is needed in Kenya, but say it is up to the Kenyans to decide their choice of political system.

But there was a clear signal from U.S. officials to the Kenyan government that Washington will not tolerate attacks on its Ambassador in Nairobi. Bush Administration officials informed the Kenyan ambassador that Washington was fully behind the Ambassador. The strong support Ambassador Hempstone received from Washington contained the implicit message that Kenya needs to implement political reforms if it wants to remain in good standing with Washington. Though Washington has not made it a policy to link U.S. economic assistance to multiparty democracy, U.S. officials are quietly pressing Kenyans to go in that direction.

Strategic Interests

The easing of tensions between the United States and the Soviet Union and the Persian Gulf crisis appear to have reduced the strategic significance of Kenya. The circumstances under which the United States entered into the 1980 military agreement with Kenya have changed, as well as the need for Washington to maintain a military relationship with troubled Horn nations. Though Washington had not used Kenya's airfields and ports for any significant military operations over the past 10 years, its military relationship with Nairobi was considered important to U.S. strategic interests in the Indian Ocean and the Gulf. Now that the United States has access to better ports and airfields in Saudi Arabia and other Gulf countries, Kenya appears less important. But some officials in Washington still maintain that continued access to ports and airfields in Kenya might be advantageous in the future, especially if relations between Washington and its Gulf allies were to deteriorate. The future of U.S.-Kenya military relations is uncertain, and more likely to be determined by internal political developments in Kenya and to a lesser extent the Middle East.

Should U.S. Aid to Kenya Be Cut?

In response to the government of Kenya's violent crackdown on pro-democracy groups in July, the United States froze its military aid to Kenya. In October, Congress suspended $7 million in economic aid (ESF) and $8 million in military aid (FMF) for FY1991, until the President certifies that the Moi government is taking steps to improve human rights and political conditions in Kenya. Bush Administration officials are of the same opinion as Congress that the Moi government must take measures to improve political and human rights conditions in Kenya, but differ on tactics.

Administration officials insist that cutting U.S. economic assistance will only hurt the common person, arguing that most U.S. funds go directly to assist the general population. These officials maintain that the United States could use its economic assistance effectively to force change in Kenya, but they note that cutting aid might produce unintended results. Critics argue that President Moi has consistently ignored U.S. calls for improved human rights conditions, and therefore he should not be rewarded for his abuses. In the view of some critics, the United States should link its assistance with human rights and democratization in Africa. According to these critics,

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the United States should only reward those governments that strive towards democratization, as has been the case in U.S. policy towards Eastern Europe.

LEGISLATION

H.Con.Res. 356 (Lantos)

Concurrent resolution regarding human rights conditions in Kenya. Introduced July 27, 1990; referred to Committee on Foreign Affairs; referred to Subcommittees on Human Rights and International Organizations and on Africa Aug. 8, 1990.

S.Con.Res. 141 (Kennedy)

Concurrent resolution expressing the sense of Congress regarding the deteriorating human rights conditions in Kenya. Reported to Senate by Committee on Foreign Relations Oct. 2, 1990; passed Senate Oct. 18, 1990.

PERSPECTIVE ON SOUTH AFRICA

The Battle Is Not Yet Over

Until key exceptions are corrected in De Klerk's reforms, it is too soon to celebrate the end of apartheid.

By DESMOND M. TUTU

CAPE TOWN—President F. W. de Klerk's address to open this year's session of the South African Parliament has moved the struggle against apartheid into a new phase.

For many people outside South Africa, the most startling and obnoxious manifestation of apartheid has been the formal entrenchment of racial segregation in the country's laws: features such as separate living areas and schools reserved for children of one race only.

With one major exception, De Klerk's speech on Feb. 1 has brought within sight the end of legally enforced racism in major areas of social and public life. The exception is in the area of education: The overwhelming majority of schools will remain segregated by law and De Klerk still refuses to place all schooling in South Africa under one, integrated education ministry.

Despite that exception, I have commended De Klerk for his reforms. However, at its core, apartheid is not simply the segregation of facilities and suburbs. It is the denial of political power to people on the basis of their race. This will be ended only when black South Africans have the vote, and this central thrust of our struggle against apartheid continues.

Much of the international community fails to realize the importance of this distinction when assessing how far the South African government has gone toward abolishing apartheid. Nowhere is this more clearly demonstrated than in the response of Western governments to De Klerk's proposed changes to the Population Registration Act.

This act is the law that requires every South African to be classified by race. It is a vicious law that has involved the authorities in deciding what race people are on the basis of the shapes of their noses or on the curliness of their hair. It has split families and led to suicides. It is one of the pillars of apartheid and its repeal is a fundamental requirement for the lifting of sanctions, including those imposed by the United States.

Until Feb. 1, the South African government's position was that the law could not go until a new constitution had been negotiated. It said the current constitution was racially based, the law classified everyone according to race, and summary repeal would render the present constitution and government inoperable. Opening Parliament, De Klerk unexpectedly announced a change. He said investigation showed it was possible to "repeal" the act, "provided that this is accompanied by the adoption of transitional measures toward the acceptance of a new constitution."

A key reason for our demand for the repeal of the Population Registration Act is because it enables the exercise of political power to be limited on the basis of race. Yet the government clearly intends replacing the law with measures having substantially the same effect in that crucial area: Pending the conclusion of negotiations on a new constitution, government will be on the basis of the current constitution. The implications are that white South Africans will have the right to veto the terms of a new constitution. This is totally unacceptable.

If we are going to have a constitution that commands the loyalty and acceptance of the vast majority of South Africans, then it must be drawn up by a body that is truly representative of all the people of our country. That is why many of us are calling for the negotiation of a new constitution by a constituent assembly elected on the basis of one person, one veto, on a common voters' roll. The Namibian constitution was drawn up very quickly and with overwhelming consensus in this way. Elections to such a body would also help to eliminate political violence in South Africa. One of the causes of the current fighting is a struggle for turf by different political organizations whose claims of support have never been tested by a democratic vote.

We are angered at the way in which Western governments have sided with the South African government on the issue of the Population Registration Act. Their response to De Klerk's decision was one of elation. The act is to be replaced, it is said, and a condition of the lifting of sanctions has been met. We have heard no expressions of caution, no calls for elaboration of the nature of De Klerk's "transitional measures." In fact, a South African government source has claimed to local newspapers that its stratagem was planned in collusion with the U.S. and British governments.

De Klerk's address had other shortcomings. For example, he did not deal with the very serious questions raised by the government's use of police and army death squads and the existence of a "third force" stoking violence in black communities.

He also failed to address another requirement for the lifting of U.S. sanctions: the freeing of all political prisoners. I am as eager as anyone to have sanctions lifted. Apartheid has created tremendous backlogs in housing, health, education and many other areas, and we need a strong, vibrant economy and a high growth rate to help us eliminate its effects. The intended abolition of the Group Areas Act and the Land Act, which limit land ownership and occupation on the basis of race, will mean very little unless black South Africans can afford to buy land.

But before I can call for sanctions to be lifted:

—Schools have to be opened to all races without qualification, under one education ministry.

—All political prisoners must be freed and exiles allowed home under a general amnesty.

—The Population Registration Act has to be abolished without qualification.

—A mechanism needs to be established for negotiating a new constitution that is representative of the people of South Africa and does not allow groups defined by race or ethnicity to veto decisions that are democratically reached.

The South African government wants to be both a player in constitutional negotiations and a referee with final power to make decisions. De Klerk is a bold and courageous reformer, but his government needs to be told that the only way to negotiate a democratic constitution is by democratic means.

Desmond M. Tutu is the Anglican Archbishop of Cape Town, South Africa.

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WASHINGTON POST

THURSDAY, FEBRUARY 7, 1991 A19

Michael Kinsley

African Time

JOHANNESBURG—Police say the prisoner died while trying to escape. The deceased's relatives complain that there were bruises and abrasions all over the body. The authorities have promised to investigate. Etc. etc. It could be almost anywhere in the world. But the story was in the Johannesburg Weekly Mail last month, and this detail caught my eye: "Police told Maphumulo's attorneys that he had drowned in the swimming pool at Protea police station." In South Africa, even the police stations have swimming pools.

In his recent memoir, "My Traitor's Heart," South African journalist Rian Malan writes: "Anywhere else in the world, save perhaps the United States, a blue-collar worker would consider himself terribly lucky to be floating face up in cool water under a hot blue sky in a country garden. In South Africa, however, such an experience was a white man's virtual birthright." Even in the United States, though, it's a rare blue-collar worker who has a country house and swimming pool.

High-minded white South Africans love to tell you, no doubt correctly, what a failure apartheid has been as an economic system. But apartheid enabled many, many whites to enjoy a bigger piece of that smaller pie. The exclusion of the black majority from the best jobs and lands, the assured pool of servants and cheap labor and so on have given middle-class whites a lifestyle that free-market forces, wonderful as they are, could not duplicate.

Politically, there are reasons for optimism. On Friday, President F. W. de Klerk announced that his government would repeal the last pillars of legal apartheid. The government and the African National Congress have agreed to a multiparty conference as the next stage in devising a new constitution. The ANC's Nelson Mandela and his Inkatha rival, Chief Mangosuthu Buthelezi, have kissed and made up.

But the real trauma is going to be economic. Everyone recognizes that any political solution will create powerful economic expectations among blacks. What good is freedom without electricity and plumbing? Where is the payoff for their decades of struggle? Meanwhile, even liberal whites seem resigned to the notion that the economy will shrink, not grow, when the blacks take over. They see the ANC's present internal chaos as a harbinger of what the whole country will be like. "African time," said one businessman with a smile and a shrug when I mentioned that a black pol had been very late for an appointment.

Two questions get muddled in discussing new economic arrangements for South Africa. One is how to create growth; the other is how to share the goodies. In fact, the growth question is largely settled. Those who believe that blacks will bungle any economic system are beyond consolation, but there's little need to fear that South Africa's future leaders will choose the wrong system. It's a cliché in South Africa that the country is lucky the death of apartheid coincided with the collapse of communism. The grim experience of African socialism is also duly noted.

But that doesn't settle the issue. Even the most devoted believer in free-market capitalism as a creator of wealth would have a hard time looking at South Africa and saying: Fine, let's start tomorrow with a free market and forget about who's got what at the moment. Nowhere else in the world do so much Western-style affluence and Third-World poverty exist side-by-side. And this disparity was a deliberate creation of the government. The about-to-be-repealed Group Areas Act, to take just one example, forcibly removed 3.5 million black people from "white" areas and dumped them in arid "homelands." Should these people be satisfied that from now on it's a level playing field?

Growth alone won't provide enough resources to do justice to the black majority without impinging on the prosperity of the white minority. True enough, any serious exercise in redistribution will itself discourage economic growth. But to concede that point doesn't put redistribution beyond bounds. Blacks, like whites, are entitled to think of the slices as well as the pie.

How much white prosperity will be impinged upon is the biggest unresolved political question. Hard economics—who gets what—lies behind much of the theoretical debate about the shape of the new constitution. Whites want guarantees against nationalization, redistribution and other statist meddling. This passion for hands-off government is as recent in economics as in civil liberties. The present South African economy is dominated by state industries and government-sanctioned cartels.

Over a drink at a fancy hotel in a Johannesburg suburb called Sandton, I asked Saki Macozoma of the ANC whether Harry Oppenheimer, head of the giant Anglo-American conglomerate, ought to fear majority rule. He said, "People at the level of Harry Oppenheimer needn't be concerned in any event. The more important question is: Will a person with a middle-class job and a maid and a pool lose that? Yes, they will have to lose some of that, because we don't have the resources. . . . People say, 'moderate the expectations of your people.' I say, we will moderate our expectations *pari passu* [in step] with Sandton. I can't say to people in Soweto, forget about running water while people in Sandton have two German cars." A pretty good answer, I thought.

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World Bank Technical Paper Number 130
Africa Technical Department Series 1990

Living With Wildlife: Wildlife Resource Management With Local Participation in Africa

by Agnes Kiss, editor

ABSTRACT

The decline in Africa's wildlife heritage and the persistent poverty of its rural people are linked by a common denominator: rapid human population growth and the resulting misuse and degradation of the land. Expanding settlements, crops, and livestock in marginal areas are reducing agricultural productivity and displacing wildlife. This conflict between people and animals is one which the animals must lose, and a rich natural resource may be lost before its true value is realized.

Fortunately, conservationists and development planners are exploring a common solution: developing alternative land uses based on wildlife resources generating food and income for rural communities. This paper examines the experience, the potential, and the constraints of wildlife management programs which involve and benefit local people. It also explores the potential for wildlife management to stimulate independence and institutional capabilities in rural communities, and greater complexity and diversity in their economies.

The paper is divided into four main sections:

PART 1: PRINCIPLES AND ISSUES

This section examines the objectives of wildlife utilization and management schemes and explores the integration of conservation and economic development based on sustainable exploitation of wildlife resources. A small number of wildlife projects are based outside protected areas. These aim at conserving and developing wildlife resources to generate food and/or income in fragile marginal areas which are unable to sustain productive agriculture or livestock husbandry. Most projects, however, are centered on protected areas and seek to preserve them. But, where possible, they have incorporated economic exploitation of wildlife to meet costs and win the support of the local community. This "new" approach of community-based, integrated conservation/development projects shares many of the basic principles --and many of the complexities and problems -- of the concept of Integrated Rural Development, popularized in the 1970s. It emphasizes understanding and working with local communities, involving them in project planning and implementation and, to the extent possible, relying on local institutions to implement components which involve public participation. However, incorporating wildlife resources as an economic asset in rural development raises new issues concerning the relationship between rural peoples and wildlife. The most important of these relate to ownership -- often poorly defined or claimed by the state -- and practical problems in controlling access to wildlife. The success of any community-based wildlife utilization plan will depend on ensuring that individuals derive benefits from conservation and sustainable management of the resource.

PART 2: PLANNING, PREPARATION AND IMPLEMENTATION OF WILDLIFE MANAGEMENT PROJECTS

This section defines the economic, policy, technical, sociological, institutional, and human resource development issues in community-based wildlife management and, based on past and present experience, suggests ways to address them.

Key economic issues include: (i) proper evaluation of the costs and long-term returns from wildlife management compared to alternative land uses; (ii) distribution of costs and benefits between national and local levels and among members of the local communities; (iii) concrete, short-term benefits or incentives to sustain community support for a project, even if the real environmental and economic benefits emerge over the long term (but maintaining a clear linkage between such incentives and the long-term conservation and management objectives); (iv) the likely need for substantial external funding, often over a long period, before a project can be expected to become financially self-sufficient, if ever; (v) opportunities for multiple use of wildlife resources (tourism, sport hunting, meat, etc.); and (vi) developing appropriate marketing structures and institutions to enable wildlife use to compete with land uses generally supported by well-established and often heavily subsidized infrastructure.

The central policy issues include: (i) defining the role of wildlife resources in national economic development, (ii) proprietorship of wildlife, and (iii) distribution of authority and revenues between local and national levels. Many other national policies -- land tenure, exchange rates, import controls, foreign investments, access to firearms, public sector employment, quarantine and veterinary regulations relating to marketing or export of wild meat, administration and regulation of tourism and population -- can influence the success or failure of wildlife-based enterprises and community programs. External donors play a significant part as well, especially in promoting the empowerment of local communities to manage indigenous natural resources and the willingness to support consumptive use of wildlife.

This paper does not try to provide detailed coverage of technical issues. It does, however, identify some technical aspects critical to the planning and implementation of wildlife management projects. These include: (i) assessment of existing wildlife populations and the factors which threaten or limit them; (ii) population dynamics of key species, particularly those targeted for consumptive use; (iii) monitoring and survey systems to track changes in populations and habitat conditions; (iv) market demand for various types of wildlife utilization; (v) harvesting, processing and marketing methods, and requirements for implementing them; and (vi) promotion, management, and regulation of sport hunting and tourism for maximum financial return and minimum environmental damage.

Sociological and socio-economic issues relate to two aspects: (i) integrated rural development and communal management of natural resources, and (ii) communities' attitudes and relationship to wildlife. Both require a thorough understanding of the community's history and current dynamics --especially authority structures and patterns of resource use. It is essential to identify all groups with a legitimate claim to the resource and address their interests and needs. Often, these needs are religious and traditional, as well as economic. The greatest challenge is stopping individuals from over-exploiting commonly held resources for short-term, personal gain at the expense of long-term community stability.

There are institutional issues for each of the three phases of a program: (i) initiation, (ii) establishment and implementation, and (iii) self-sufficiency and continuity after external inputs cease. The initiation and establishment/ implementation stages should lay the groundwork for sustainability. However, it may be argued that successful transition to the third phase has not yet happened in any African wildlife project. Institutions are needed to fulfill a wide range of functions including: (i) technical wildlife management, (ii) regulation and enforcement, (iii) administration of financial and other resources, (iv) allocation of responsibilities and benefits within the community, (v) promoting development of local enterprises, (vi) determining policy, and (vii) representation to higher levels of administration. It is important to create institutional capacity to fulfill these functions without building an inflated bureaucracy. It is best to adopt and strengthen traditional institutions and systems for wildlife management where they exist.

Training and education are essential elements in a wildlife program. Beyond technical training though, wildlife officials must be sensitized to the sociological aspects and be trained to communicate and work with local communities. Local people must learn about the present and potential value of wildlife and natural habitats and be trained in the technical, financial, organizational, and management skills needed to secure these benefits for themselves and their communities.

PART 3: CASE STUDIES

This section examines 17 projects in 12 African countries. These are divided into two categories: (i) projects whose initial objective was preserving particular endangered species or protected areas; and (ii) projects not centered on protected areas and which aim to develop wildlife resources to improve the living standard of rural communities. The projects also represent a variety of ecological and institutional environments, in some cases within a single country. Each case study analyzes the objectives of the project, the extent to which these objectives are being met, and the sociological, political, economic, and institutional factors which contribute to its success or failure. Particular emphasis is placed on the types and effectiveness of active community involvement.

PART 4: ECONOMIC ASSESSMENT OF WILDLIFE UTILIZATION AS A LAND USE OPTION IN THE SEMI-ARID RANGELAND OF SOUTHERN AFRICA

The success of community-based wildlife management programs ultimately depends on the overall economic value of the wildlife asset and its comparative advantage in relation to alternative land uses. In Africa, this has been most seriously explored in the semi-arid rangelands, and particularly in southern Africa where commercial wildlife use is replacing livestock husbandry over a significant area. An examination of trends and ecological and economic data from Zimbabwe shows that wildlife systems have significant advantages in this ecosystem, in both earning capacity and sustainability. This applies even in the face of market distortions which obscure the true economic costs and benefits of wildlife vs. livestock production. The most important constraint, as demonstrated by the example of Zimbabwe, which has alleviated it, is the status of wildlife as state property or as a *de facto* open-access resource. Other important factors include: (i) failure to take account of environmental degradation and investment of "environmental capital;" (ii) direct and indirect subsidies to the livestock sector; (iii) quarantine and veterinary policies which constrain production, local sale and export of wild meat; (iv) consumer preference for domestic meat; and (v) lack of research, training, and infrastructure to support wildlife development. Correction of these distortions could greatly increase wildlife use throughout the semi-arid rangelands of Africa.

JOURNAL OF COMMERCE, January 1, 1991

African Farmers Are 'State Serfs'

By MILTON ALLIMADI

The Uruguay Round of trade talks under the General Agreement on Tariffs and Trade has come to an impasse over the issue of agricultural trade. But even if a multilateral agreement on farming issues eventually is achieved, farmers in many African countries still would be unable to take full advantage of the increased export potential brought by a reduction in farm supports and the opening of markets abroad.

That's because at home they still face production disincentives created by agricultural "marketing boards." These government-controlled boards, which administer the purchase and export of agricultural commodities, have cultivated the highest form of indirect taxation probably anywhere in the world. If African farm exports are to compete on the world market, this system, which skims the cream off export earnings to subsidize national governments, must be reformed.

To African peasant farmers, who lack the organizational structures to move commodities to end markets abroad, the board is, for all practical purposes, their "world market." The boards are the sole legal purchasers and exporters of most major cash crops, such as coffee, cocoa, cotton and vegetable oils, grown in Africa.

At the beginning of every crop season, each board announces the price at which it will purchase a commodity from the farmers it is, invariably, several times less than the price on the world market. The purchases are made with local currency and the commodities are sold at much higher prices on the world market for convertible currency. The export earnings then are redistributed by the state, effectively subsidizing other government departments.

For that reason, African farmers don't benefit, even when export demand increases and the price goes up. In 1977, for example, at the height of an international "coffee boom," Ugandan farmers earned only 15% of the crop value, with 4% going to the millers while the balance was retained by the state.

The prices may have changed since then, but the percentage of farmers' earnings from their crops still are abysmally low compared with those of farmers elsewhere. This system is akin to state serfdom. Some African producers have tried, either through smuggling or abandoning commodities production and switching to other food crops, to escape the boards' stranglehold. But it continues to hold back efficient and rewarding agricultural production.

The boards are an unfortunate legacy of Africa's colonial past. Britain, fearing loss of supplies of crucial commodities during World War II, first introduced the concept in West Africa to ensure the stockpiling of surplus and to prevent the local price of cocoa from collapse as a result of shrinking markets and shipping shortages.

The first board was empowered to purchase all cocoa sold in British West Africa. The system soon was adopted in other countries and the power of the boards grew to include wider administrative duties.

Today the boards, inherited by new governments, have tremendous clout in their respective countries; their influence is as pervasive as that of telephone monopolies in the United States. The difference is that they are state monopolies, so key officials, including the chairman and directors, usually are presidential appointees.

Economists would wish away these boards altogether, but in most African countries it would be politically unfeasible to abolish them. For most governments, that would be tantamount to economic suicide. Apart from foreign aid and loans, the convertible currency they receive from these commodities exports are their main source of revenue.

A more realistic solution would be for the governments gradually to permit increased participation by farmers in the operations of the boards, including decisions about redistributing export earnings. One option would be to run the boards like corporations, with some traded shares. A certain percentage of the shares would be reserved exclusively for farmers.

A handful of countries have begun belated reform efforts. In Burundi, the small southeastern country below Uganda, a commodity board still exists, but private businessmen now are allowed to purchase and export commodities and retain the export earnings. Thus, farmers can circumvent the commodity board and perhaps negotiate better prices for their crops.

Another reform effort is being undertaken in the Central African Republic, where the purchase and sale of commodities is under the control of a management board representing producers and consumers. The government has no access to the commodities export earnings.

Hopefully, more countries will follow these examples. The World Bank has recommended the privatization of Africa's parastatals, or state-run companies, including commodities trading businesses. But so far, reform in this area of agriculture has not been made a condition for future development funding.

Privatizing commodities trading in Africa would give farmers real incentives to produce according to market conditions and would allow them to recover more of the true value of their crops. The surplus revenue then would be redirected more efficiently by the private sector.

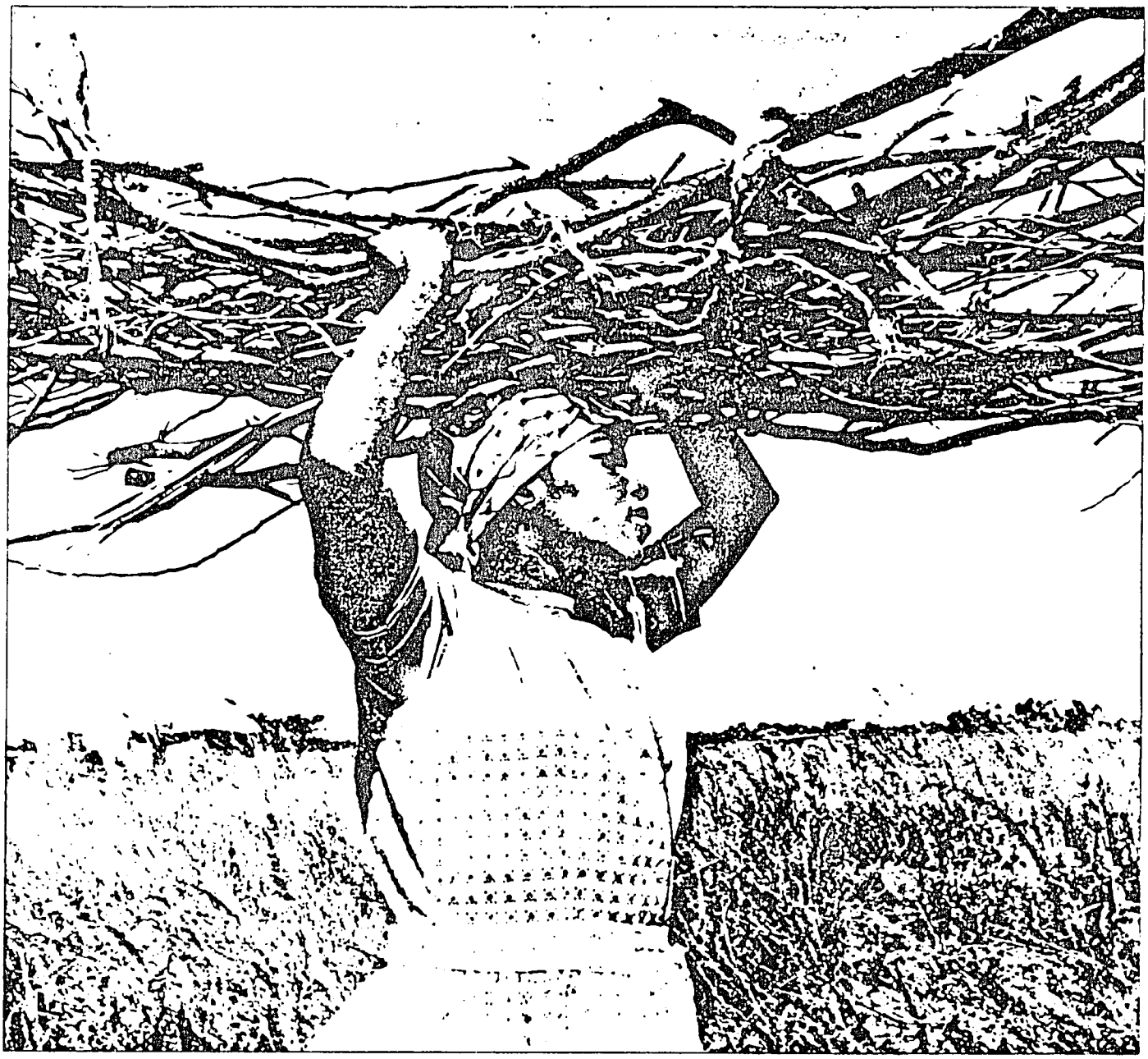
Within a short period — perhaps 10 years — farmers could translate surplus into reinvestment in agriculture and rural light industrial production. That would set the foundation for wider-scale industrialization.

By disinvesting the boards of their powers, government would increase the private sector's role in economic development. And freeing peasant farmers from the hold of the boards could offer them economic empowerment, steer surplus toward productive investments and lead to true social transformation and sustainable growth. Wouldn't it be ironic if agricultural markets were opened up in subsequent multilateral trade talks only to leave African farmers at the mercy of even more powerful marketing boards?

Milton Allimadi, a free-lance writer based in New York, writes on economic development issues.

A blueprint for Africa

Some 80 million Africans, like this Swazi woman, have difficulties finding fuelwood.



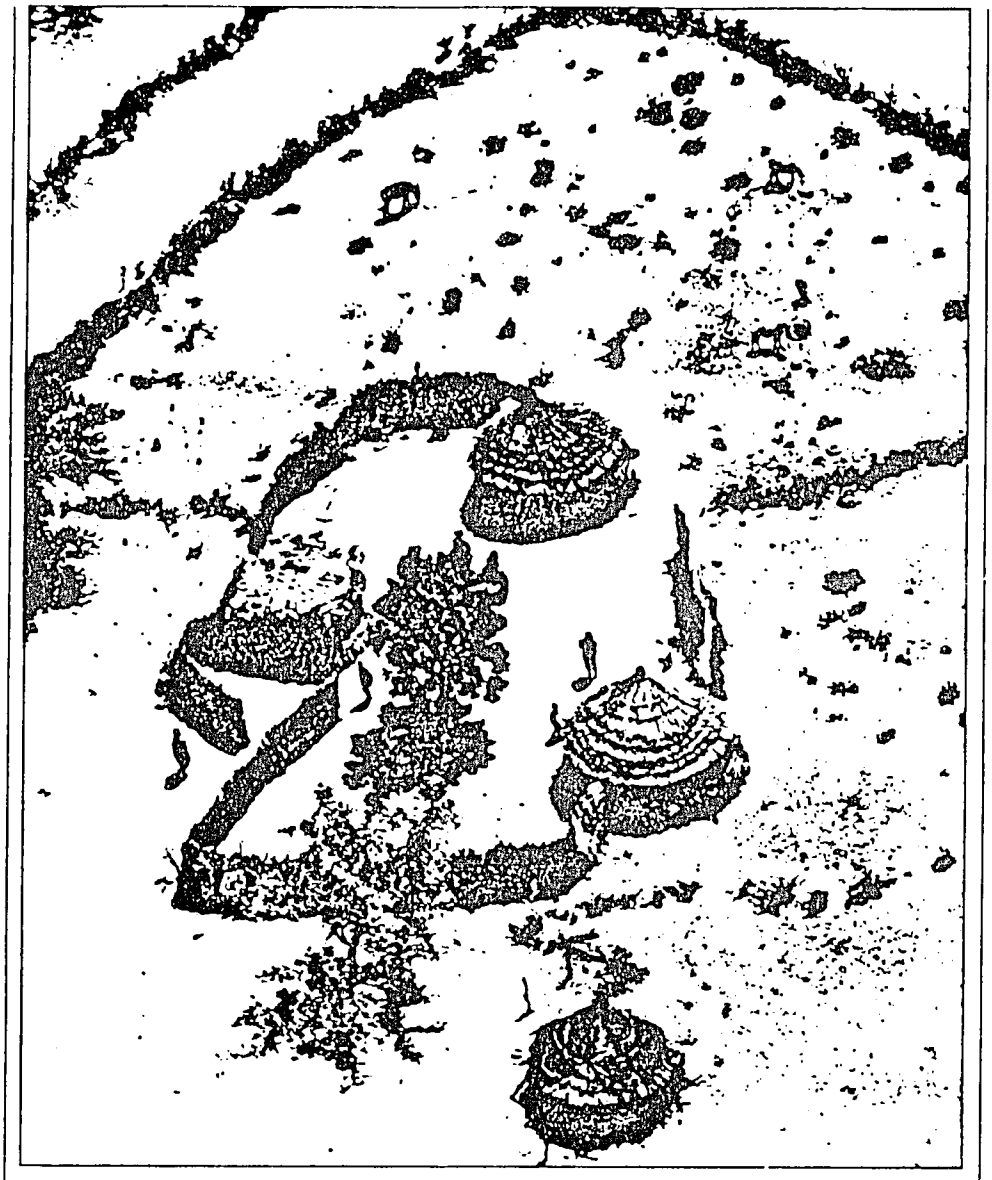
There is no easy or quick solution to Africa's problems, says former World Bank President *Robert S. McNamara*. But solutions are possible, he says, if Africa's leaders and the international community play their part in developing long-term policies and plans to increase agricultural production, conserve the environment and slow population growth, in an integrated strategy.

Sub-Saharan Africa poses the greatest development challenge facing the planet today. The problems are deep-seated and multifaceted.

To register even a modest improvement in the quality of life, the Sub-Saharan economies must raise their rate of economic growth from less than 1 per cent per annum – the level of the 1980s – to at least 4-5 per cent a year. Allowing for population growth, this is equivalent to 1 or 2 per cent per capita.

During the next decade, I see expansion of agricultural output as the foundation of growth. But that will require the relationship between agricultural stagnation, explosive population growth, and degradation of Africa's resource base to receive far more emphasis than in the past.

Although the majority of the people of Sub-Saharan Africa are dependent on the land for their living, the land's capacity to produce is ebbing away under the



IPPF/MARK EDWARDS

Desertification threatens the Sahel: village homestead, Kordofan province, Sudan.

pressure of rapidly growing numbers of people who do not have the wherewithal to put back into the land what they are forced to take from it. Trees are being cut down 30 times as fast as they are being replaced; sor[illegible] million Africans have serious [illegible] fuelwood and, in cou[illegible] [illegible]opia, topsoil losses of as much as 290 tons per hectare have been reported.

As the land's vegetative cover – trees, shrubs, grasses – shrinks, its already fragile soils lose the capacity to nourish crops and retain moisture. Consequently, agricultural yields fall and the land becomes steadily more vulnerable to the naturally variable rainfall, turning dry spells into droughts and periods of food shortage into famines.

This vicious cycle spins in different ways and at different speeds in different places. The nature of environmental degradation, for example, varies from country to country. Some countries, such as those in the Sahel, Namibia and Botswana, face serious desertification. Others in coastal West Africa are witnessing rapid destruction of their tropical forests. Some countries – like Madagascar, Lesotho and Mauritius – have already put national environmental programmes in place.

Despite these variations, the basic linkages between agricultural stagnation, population growth and environmental degradation are common for the region. And this nexus poses a critical threat to Africa's development in the 21st century.

The magnitude of this task comes into focus when one considers that over the last 25 years agricultural production in Africa rose by only about 2 per cent a year – below the average population growth rate of about 2.8 per cent. Per capita food production has declined. And though food imports are increasing and food aid has expanded, about 100 million Africans are malnourished.

This failure of African agriculture has also choked off the continent's earning potential in the global economy. Agricultural exports have declined sharply – by more than 3 per cent a year – since 1970.

As Africa's agriculture declines, her population is growing – exponentially. Sub-Saharan Africa's average total fertility rate (the average number of children born to women in their childbearing years) has remained constant at extraordinarily high levels since 1965. At current fertility rates, the region's population – now approximately 500 million – would reach 1.6 billion by 2020. No region of the world has ever managed to develop satisfactorily with this rate of population growth.

Yet, many Africans remain to be persuaded of the imperative of smaller families. They see land as abundant and labour as scarce. It is an increasingly false perception.

As Sub-Saharan Africa's population has grown, the amount of arable land available per person has declined. In some countries, the pressure of population on arable agricultural land and other natural resources is already intense – for example, in much of the Sahel, Burundi, western Cameroon, Kenya and Rwanda. Other countries will soon face similar situations. In Nigeria, for example, at the present rate of population growth, arable land per capita will decline to 0.19 hectares from the current level of 0.3 hectares by the year 2000.

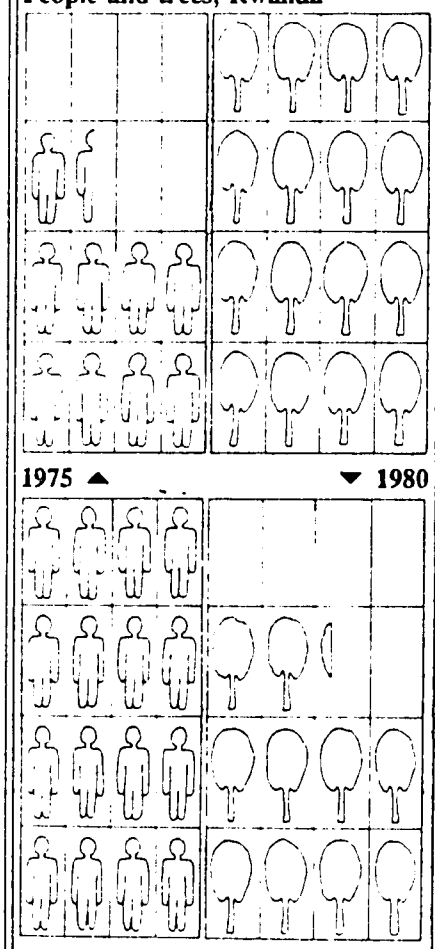
The demographic choice facing Africa can no longer be deferred. Africa has to decide whether to fill its land quickly with many ill-fed, unhealthy, uneducated, unemployed people; or to space its children so that they and the society as a whole have a better chance of a

much better life.

The choice has to be made now because exceptionally high population growth is already compromising economic growth and family welfare – and is jeopardizing Africa's future development. No other continent's destiny has been so shaped by population growth as has Africa's in the late 20th century.

The demographic consequences of procrastination and delay are inexorable. For example, if Nigeria were to act so as to achieve replacement level fertility by the year 2010 (instead of the year 2035, as is presently projected) its population would level off at about 324 million instead of 509 million.

People and trees, Rwanda



In 1970, population was 2.7 million and forest area 251,300 ha. By 1985, population was 6.3 million and tree cover had shrunk to 162,300 ha.

This potentially catastrophic situation can be reversed only by a combination of a reduction in population growth, improved agricultural performance and better environmental management. Here, in summary, are my suggested targets and action programmes for each of these areas.

Terracing work, as here in Kenya, can help stop soil erosion.

To transform Africa's agriculture, expand its productive capacity and achieve food security, food production will have to grow at about 4 per cent a year – above the current 3.1 per cent population growth rate. Beyond that, to raise incomes and meet Africa's import needs, the production of export crops must grow by no less than 4 per cent a year. Thus Africa must set its overall target for long-term agricultural growth no lower than 4 per cent a year – twice the rate achieved in the 1980s.

This is an ambitious, but not impossible target.

To achieve it all African countries will need to allow prices to move flexibly in response to changing market conditions; to turn over the supply of inputs, marketing, processing, and exporting largely to individual entrepreneurs and reduce administrative controls; to promote credit at realistic interest rates through homegrown financial institutions such as co-operatives and credit unions (as already exist, for example, in Cameroon and Rwanda); to gradually reform systems of land tenure to increase security of ownership and stimulate investment in land improvements; and to upgrade rural roads using small local contractors and local community contributions.

There is much evidence that the African farmer, like farmers everywhere, will respond to such incentives. In recent years, increased production of maize in Zimbabwe,

coffee in Guinea, cotton in Benin and Tanzania, cocoa in Ghana, and groundnuts in the Gambia can be attributed in large part to policy and, especially, price reform.

Slowing population growth is the second imperative. The positive impact of modernizing African agriculture is likely to be nullified if population growth continues to be high. A minimum target would be for Africa to realize the rates of fertility decline (a 50 per cent reduction in three decades) already achieved by other developing countries. Even under this scenario, the Sub-Saharan population would be over 1.2 billion by 2020 and would not level off below 3 billion. Moreover, the target is highly ambitious in the African context – requiring a nearly 50 per cent reduction in the total fertility rate by 2025. How can this be achieved?

Most African governments now officially endorse child spacing and family planning. But there is an urgent need to match expressions of general commitment with specific technical, financial and political support. There is strong evidence that when family planning services – which today are woefully weak – are made widely available, and especially when they are backed by mass media campaigns and community-based education, contraceptive use rises.

Zimbabwe, for example has been developing family planning services since its Independence. As a result, the contraceptive prevalence rate has risen from 5 per cent in the late 1960s to an estimated 43 per cent in 1988. The total fertility rate has dropped from over 7 to 5.3 over the past 10 years.

Such a 'success story' in fertility reduction stands in stark contrast to most African countries where, on average, only an estimated 11 per cent of couples use contraceptive methods (whether modern or traditional) – compared with over 80 per cent in China and 40 per cent in India.

To reach the fertility rate target by the year 2025, nearly half of African couples would need to be using effective contraception. Achieving this target will require an intensive effort by African countries and greater, more enlightened, support from the international community. The record in Asia and Latin America clearly shows it can be done.

This Madagascan farmer had plenty of land, but now it is fragmented between his nine children.

To meet these fertility targets, family planning aid would need to be increased to about $650 million a year by the turn of the century. As for the costs to individual countries, based on recent experience in Zimbabwe and Botswana, annual allocations of no more than 0.6 to 0.8 per cent of GNP would allow countries to put in place substantial family planning programmes. Not only are these costs modest, they would be more than offset by the savings in education and health budgets and food imports that lower fertility would bring.

Reducing the population growth rate and increasing the productivity and sustainability of agriculture will be the two most effective means of helping to protect Africa's environment. But a specific and extensive affirmative environmental programme will also be required. This must combine productivity and protection and help African farmers to make the right decisions in their own self-interest.

Each country will need an environmental action plan – backed with sufficient staff, institutional and financial resources, and political support.

Donors currently provide about $500 million a year to Africa for environmental activities. This is totally inadequate. In Madagascar alone, the World Bank has put the cost of continued environmental degradation at between $180-300 million a year. The cumulative loss to Nigeria of continued water contamination, deforestation and soil erosion is much higher, some say as high as $5 billion per year. I suggest that external environmental assistance to Africa be doubled at once.

Are Africa's problems intractable? They certainly have not been handled successfully by myself and others – in the past 30 years. But surely we will not accept that they cannot be solved in the future? The action required must start within Africa. In that respect, in the past five years or so, there has been one great sea change for the better: African governments and institutions are coming to the realization that the primary responsibility for Africa's future rests in its own hands.

But I would add that Africa also needs sustained and increased external support – including debt relief mechanisms – if it is to overcome its development crisis. ■

The full text of a speech by Robert McNamara to the African Leadership Forum in Lagos last June, in which he gives a more extended account of the views expressed here, is available from the World Bank, 1818 H Street NW, Washington DC 20433.

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Testimony of Teresita C. Schaffer
Deputy Assistant Secretary of State Bureau of Near Eastern and South Asian Affairs
before the Subcommittee on Asia and Pacific Affairs
House Foreign Affairs Committee
March 7, 1991

Mr. Chairman, Members of the Subcommittee:

I appreciate this opportunity to appear before you today, joined by my colleagues from the Defense Department and the Agency for International Development, to discuss the current situation in South Asia and our aid policies and programs for the region.

Since Ambassador Kelly testified on November 2, democratic institutions have displayed encouraging vitality. Bangladesh held elections February 27 and elections are scheduled for May 12 in Nepal. The new government in Pakistan, elected in late October, has established itself following elections which we believe to have been on balance free and fair despite some irregularities. The orderly change in the Indian government last November in spite of serious social and communal disturbances demonstrated the dynamics of democratic government in the world's most populous democracy. We are confident India will find a solution to the crisis sparked yesterday by Prime Minister Chandra Shekhar's resignation in accordance with the same democratic principles.

There have been some signs of improvement in regional stability as well, notably in Indo-Pakistan relations. However, other trends remain problematic. The problems of Afghanistan, Kashmir, and Sri Lanka continue to fester. We

continue to be concerned about nuclear weapons competition in a region as volatile as this.

All countries in the region support the twelve UNSC resolutions which formed the basis of our actions in the Gulf, though the shock of the outbreak of hostilities generated a spasm of anti-American demonstrations in several countries.

The basic United States policy goals for South Asia are:

-- to continue to support and promote security in the region through decreasing tensions between states;

-- to discourage a race toward acquisition of weapons of mass destruction;

-- to promote and strengthen democratic institutions through economic development, encouraging privatization, and assisting with the building of democratic structures; and

-- to seek support for a successful winding up of the issues raised by Gulf War.

U.S. economic and security assistance is a key tool in supporting these goals. My colleagues and I will be reviewing how this is being accomplished.

First, however, I need to discuss the impact of the Gulf War at greater length. It is an event external to the region, but nevertheless has an immediate impact that overshadows longer term trends. South Asian nations opposed Iraq's brutal occupation of Kuwait. They all honored the UN economic sanctions against Iraq, at some expense to their own economies. Pakistan, Bangladesh, and Afghan Resistance organizations sent troops to help defend Saudi Arabia. The war's economic impact on South Asia has not been as heavy as was feared last Fall, largely because oil prices have returned to traditional levels and supplies are plentiful. Almost all countries in the subcontinent, however, have suffered because of a serious decline in remittances, as well as a drop in trade with the Gulf region. This has been accompanied by a great deal of personal hardship and dislocation for South Asian expatriate workers.

In Pakistan, there were demonstrations against U.S. Gulf policy and in favor of Saddam Hussein. These disturbances were also rooted in other resentments, particularly the suspension of U.S. aid in October because of the nuclear issue, and attempts by political parties to manipulate popular passions for short term gains. However, Prime Minister Sharif's government continued to support implementation of all the UNSC resolutions related to the Gulf crisis, including total and unconditional Iraqi withdrawal from Kuwait. In addition, Pakistan contributed 11,000 troops, which are stationed in Saudi Arabia. This support has prevailed despite strongly

negative reactions from the Pakistan Peoples' Party opposition and certain Islamic parties, and the different views articulated in December and January by the military leadership. We estimate that Pakistan's economy could lose up to $1 billion as a result of the crisis.

The Afghan regime told the UN Secretary General in late December that it was complying with sanctions. Privately, it appeared to favor Iraq, with prominent media coverage of anti-coalition demonstrations in Kabul. Afghan Resistance parties split between Hekmatyar, Sayyaf, and Rabbani, who condemned coalition efforts, and Mojaddedi, Khalis, Mohammedi, and Gailani, who supported the defense of Saudi Arabia and liberation of Kuwait. Most mujahidin commanders and refugees, while sympathetic to the suffering of the Iraqi civilian population, were opposed to Iraq's takeover of Kuwait, and supported the expulsion of Saddam's forces. The Gulf crisis has had no significant impact on the Afghan economy. Despite initial concerns about sharp cut-backs in funding, private Saudi and Kuwaiti assistance organizations have continued to serve Afghan refugees throughout the crisis.

We have welcomed India's continued support for the UN resolutions. We also appreciated India's willingness to refuel our supply planes en route to the Gulf, even though we decided to make alternative arrangements when domestic criticism of the government over the flights became intense. However, India also joined NAM efforts at the UN and elsewhere to promote an

early ceasefire, without the explicit linkage to concrete Iraqi moves to withdraw from Kuwait which we consider essential. Many anti-war and anti-U.S. demonstrations have taken place in India; in Calcutta they threatened the security of our Consulate. The Gulf crisis has seriously worsened India's already weak balance of payments situation.

The interim government in Bangladesh supports the UNSC resolutions on Iraqi withdrawal from Kuwait and continues the deployment of 2,300 troops to defend Saudi Arabia. Popular sentiment expressed in generally peaceful demonstrations and in the press, ranges from anti-Iraq to pro-Iraq. Bangladesh has been particularly hard hit by the Gulf war. Taking into consideration its increased oil bill and the loss in remittances and trade, the overall decline of its GNP is 2.5%.

Nepal has complied fully with economic sanctions and supports the 12 UNSC resolutions. It had few citizens in the Gulf and minimal trade relations with Iraq and Kuwait so the overall economic impact of the crisis is not great. However, the crisis has caused a 50% reduction in the important tourist industry, reducing Nepal's annual foreign exchange receipts by around 3%. Higher fuel and transportation costs caused by the crisis are affect garment sales already hurt by the U.S. recession.

Earlier this month, the Government of Sri Lanka reaffirmed its support of all UNSC resolutions on the Gulf. Citing UNSCR

678, it restored refuelling privileges for coalition ships and aircraft which it had briefly suspended. The costs of the Gulf crisis to Sri Lanka, originally estimated by the Asian Development bank at 5% of GDP, will probably be much less than anticipated given reduced oil prices and the brevity of the fighting.

Strengthening support in the region for the UN Security Council resolutions will be one of our key policy goals as we move forward. Stability and peace in South Asia take on added importance as we contemplate the establishment of a more durable regional security system.

Mr. Chairman, before I discuss each of the South Asian countries in turn, relating our aid request to our overall policy goals, I would like to address a management issue you have raised. The Department transmitted on June 25, 1990, its report on the reorganization of the regional and functional bureaus, as required by Section 127 of the 1990 - 1991 Foreign Relations Authorization Act. The report was transmitted to the Chairman of the House Foreign Affairs and Senate Foreign Relations Committees. It included a section on the Bureau of Near Eastern and South Asian Affairs specifically addressing the issue of whether to establish a separate South Asia Bureau. The conclusion of the study was that there were strong substantive and management arguments against dividing the present Bureau of Near Eastern and South Asian Affairs. Accordingly, we plan to retain our current organizational

structure. Our experience since Iraq's invasion of Kuwait last August confirms our view that setting up a separate South Asia Bureau would not be advisable. Our internal organization has withstood the extraordinary stresses of this period, and we are satisfied that the present structure provides for both good staff support and strong attention from the leadership of the Department to the problems of South Asia.

AFGHANISTAN

To support war-affected Afghans who have remained in their country and to create conditions which will draw Afghans home, we are continuing our cross-border program at a level of $60 million. An additional $4.8 million will go for food assistance to needy civilians.

In addition to our support for UN efforts to encourage a political solution, the U.S. and Soviet Union have continued discussions on ending the Afghan conflict which would include a cut off of U.S. and Soviet arms support. We are in general agreement in a number of areas, including the need for a transition process that would guarantee free and fair elections. We have not been able to agree on how best to disengage our respective support and to achieve a ceasefire. We anticipate renewing senior level discussions with the Soviets but have not set a date. Both we and the Soviets recognize that it is the Afghans themselves who will have to determine their own future.

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In Afghanistan, there was considerable fighting over the past year, but little significant change in control of territory. The Najib regime continues to seek increased international recognition, but has not broadened its internal support. Within the Resistance, the Afghan Interim Government has degenerated into ineffectiveness and disarray as party leaders have continued their rivalries. Divisions have deepened over the Gulf War. The National Commanders' Shura has gained support from a broad range of Afghans and is focussing on coordinating military activities. The increased cooperation among commanders could extend into administrative and political areas in the future and is an encouraging development.

PAKISTAN

For Pakistan in Fiscal Year 1992, the Administration is requesting $100 million in Economic Support Funding, $25 million in Development Assistance, $ 113.5 million in Foreign Military Financing, and $.9 million for International Military Education and Training. We also expect to continue providing about $7 million in counter-narcotics assistance.

As you know, Mr. Chairman, new aid to Pakistan as well as U.S. Government military deliveries have been suspended since October 1 because the President has not certified, as required by law, that Pakistan does not possess a nuclear explosive device and that continuation of our assistance and military

supply programs will significantly reduce the risk of its doing so. We have allocated aid for Pakistan this fiscal year in the hope that developments on the nuclear issue will lead to a Presidential certification, permitting resumption of aid. If this does not occur, the funds would become available for reprogramming to other recipients.

As a result of overall constraints on the foreign assistance budget, and the necessity to address pressing needs elsewhere, the FY 91 allocation was significantly reduced from the earlier Administration request. For FY 91, a total aid package of $237.8 million was allocated, including $91.9 million in foreign military financing (in the form of both grants and concessional credits), $.9 million in International Military Education and Training, $100 million in Economic Support Funding, $25 million in Development Assistance and $20 million in PL 480 Title I. In addition, we are providing $ 7.5 million in counter-narcotics assistance, aid that is not limited by Pressler.

Pakistan remains a valued friend, with shared interests in a just political settlement in Afghanistan, maintaining peace and stability in the region, combatting the spread of illicit narcotics, strengthening democratic institutions, and fostering economic growth. The U.S. is encouraged by the Sharif Government's steadfastness regarding the Gulf and its efforts to liberalize the economy, and will continue to work to restore the relationship to a more balanced footing. Within the

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constraints of our nonproliferation objectives, we would like to be able to continue our material support for Pakistan's economic development and security.

The October 1990 national elections represent another step toward the institutionalization of democracy in Pakistan. Despite indications of possible fraud in a small number of National Assembly constituencies, on balance, the elections were free and fair, producing a result that we believe reflects the will of the electorate. Although the elections were held in a more polarized political atmosphere than the 1988 elections, and there have been a number of unsubstantiated charges of vote-rigging and fraud, given the paucity of hard evidence to support these allegations and the magnitude of the victory by Prime Minister Sharif's coalition, any irregularities would not have been significant enough to affect the overall outcome of the vote.

The Administration's commitment to nonproliferation remains strong. The issues posed by Pakistan's nuclear program are being carefully monitored by our government and are under discussion with the Government of Pakistan. We are confident that the GOP fully understands the requirements that we face under U.S. law. In addition to our bilateral discussions of the nuclear issue with the Pakistanis, we remain concerned about the broader problem of nuclear competition in South Asia. The Administration continues to encourage regional efforts to prevent the proliferation of nuclear weapons.

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Pakistan and India have taken some initial steps to address this problem, including the January exchange of instruments of ratification for their agreement not to strike at each other's nuclear facilities. We hope that they will be able to identify further steps they can take -- either bilaterally or with outside support -- to reduce the risk posed by these nuclear programs in a volatile region. We are ready to do what we can to help.

Indo-Pakistani relations have continued to make progress since I last appeared before you. The level of tension between New Delhi and Islamabad over Kashmir is perceptibly lower than it was last Spring. At upcoming talks, the two Foreign Secretaries may sign agreements on military confidence building measures which could contribute positive momentum to the relationship while reducing risk of stumbling into conflict. We continue to urge both India and Pakistan to find ways of broadening their understanding in this crucial area.

INDIA

The Administration is requesting $99.9 million in aid to India for FY-1992: $22 million in Development Assistance, $77.6 million for PL 480, $15 million in housing guarantees, and $.345 million for International Military Education and Training. The PL 480 program, the largest Title II program in the world, integrates food supplements with maternal and child health programs administered by voluntary agencies.

Development Assistance focuses on increasing participation of the private sector in the Indian economy.

Prime Minister Chandra Shekhar's surprise resignation yesterday throws the Indian political scene into disarray. The President accepted the resignation, and has asked Chandra Shekhar to stay on as caretaker. The President must now decide, however, whether to ask Rajiv Gandhi, as leader of the largest bloc in Parliament, to form a new government, which would require him to find an additional fifty supporters. If the President does not ask Gandhi, or Gandhi declines, new elections must be held after 35 days and within six months.

The government faces a pressing balance of payments problem exacerbated by the Gulf conflict. To deal with this, India departed from past practice and obtained $1.8 billion in assistance from the IMF. This may not be sufficient to bridge the balance of payments gap for the coming year.

The Shekhar government tried to resolve the conflicts in Punjab and Kashmir through dialogue. The Prime Minister consulted widely on the Kashmir problem and declared willingness to meet with anyone to discuss resolution of this conflict. Militant groups rejected his offer, and the violence continued. The daily rituals of militant attacks and security force counterattacks have claimed almost 200 lives in Kashmir this year. Our view on the violence in Kashmir continues to be that there must be a resolution through political dialogue. In

Punjab, Chandra Shekhar replaced the governor and police chief soon after taking office. More importantly, he met in late December with Akali Dal leader S.S. Mann to lay the groundwork for future substantive meetings. The number of violent incidents declined somewhat in December and remained fairly constant in January and February. Even so, in Punjab more than 675 people have already died this year in terrorist-related activities.

India's domestic economic activity remains hampered by excessive central control and government interference. India's investment regime effectively discourages U.S. businessmen from committing capital there. Even though the U.S. was the leading foreign investor in India last year, the amount was tiny -- $19 million from a total of $76 million. In Uruguay Round negotiations, India supported us on agricultural policy, but important differences remain on other fundamental issues such as intellectual property rights, market access, and trade-related investment matters.

India's membership on the Security Council will give it an opportunity -- and a responsibility -- to help shape some of the major features of the world political landscape. The U.S. and India consult closely on issues likely to come before the Council, and share the hope that the UN will be able to play a constructive role in reducing the risk of instability and conflict in the world. We don't always see eye-to-eye, but I believe the enhanced dialogue increases mutual understanding and thus strengthens bilateral ties in the long run.

BANGLADESH

For Bangladesh in Fiscal Year 1992, the Administration is requesting $62 million in Development Assistance, $74.5 million in P.L. 480 food and commodity assistance and $350 thousand in International Military Education and Training Funds. This assistance will improve the lives of the Bangladeshi people, strengthen the partnership between business and development and promote and consolidate democracy.

During the past six months, while the world's attention has been focused on the Gulf, there has been a peaceful democratic evolution in Bangladesh that compares favorably with last year's democratic change in Eastern Europe. On February 27 the people of Bangladesh went to the polls to elect 297 members of Parliament from a field of over 2700 candidates representing over 60 political parties. The elections have been viewed by international observers, the press, the students, and the diplomatic community as the most free, fair and non-violent in the twenty year history of Bangladesh. We commend the interim government of Bangladesh, the political parties, the students, the security forces and the voters who worked together in the spirit of compromise and cooperation to build democracy in Bangladesh.

We consider this election to be only the beginning of Bangladesh's progress toward stronger democratic institutions.

The next months will present the unique challenges of forming a parliament and then holding presidential elections or changing the Constitution to allow for a parliamentary democracy as preferred by some parties. We look forward to working with the new Government.

The U.S.has actively promoted democracy in Bangladesh for many years. USAID-funded programs have contributed to the process through voter education programs and training of poll watchers and indigenous election observers. The National Democratic Institute for International Affairs has sent several missions to Bangladesh, including a four-person team for the parliamentary elections, that worked with local election observers and party members to develop election monitoring skills. We consider the recent election to be a solid foundation for U.S. cooperation with Bangladeshi efforts to strengthen its evolving democratic institutions.

The U.S. continues to be interested in the economic development of Bangladesh. We have contributed over $3 billion to the country's development since its independence in 1971. Bangladesh continues to enjoy one of our largest Development Assistance and P.L. 480 food and commodity assistance programs totalling over $130 million annually. These programs emphasize helping Bangladesh to meet basic human needs particularly in the areas of health and population, agriculture development and employment generation.

The Administration and Congress have been concerned about the debt of the poorest countries. In this context Congress passed Section 572 of the 1989 Foreign Operations Appropriation Act which relieves the burden on the neediest debtors who are making appropriate economic reforms. Mr. Chairman, you and other colleagues have expressed interest in seeing this provision benefit Bangladesh. Because of Bangladesh's commitment to continue economic reforms and its efforts toward strengthening democratic pluralism, the Administration has announced relief for Bangladesh's outstanding Development Assistance debt of $292 million during this fiscal year. This debt is for Development Assistance provided prior to 1983. Since 1983 all Development Assistance aid to Bangladesh has been in grant form. We believe that debt relief can make a significant contribution toward the country's economic and political development.

We are satisfied with the Government of Bangladesh's efforts to continue economic reform. Last year's sharply falling foreign reserves have stabilized and Bangladesh is apparently sticking to its IMF Enhanced Structural Adjustment Program negotiated in August of 1990, in spite of the impact of higher oil prices last Fall and lost remittances from workers in Kuwait and Iraq.

NEPAL

For Fiscal Year 1992, the Administration is requesting $15

million in Development Assistance, $500 thousand in Foreign Military Financing, and $185 thousand in International Military Education and Training funds for Nepal. We will continue to stress liberalizing markets with a strong sectoral emphasis on agriculture/forestry and health/population, working closely with the World Bank and the Asian Development Bank in restructuring agricultural policy.

Nepal continues its transition to democracy. On November 9, King Birendra promulgated a new Constitution which establishes constitutional monarchy and multi-party parliamentary democracy, guarantees basic human rights, and provides the framework for democratic institutions. Nepal's first multi-party elections in 30 years are scheduled for May 12.

The mechanisms planned and implemented by the National Election Commission (NEC) were designed to ensure a free and fair election. The NEC registered 10.7 million voters and evaluated applications from 47 groups seeking recognition as political parties. To qualify, groups had to adhere to democratic norms, hold internal elections, and be "national" in character (i.e., not based on ethnic, regional, tribal, religious, or caste identities). The Delineation Commission drew the lines for 205 constituencies, which have an average of 35,000 voters each.

The United States has encouraged and supported Nepal's democratic transition from the beginning. Through the Asia

Democracy Program, we provided more than $800,000 in FY 90 to support constitutional reform and the development of pluralistic democratic institutions. An additional $130,000 has been made available from FY 91 funds. Some of these funds are being used to finance ongoing voter and citizen education projects, and some have been allocated to such activities as parliament strengthening, election observer training, assistance to the election commission and to non-partisan human rights organizations, and training assistance for a number of emerging political leaders.

The Embassy has been in contact with the National Endowment for Democracy (NED) and the two U.S. party institutes, NDI and NRI, since April 1990 to use their expertise and resources in support of Nepal's democratic process. We plan to field a 10-member NDI/NRI observer team coordinated by International Foundation for Electoral Systems, and we will continue to offer our experience of democratic systems in whatever way the Nepalese find useful.

SRI LANKA

For Sri Lanka in fiscal year 1992, the Administration is requesting $19.3 million in Development Assistance, $21.6 million in P.L. 480, and $200,000 in International Military Education and Training funds.

Sri Lanka embodies one of South Asia's starkest paradoxes. On the one hand, it takes pride in a strong, democratic tradition and dynamic economic policies which brought a five percent annual growth rate for 1990. At the same time, Sri Lanka has suffered two brutal insurgencies. Although the JVP, which has a brutal record, was crushed by early 1990, the Liberation Tigers of Tamil Eelam continue to wage a bloody separatist war against the Government. Deputy Defense Minister Ranjain Wijeratne, who was assassinated on March 3, was the latest victim of Sri Lanka's tragic cycle of violence. We have consistently urged dialogue, not bloodshed, as the means to resolve Sri Lanka's ethnic differences. While the ceasefire in early January did not last, we are encouraged that the Government left the door open to future talks.

We are also troubled by the human rights abuses committed by all parties to the conflict, including government forces. The Government's establishment of a human rights task force was a welcome development. We commend its efforts to maintain communal harmony and to promote military discipline while fighting a violent insurgency. Plainly, a democratically-elected government has the right to protect itself from those who would overthrow it by force. Yet those charged with enforcing the law -- including the Sri Lankan military and police -- have a special obligation to obey it. On human rights matters, the Government of Sri Lanka's primary responsibility is to vigorously investigate all extrajudicial killings and disappearances credibly linked to security forces

and bring those responsible to justice. Beyond that, there must be greater effort to investigate officials linked to serious abuses. Discipline in the security forces must be strengthened. We have underscored this point on many occasions, including at the donor Consultative Group meeting in Paris on October 25. Other delegations, including the European Community, expressed similar concerns in their statements.

I would like to conclude, Mr. Chairman, by noting again our encouragement by the improved climate for democratic institutions in several South Asian nations. U.S. assistance programs, supported by the Congress, have made a real contribution to this development. But working for greater democratic government and widened opportunities for free enterprise in South Asia, as anywhere else, is a means to an end: an improved life for the people of the region. We will continue our diplomatic efforts in South Asia on behalf of non-proliferation, increased security, and improved human rights. We also must continue our programs to help build the political, economic, and social foundations required for South Asian nations to adequately address themselves the tremendous problems they face.

Opening Statement of Rep. Stephen J. Solarz
Chairman, Subcommittee on Asian and Pacific Affairs

On Foreign Assistance Legislation for Fiscal Years 1992-1993

Wednesday, March 6, 1991

This is the first in a series of hearings that the Subcommittee on Asian and Pacific Affairs will hold on the Administration's proposals for Foreign Assistance for Fiscal Year 1992.

In today's session, Administration representatives will present the entire aid proposal for East Asia and the Pacific. In tomorrow's session, Administration witnesses will present the proposal for South Asia. And in subsequent sessions, the Subcommittee will consider aid proposals and policy issues surrounding Cambodia and Philippines, two countries of particular importance to U.S. policy in the region.

On March 12, Administration and non-governmental witnesses will testify on developments affecting Cambodia, including the issue of aid to the non-communist resistance and to others within Cambodia, as well as the prospects for success in efforts to negotiate an internationally recognized political settlement. On Thursday, March 14, Administration witnesses will testify on recent developments in the Philippines. At that time, we will consider the Administration's aid proposal for the Philippines for 1992, as well as progress on the Philippine base negotiations.

The Subcommittee's markup will be held on March 20 and, if necessary, will contnue on March 21.

It is my understanding that the full Committee will mark up the foreign aid bill soon after the March-April recess, after which the measure will be scheduled for floor action.

Because we will be focussing on Cambodia and the Philippines at separate hearings, we will focus attention today on aid programs and U.S. policy toward the other countries of the East Asian and Pacific region.

An initial examination of the aid figures indicate few major changes in the program for 1992 as compared to 1991. I am happy to see that that the Administration is proposing a

doubling of aid to Mongolia, the first Asian Communist country to attempt a transition to democratic rule. I am also encouraged by the request for development aid to the South Pacific, which would amount to an increase of about 70% over the 1991 allocation, much of which would represent a restoration of aid levels that have been cut in recent years. I might add that the increase would be consistent with recommendations made by a congressional delegation that conducted a study mission to the region in 1989 and urged that U.S. policy-makers accord higher priority to the region's development challenges.

On the other hand, other aid requests raise important questions about which we will be eager to obtain Administration comment. For instance, the Administration is requesting International Military Assistance and Training funds for Malaysia, which were eliminated in last year's Appropriations Act due to the Malaysian practice of pushing off Vietnamese boat people. In view of the Malaysian Government's continued unwillingness to grant first asylum to newly arriving boat people, I will be interested in the Administration's response to concerns that resuming IMET would send the wrong signal to the Malaysia.

Finally, I look forward to Administration comments on recent events in Thailand, and, in particular, on whether the recent military coup triggers the provision of U.S. law that would suspend foreign assistance to that country. I note that the Administration's 1992 request for $17.3 million in aid to Thailand represents a 23% increase over the figure for 1991, and we will want to learn whether the Administration is thinking of reevaluating the request in light of recent events.

To help us consider these issues, we are fortunate to have a panel of distinguished Administration witnessess, including:

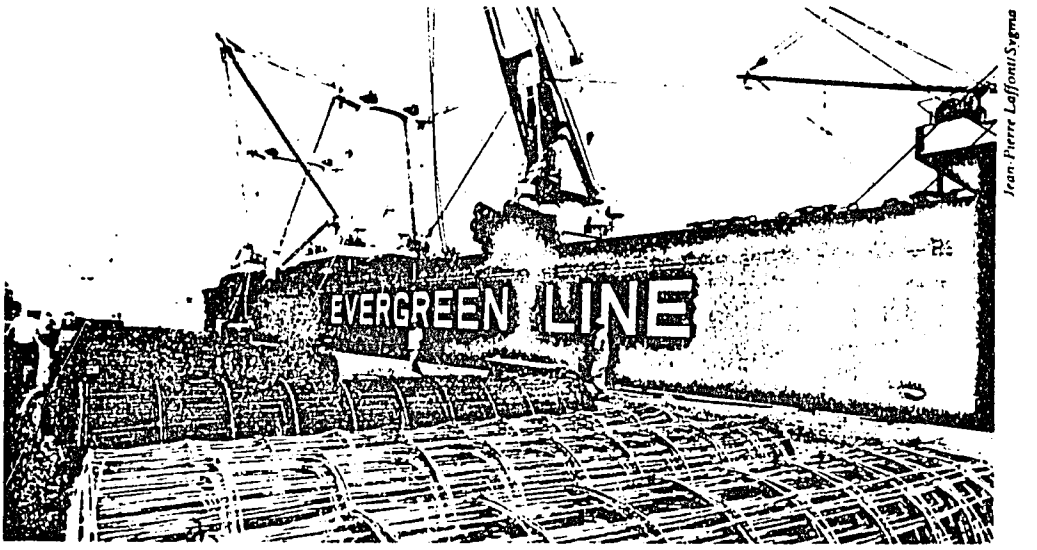
Richard Solomon, Assistant Secretary for East Asia and the Pacific, U.S. Department of State,

Carl Ford, Principal Deputy Assistant Secretary for International Security Affiars, U.S. Department of Defense,

and Henrietta Holsman Fore, Assistant Administrator, Bureau for Asia and the Pacific and Private Enterprise, U.S. Agency for International Development.

Mr. Solomon, you may begin...

Co-operation with the Dynamic Asian Economies



Jean-Pierre Laffont/Sygma

One of the main strengths of the OECD is its capacity to adapt its activities to new developments in the world economy. In January 1989 the OECD broke new ground by embarking on an informal dialogue with the East and South-East Asian economies which have exhibited considerable dynamism in their market-oriented development: the Dynamic Asian Economies. What economic circumstances underlie the mutual interests that are the basis for this dialogue, and how has it progressed?

André Barsony

Over the three decades of the OECD's existence, the gross domestic product of the OECD area, measured in real terms, has risen at a rate of approximately 3.9% per annum. While it is difficult to identify the relative importance of various factors which contributed to this impressive performance, two appear to have been critical.[1] One has been rapid technological change, especially in communication and transportation. The second is the liberalisation of international movements of goods, services and capital.

Time is a great leveller. The remarkable performance of OECD growth in the last few decades has led to the convergence of productivity and per capita income levels among OECD countries.[2] During the period of economic integration that covered the life of the the OECD's predecessor, the Organisation of European Economic Co-operation (OEEC) and the early years of the OECD itself (1950–65), this convergence stemmed mainly from Europe's recovery from the Second World War. In the years that followed, shifts in economic weight inside the OECD area reflected mainly the 'catching up' of the technological and economic management capabilities of Japan with those of the most advanced industrial countries (Table 1).

A striking development is that the convergence process has begun to encompass a number of economies from outside the OECD area. The emergence of the Dynamic Asian Economies (Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand) as major economic partners, notably as importers of merchandise and exporters of manufactured goods (Table 1), has significantly expanded the foundations and improved the prospects for growth through economic integration.

The Dynamic Asian Economies (DAEs) showed strong economic performance in the 1980s (Table 2). On average, they outperformed OECD countries by a healthy margin, growing at considerably higher rates. Indeed, productivity and per capita income in several DAEs are close to average OECD figures. During the latest upswing in world economic activity (1983–89),

André Barsony is Deputy Head of the Liaison and Co-ordination Unit of the OECD's General Secretariat.

1. See Raymond Vernon, 'Global Interdependence in a Historical Perspective', in **Interdependence and Co-operation in Tomorrow's World**, OECD Publications, Paris, 1987.

2. See **OECD Economic Outlook**, No. 42, OECD Publications, Paris, 1987, and John Helliwell, 'Globalisation and the National Economy', in *Perspective 2000*, Economic Council of Canada, Ottawa, 1988.

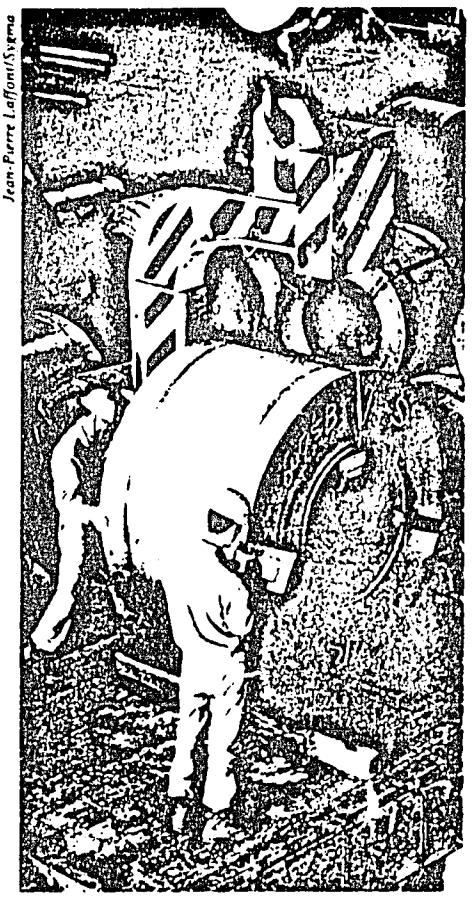
labour productivity in the manufacturing sector increased by 104% in Korea, 40% in Taiwan, 45% in Japan, 24% in the United States and 20% in Germany. In terms of per capita income, Singapore and Hong Kong are fast approaching Australia, while Taiwan is closer to Spain. In turn, income per capita in Korea is approximately the same as in Portugal. And, further down the income scale, Malaysia and Thailand are close to Turkey.

In the 1980s, the convergence of productivity and incomes in DAEs towards OECD figures occurred during an extended period of non-inflationary growth in the OECD area, combined with a favourable trading environment and currency realignments which led to a rapid increase in the demand for DAE exports. In parallel, policy reforms based on market principles further increased the flexibility of the DAEs and contributed to the full exploitation of the extremely favourable external environment.

Table 1
SHIFTS IN RELATIVE ECONOMIC WEIGHT, 1965–89
The United States, Japan, Germany and the DAEs[1]

	1965	1975	1985	1989
Real Gross Domestic Product as % of the total				
Japan	14.2	21.0	23.3	23.9
DAEs	2.1	3.3	4.9	6.0
Total	100.0	100.0	100.0	100.0
Merchandise Imports as % of the total				
Japan	14.5	20.7	16.4	16.0
DAEs	10.3	12.0	16.7	23.0
Total	100.0	100.0	100.0	100.0
Exports of Manufactured Goods as % of the total				
Japan	17.0	23.3	28.2	24.0
DAEs	3.8	7.8	17.0	20.0
Total	100.0	100.0	100.0	100.0

1. Dynamic Asian Economies: Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand.
Source: OECD


Jean-Pierre Laffont/Sygma

A steel mill in South Korea

More specifically, the 'catching up' process rests on several factors that the DAEs have in common, to various degrees:

- generally sound monetary and fiscal policies providing a stable macro-economic environment for the efficient allocation of resources, including particularly successful policy responses to external shocks
- financial policies promoting high domestic savings as a proportion of GDP
- high efficiency in investment achieved in the framework of outward-oriented policies, providing similar incentives to the promotion of exports and the substitution of imports with domestic production
- large investments in education, training and, most importantly, public and private science and technology programmes, creating the capacity in individual firms to introduce new technologies (this is particularly true for Singapore, Hong Kong, Korea and Taiwan, with a broader and perhaps deeper sectoral expertise in the two larger economies; Malaysia and Thailand have narrower but rapidly expanding technological capacities)
- modern transportation and communication infrastructures, especially in Hong Kong and Singapore.

The impressive performance of the DAEs in recent years took place in the context of

Table 2
PERFORMANCE INDICATORS FOR THE DAEs

	1980–85	1986	1987	1988	1989
Growth of real GDP (%)					
Korea	[illegible]	[illegible]	[illegible]	11.5	[illegible]
Taiwan	6.5	11.6	12.3	7.3	7.4
Hong Kong	[illegible]	[illegible]	[illegible]	7.2	2.5
Singapore	6.3	1.8	8.3	11.0	9.2
Thailand	[illegible]	[illegible]	[illegible]	12.0	10.8
Malaysia	5.2	1.2	5.3	8.7	7.6
Saving as % of GDP					
Korea	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Taiwan	32	36	38	35	32
Hong Kong	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Singapore	42	39	40	41	43
Thailand	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Malaysia	33	32	33	39	37
Investment as % of GDP					
Korea	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Taiwan	23	18	20	23	23
Hong Kong	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Singapore	47	33	39	37	38
Thailand	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Malaysia	35	26	23	26	28
Growth of real exports of goods and services (%)					
Korea	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Taiwan	9.4	27.6	18.9	5.7	4.9
Hong Kong	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Singapore	5.1	14.5	13.1	27.9	9.1
Thailand	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Malaysia	7.3	17.6	10.0	15.5	n.a.
Growth of real imports of goods and services (%)					
Korea	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Taiwan	3.4	22.3	28.0	18.6	9.1
Hong Kong	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Singapore	4.8	11.0	12.4	25.5	8.2
Thailand	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Malaysia	6.0	-2.7	8.8	22.6	n.a.

n.a. = not available.
Source: OECD

increasing integration between these economies and those of the OECD. First, the DAEs' share in the OECD imports of goods from the rest of the world increased from 12% in 1980 to 30% in 1989. Second, the DAEs grew considerably in importance as markets for OECD goods and now account for nearly a third of OECD exports to the rest of the world.

In sum, then, the emergence of the DAEs has expanded the foundations of and improved the prospects for growth through economic integration. But clearly, by the end of the 1980s, the OECD/DAE economic relationship has moved out of the confines of the then existing framework for intergovernmental co-operation between OECD countries and countries outside the OECD area. It was against this background that the OECD member countries considered that discussions with the DAEs – based on mutual interests and taking into account the diversity of these economies – could contribute to a better understanding and the convergence of views on policy co-operation (box).

Macro-economic Interdependence

Trade linkages are the main channels of macro-economic interdependence between OECD countries and DAEs. The OECD is the main export market for the DAEs as a group, accounting for nearly 70% of their merchandise exports in 1987. The United States remains the most important single market, absorbing 35% of DAE exports. Singapore is the least dependent on OECD markets (51%), while Korea exports most of its merchandise to the OECD area (78%).

Conversely, almost two-thirds of the DAE merchandise imports (61% in 1987) originates in the OECD area. Japan is the most important source, accounting for 26% of their imports. OECD estimates indicate that an increase in domestic demand in four DAEs (Hong Kong, Korea, Singapore and Taiwan) of 4% leads to additional growth of 0.5% in US exports and 1.0% in Japanese exports. These are significant effects, and yet 4% is a relatively small increase in the domestic demand

THE OECD/DAE INFORMAL DIALOGUE

The emergence of dynamic, market-oriented economies in East and South-East Asia has significantly expanded the foundations for sustained global economic growth. This is why the OECD countries considered that discussions involving these new important economic actors, recognising mutual interests and taking into account the diversity of the economies concerned, could improve mutual understanding and help views on policy co-operation converge for the continued growth of the world economy.

They agreed to propose an informal and exploratory dialogue not only to the four economies (Hong Kong, Korea, Singapore and Taiwan) which are customarily termed 'newly industrialising economies' (NIEs), but also to two others (Malaysia and Thailand). Indeed, the aim was to engage in a dialogue with the six economies which had demonstrated particular dynamism in their market-oriented development: the Dynamic Asian Economies (DAEs).

First Contact: An Informal Seminar held in January 1989

As a result, an Informal Seminar was held in January 1989 at the OECD under joint sponsorship with the Institut Français des Relations Internationales. Its aim was to offer an occasion for informal discussion of an exploratory character on broad topics and among people from the public, business and academic sectors, participating in their personal capacities.

The Informal Seminar served to confirm that there is a basis and, indeed, a need for a policy dialogue. A clear consensus emerged from the Seminar on the desirability of engaging in further contacts. It was considered that, although Malaysia and Thailand did not participate in the Informal Seminar (Thailand sent an observer), the possibility of their future participation in the dialogue, should they so wish, would remain open.

Four Informal Workshops held in early 1990

Four mutually agreed topics were developed through a series of Informal Workshops in order to gain a more thorough understanding of the substantive aspects of the OECD/DAE relationship:

- 'Financial Markets', Paris, February 1990
- 'The International Trading Environment: Issues and Policies', Seoul, March 1990
- 'Macro-economic Linkages and International Adjustment', Tokyo, April 1990
- 'Trade, Investment and Technology: New Patterns and Associated Policy Issues in a Global Economy', Paris, April 1990.

Participants from all six DAEs (including Malaysia and Thailand) and the OECD countries attended the Informal Workshops. They came, as before, from the public, business and academic sectors and, again, in their personal capacities.

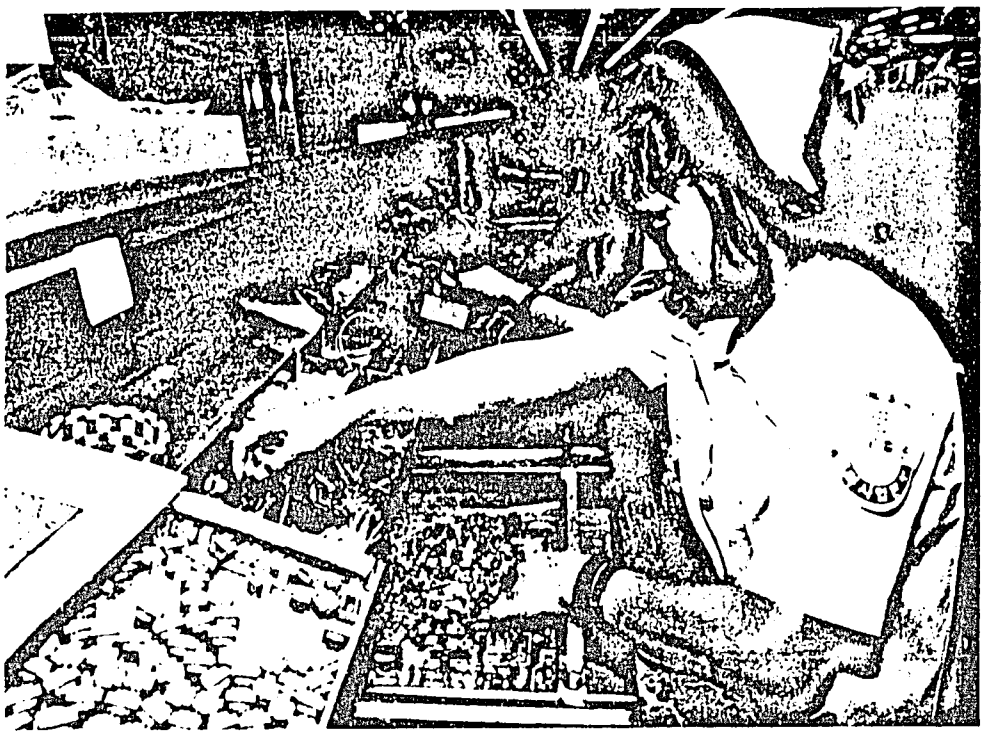
The successful completion of these four Workshops has served to show that there is a strong potential for a special relationship between OECD countries and DAEs based on converging interests. That is true despite some of the basic characteristics of the DAEs; indeed, a recurring theme expressed by DAE participants, not only from Malaysia and Thailand but also from Korea and Taiwan, throughout the Informal Workshops was that development considerations should be given their due weight in the course of the dialogue.

Deepening and Broadening the Informal Dialogue

The discussions in the Informal Workshops held in early 1990 on specific topics showed that in the opinion of the participants, these Workshops were of interest and useful to both the DAEs and the OECD countries. They confirmed that their usefulness had by no means been exhausted. And they demonstrated that the informal dialogue should therefore be deepened in the future by treating some of the subjects dealt with in the Informal Workshops in more detail.

Simultaneously, a progressive broadening of the dialogue to other sectors also seemed desirable. Consultations with the DAEs on the work programme revealed broad support for the strengthening of the dialogue although, on the whole, with a clear preference for 'deepening' topics. The topics retained for the next phase of the dialogue are:

- recent trends in the organisation and regulation of securities markets
- global macro-economic modelling
- macro-economic policy dialogue
- an informal meeting on trade after the Uruguay Round
- long-term perspectives of the world economy
- the DAEs and the integration of central and eastern Europe in the global market economy.



Charlie Cole/R.E.A.

A video and TV plant in South Korea.

of these economies when compared with the experience of the last decades. The estimated effects underline the importance for the OECD of a thorough understanding of economic developments and policies in DAEs.

Macro-economic financial linkages differ among DAEs because they are at rather different stages of financial development and have different policy approaches. In Hong Kong and Singapore, domestic and international financial markets are strongly integrated. While the other four DAEs are not participating as directly as Hong Kong and Singapore in global financial markets, they do not face the kind of external financing constraints that most developing countries encounter. Instead, these DAEs are confronted with critical policy choices involving their current account and net international asset position.

In Korea and Taiwan, a number of such policy choices might be identified:

- the appropriate mix of consumption and domestic savings, in view of the actual and expected rapid increases in incomes
- the allocation of domestic savings between domestic and foreign investment
- the respective roles of currency appreciation and trade liberalisation in the pursuit of more efficient resource allocation.

In Malaysia and Thailand, a central issue might be the appropriate balance between foreign and domestic financing of the large investments in human and physical capital that these developing economies must undertake to build up an advanced outward-oriented manufacturing structure alongside a dynamic primary sector and thus to reap fully the efficiency gains of their integration into the global market economy.

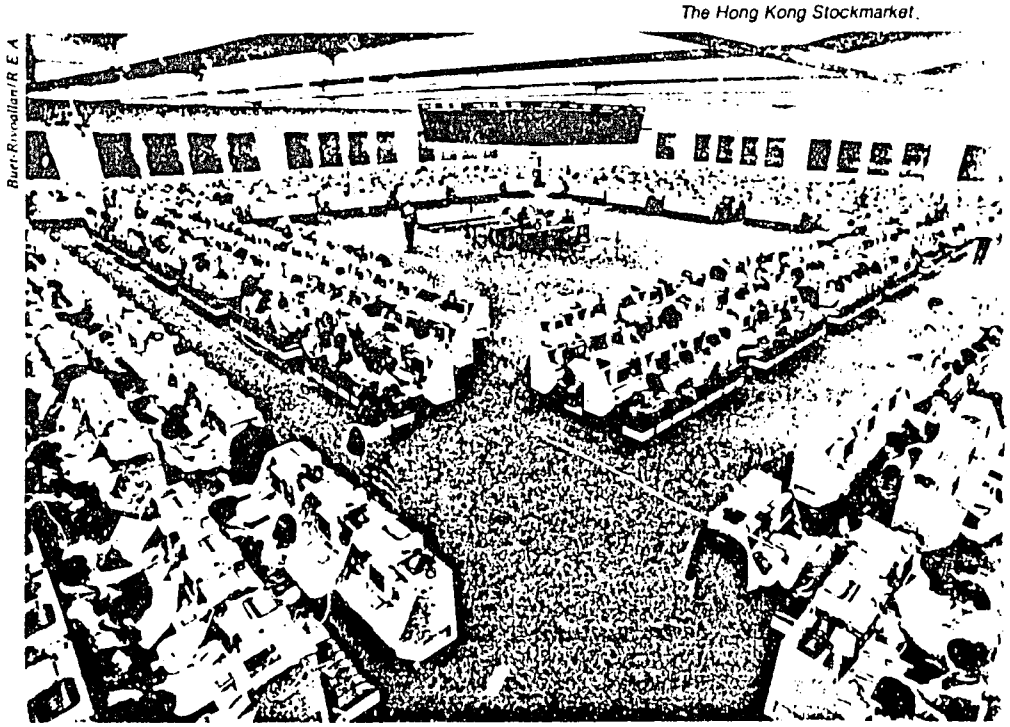
Financial Markets

The DAEs have adopted successful financial policies: they have generated both high rates of savings and investment, and directed financial resources to productive uses. While the financial sector has contributed to increases in productivity in each of these countries, an examination of their individual experience immediately reveals several rather distinct financial policy approaches, each of which is of considerable interest.[3]

In Hong Kong and Singapore, financial institutions were seen as operating in an internationalised market, and were basically left free to respond to international competition. Financial policy in Korea and Taiwan, although recently becoming more market-oriented, has generally been characterised by heavy official intervention, particularly through a strict control over interest rates and over the allocation of credits with limited discretion for financial institutions. Moreover, the financial system has been largely closed to international competition.

But the authorities in Korea and Taiwan clearly recognise that their economies have now entered new phases of economic development where significant modifications of the earlier patterns, although successful, are required. For one thing, both economies have now reached the point

The Hong Kong Stockmarket.



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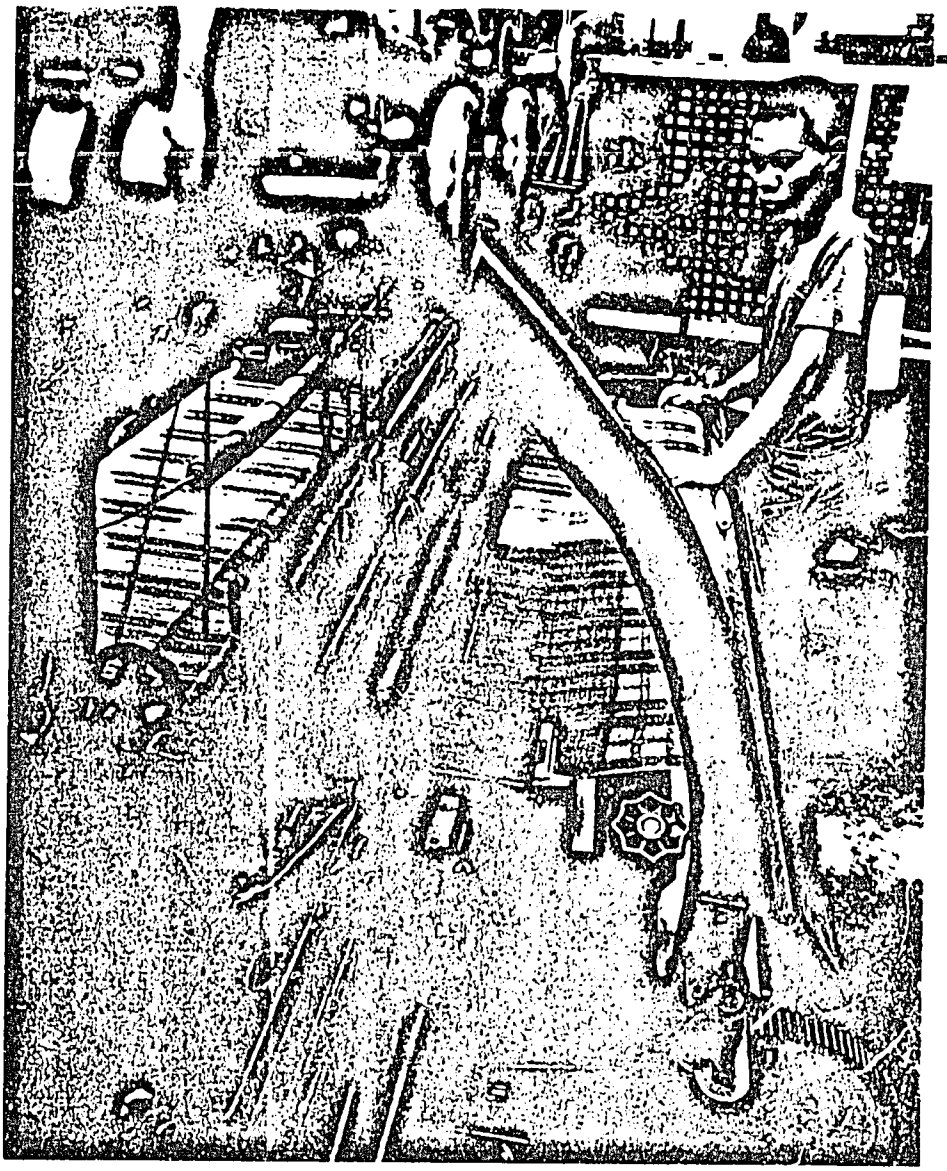
3. See 'Financial Systems and Financial Regulation in Dynamic Asian Economies', **Financial Market Trends**, No. 47, OECD Publications, Paris, 1990.



UNIDO

Textiles in Malaysia.

where their balance on current account is either always or usually in surplus and hence international assets are accumulating. For another, outward direct investment is expanding rapidly: Korean and Taiwanese companies are seeking to relocate many labour-intensive productive facilities abroad, especially in the lower wage countries of south-eastern and southern Asia and to invest in the OECD area in order to gain access to markets and technologies. Finally, these two economies are soon likely also to become major international portfolio investors.

A large number of financial institutions (banks, securities firms, insurance companies and other institutions) from OECD countries are established in DAEs. A small but growing number of financial institutions from DAEs are also established in OECD markets. The process of globalisation, which first affected banking, has more recently affected the securities business. Hong Kong and Singapore have participated fully in the process. The amount of cross-border trading that occurs between these offshore centres and the markets of OECD countries is exceeded only by the volume of dealing among a few of the largest markets in the OECD countries. Indeed, the domestic markets of the two DAE offshore centres are already inextricably linked with financial centres in other regions of the world.

The markets of the two large DAEs (Taiwan and Korea), although substantially isolated from global financial markets, are important enough to merit serious consideration in their own right. Thus, reflecting the global view of securities markets participants, foreign interest in the securities markets of Taiwan and Korea has grown.

Table 3
MERCHANDISE TRADE PERFORMANCE OF THE DAEs, 1988

	Value US$ bn		Rank in world trade	
	Exports	Imports	Exports	Imports
South Korea	60.7	51.8	12	15
Singapore	39.3[a]	43.9[b]	18	18
Thailand	15.7	19.5	35	29

a. Includes substantial re-exports.
b. Includes substantial imports for re-export.
Source: GATT

As the process of domestic deregulation and international liberalisation proceeds, these markets will participate more directly in global financial markets.

In view of this growing relationship, a certain number of key issues in the financial sector emerge as matters of interest:

- the prospects of deregulation and liberalisation of the financial markets, not only in Korea and Taiwan but also in Malaysia and Thailand, a process which may well be similar to the experience of decontrol of financial markets that has been occurring in OECD member countries in the past 15–20 years and which is continuing
- the systemic risks arising from internationalised markets in banking and securities and the challenge thus posed for financial supervisors and regulators world-wide
- the importance of ensuring fair market access for institutions from all countries to the financial services sector.

Developments in Trade

The DAEs have reached the top ranks of the world's merchandise traders, both as exporters and importers (Table 3). This development has primarily been the result of increased exports and imports of manufactured products, although exports of food and raw materials represented a significant but decreasing share for Malaysia and Thailand. Another characteristic of this evolution was that, for each of the DAEs except Hong Kong, the share of exports to and imports from the OECD countries increased, while the share of trade with developing countries declined.

But this dynamic trade growth was accompanied by growing trade frictions between OECD countries and DAEs. Indeed, the growth of discriminatory trade barriers in OECD countries, including voluntary trade restraint arrangements, has added impetus to the economic restructuring in the DAEs – but it has simultaneously heightened uncertainty over whether the rapid trade expansion observed in the past, in particular through increased market shares in OECD countries, can be sustained. Access to OECD markets, which has been a key element in the impressive

performance of the DAEs, is particularly important in view of the very high trade dependence of these economies.

The application of Taiwan for accession to the GATT and the active participation of the other DAEs in the Uruguay Round negotiations reveal that the DAEs and the OECD countries are strong allies in the goal of strengthening the multilateral, non-discriminatory trading system governed by rules. The DAEs have been active in almost all the negotiating groups covering issues of market access. Most DAEs attach real importance to strengthened disciplines, notably on safeguards, the anti-dumping code and the GATT dispute settlement.

In the three new areas of the Uruguay Round – trade in services, trade-related aspects of intellectual property rights and trade-related investment measures – the DAEs took an active role. The positions they have put forward during negotiations have often closely resembled those of the OECD countries. Finally, for Malaysia and Thailand development considerations remain very important and this justifiable concern was reflected in their submissions.

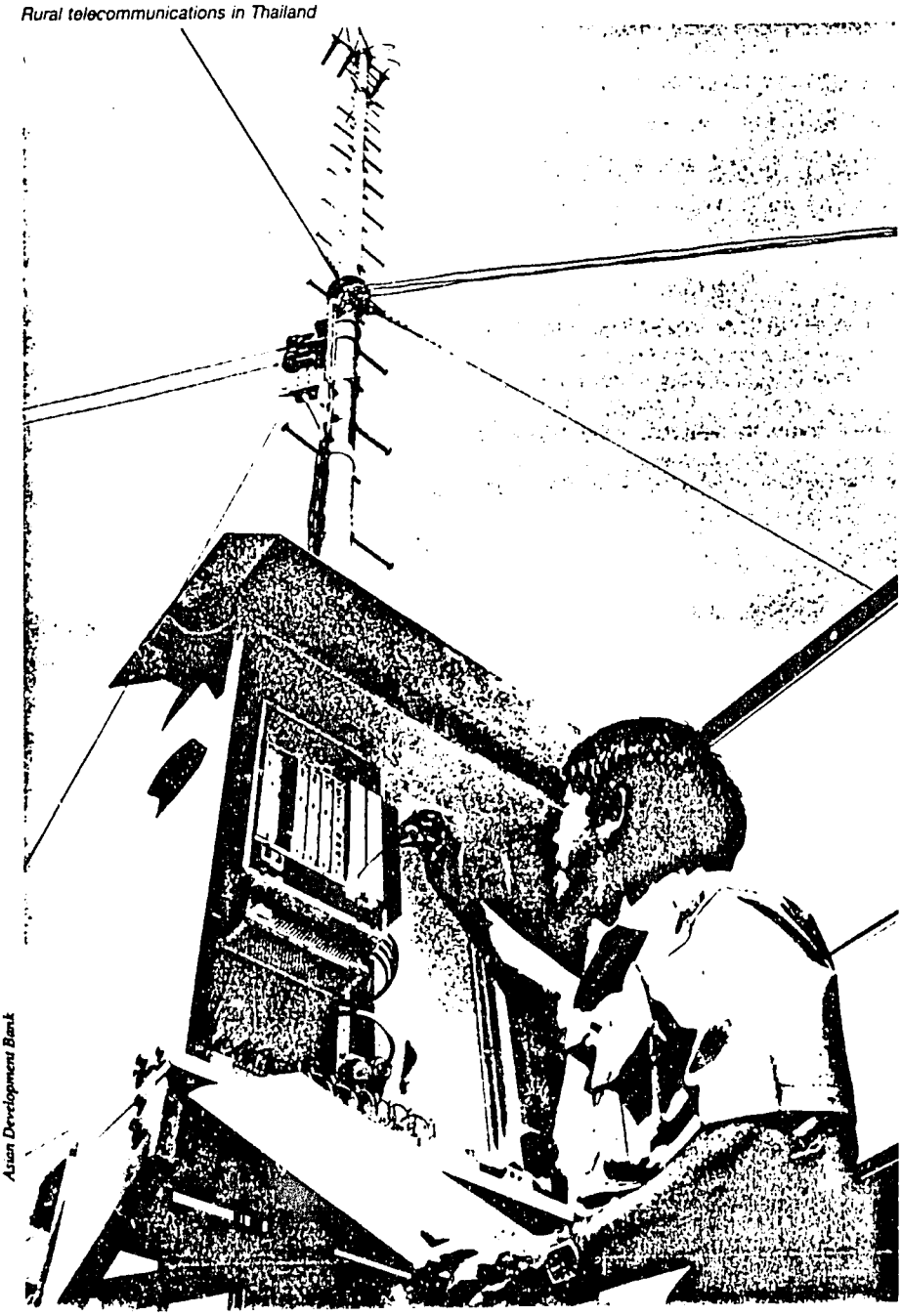
So a number of trade topics seem to emerge as matters of mutual interest to the OECD countries and the DAEs, to be addressed after the Uruguay Round:

- the relationship between trade policy and domestic macro and micro-economic policies, including competition, technology development, environment, investment and subsidies
- the trade effects from the activities of multinational enterprises, covering practices in production, pricing, marketing and sales
- the continuing analysis of protectionist policies and instruments that have not been fully disciplined in the Uruguay Round
- regional integration and its repercussions on the multilateral trading system.

□ □

To a large extent, the informal nature of the OECD/DAE dialogue acts as a common denominator of the interests of the parties presently involved. Based on topics which are generally agreed to be of value, the dialogue is likely to make steady progress in the years ahead, taking account of the wide range of aspirations and circumstances. It will no doubt improve mutual understanding and help views on policy co-operation converge for the continued growth of the world economy. ■

Rural telecommunications in Thailand



Asian Development Bank

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WORLD BANK Comparative Studies
The Political Economy of Agricultural Pricing Policy
TRADE, EXCHANGE RATE, AND AGRICULTURAL PRICING POLICIES IN PAKISTAN
Naved Hamid, Ijaz Nabi, and Anjum Nasim 1990

Abstract

Over the last three decades, government intervention had negative effects on the producer prices (and hence, the output and export earnings) of wheat, rice, and cotton in Pakistan. These outcomes were the result of a strategy designed to keep domestic food prices low and to build up the country's industrial sector by protecting it from overseas competition.

Although agriculture is still an important part of Pakistan's economy, providing employment for roughly half of the work force, its share of the gross national product (GNP) dropped to 24 percent in 1988. In 1950, by contrast, the agricultural sector accounted for 53 percent of GNP. Of Pakistan's 80 million hectares of land, roughly 21 million are cultivated, mostly in Punjab and Sind. Because of the irregularity of rain and inadequate annual precipitation, about 70 percent of Pakistan's farmland is irrigated.

Government intervention in agricultural prices has taken many forms over the years. Along with indirect intervention arising from overvaluation of the rupee, the most important types of direct intervention included the government monopoly on international trade in rice and cotton, government control of internal trade in wheat, and (at times) regulation of domestic sales of flour through a network of ration shops. The customary justification for intervention has been that it kept prices stable, particularly for consumers, who paid substantially less than world prices for wheat, rice, and cotton in the 1960s and 1970s.

Pakistan's policies, however, depressed the prices received by farmers, resulting in depressed farm production. Over the period of this study, the combination of direct and indirect (i.e.total) price intervention may have reduced actual output (compared to the potential) of wheat by 12 percent, irri rice by 25 percent, basmati rice by 32 percent, and cotton by 44 percent. (Irri rice refers to high-yield varieties developed at the International Rice Research Institute; basmati rice is a traditional long-grain aromatic variety produced mainly for export in Pakistan.)

The study also reports that, over the long run, total price intervention may have led to a very substantial reduction in foreign exchange earnings. The loss to farmers over the long run as a result of total intervention can also be put in counterfactual terms. Without intervention, average value added would have been 45 percent higher for wheat, 65 percent higher for basmati rice, 53 percent for irri rice and 48 percent for cotton.

In the 1980s, intervention in agricultural prices in Pakistan was greatly curtailed. The exchange rate became more realistic, and domestic prices for the crops discussed in this study were allowed to rise to world levels.

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Congressional Research Service
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Cambodian Crisis: Problems of a Settlement and Policy Dilemmas for the United States

by Roger G. Sutter
Foreign Affairs and National Defense Division, March 4, 1991

SUMMARY

The military conflict caused by Vietnamese military occupation of Cambodia is changing and negotiations for a peace agreement have become more active. Vietnam withdrew most, if not all, its combat forces from Cambodia in 1989. Vietnamese officials and representatives of its client government in Phnom Penh have expressed flexibility regarding a compromise political settlement of the Cambodian conflict. This has been strongly encouraged by their main international supporter, the Soviet Union. The three resistance groups (those led by the Khmer Rouge, Prince Sihanouk, and former Prime Minister Son Sann) and their main international backers in China, ASEAN (see map), and the United States have responded with varying degrees of flexibility.

All parties in the conflict appear to see their interests as better served by making some adjustment in their positions, rather than by sticking to the intransigence of the past 10 years. The five permanent members of the U.N. Security Council announced on Aug. 28, 1990, their detailed plan for a Cambodian settlement, which was subsequently endorsed by the four Cambodian parties. But obstacles to a peace agreement remain. They center on guaranteeing Vietnam's military withdrawal and achieving a peace agreement in Cambodia that will neither allow the return of the genocidal practices of the Khmer Rouge, nor permit Vietnam to continue domination over Cambodia.

U.S. policy faces a dilemma in Cambodia. The United States wants to help push back Vietnamese expansion in Indochina, and to support the positions of our treaty ally Thailand, other friends in ASEAN, and elsewhere in Asia. But the United States strongly opposes the Khmer Rouge and fears that Vietnamese withdrawal may result in expanded scope for the Khmer Rouge and their draconian rule. In the past, U.S. policy dealt with these competing pressures by adopting a low posture that followed the lead of ASEAN. The United States has provided small amounts of nonlethal assistance to the two noncommunist resistance forces led by Prince Sihanouk and Son Sann, but it has refused any support to the third and most powerful member of the resistance groups, the Khmer Rouge. As the Vietnamese have withdrawn troops and the search for a peace agreement has intensified, U.S. policymakers in the Bush Administration and Congress have proposed steps to strengthen the two noncommunist resistance groups led by Sihanouk and Son Sann, to block the return to power of the Khmer Rouge, to relieve human suffering in Cambodia, and to support international peace efforts.

But U.S. policymakers disagree about what steps are appropriate to reach these goals and support broader foreign policy objectives. In 1990, controversy centered on proposals to cut off aid to the noncommunist resistance on account of their reported battlefield coordination with the Khmer Rouge, and to open official U.S. contacts with Vietnamese-backed PRK government in Phnom Penh. Subsequently, the United States opened talks with Hanoi and Phnom Penh to reach peace in Cambodia, and withdrew support for the coalition government representing the 3 resistance forces at the United Nations. (See also CRS Issue Briefs 87210, Vietnam-U.S. Relations and 88061, POWs and MIAs in Indo-China and Korea.)

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OPINION

Western hopes to keep Pol Pot out of power in Cambodia may be undercut by a $100 million slush fund available for buying weapons and votes

Khmer Rouge's Riches

By Catharin Dalpino

WHILE attention is focused on the intricacies of the United Nations plan for Cambodia and the difficulties of getting the country's four competing factions to agree to it, the Khmer Rouge are quietly doing business on the Thai-Cambodian border. In the "liberated zones" they control in southwestern Cambodia, they are granting concessions and offering protection to Southeast Asian prospectors and businessmen, most of them from Thailand, who mine rubies and cut timber for lucrative international markets.

The monthly intake of this trade for Pol Pot and his senior officers is estimated at a minimum of $5 million per month. Western analysts believe that their cash reserves exceed $100 million, held in a central fund that is surprisingly free of mid-level pilfering. After running on foreign assistance for more than a decade, the Khmer Rouge are approaching self-sufficiency.

Such economic power could undermine the West's most cherished assumptions about the Cambodian conflict. One tenet holds that it is possible to extinguish the Khmer Rouge threat by persuading China, its longstanding patron, to cut off economic assistance and arms. Estimates of Beijing's aid to the Khmer Rouge vary between $40 million and $80 million annually.

That assistance, however, is rapidly becoming moot. With the Khmer Rouge accumulating an independent income of $60 million per year or more, China's leverage is weakened with each new gem or logging deal.

Even if Beijing stops the flow of arms completely, Pol Pot's commanders in the field would still have an existing cache of weapons, now thought to equal a two-year supply, with which to continue the struggle. And should the Khmer Rouge comply with the terms of the UN plan and surrender those stores in the context of a cease-fire agreement, they would have the ready means to purchase new arms.

A more basic assumption in the West, however, is that the Khmer Rouge might prevail on the battlefield, but they could never win by the ballot box. The UN plan attempts to create a "level playing field," on which the factions submit to the will of the Cambodian people through an open and fair election. Behind that neutral construction, the West is wagering that the Khmer Rouge will be defeated at the polls.

But disproportionate wealth can be a telling factor in the electoral process. In established democracies, the balance is often tipped in favor of the candidate able to finance sweeping media campaigns. In poorer, developing countries with little democratic tradition, the most effective and expedient use of campaign funds can simply be to purchase votes. In the 1988 general elections in Cambodia's wealthier neighbor Thailand, when vote-buying was judged to be widespread, a ballot in the rural areas went for $2 on the average, and in Bangkok for $4. On that scale, the Khmer Rouge could "buy" Cambodia several times over.

VOTE-BUYING seldom takes place at the polls. Funds are often channeled through middlemen like village leaders or factory bosses. An international team monitoring the Cambodian elections will find vote-buying far more difficult to detect than intimidation at the polls or tampering with ballot boxes.

If the Khmer Rouge are allowed to continue amassing such economic power, they could eclipse the UN plan while appearing to follow it scrupulously in form. Under this new threat, the international community needs to understand that the shelf life of the UN plan is measured in months rather than years.

Piecemeal proposals to stem the growing economic power of the Khmer Rouge have a fatal flaw. Any effort to move the UN position from that of a neutral mediator to an active crusader against the Khmer Rouge will be vetoed by China.

Nor is pressure on businessmen in the region to cease trading with the Khmer Rouge likely to be effective. In a climate of economic boom, the Southeast Asian private sector has taken an omnivorous approach to Cambodia. These businessmen are wont to maintain that they are pursuing an even-handed policy, in the spirit of the UN agreement.

Finally, the uncertainty of Cambodia's security and of its political future will make Western businesses reluctant to invest even a modest amount, much less enough to balance the books against the Khmer Rouge.

Much is made at present of the new economic vibrancy in Phnom Penh. Less attention is given, however, to the widening economic gap between the capital and the countryside, or to the growing perception in the rural areas of corruption among highly placed government officials.

It is questionable whether the benefits of foreign investment at this point would find their way to Cambodia's rural population. If they do not, the Hun Sen government could be ill-prepared to face a political challenge from the Khmer Rouge. Indeed, at the heart of Pol Pot's new "hearts and minds" campaign in the interior is an emphasis on Phnom Penh's unabashed spoils system, in contrast to the economic discipline of the Khmer Rouge.

The Hun Sen government is reluctant to give up power under a UN arrangement, and the prognosis for the plan is wobbly at best. But it constitutes the best hope of dismantling the Khmer Rouge economic apparatus in the liberated zones, since the UN would assume control of the financial affairs of the country for the interim period between a cease-fire and elections.

The West should use whatever influence it has on Phnom Penh to underscore that fact. By surrendering some degree of power now, the present leadership of Cambodia may find that it is preserving its best chance to compete for influence in the future.

■ *Catharin Dalpino is a resident associate at the Carnegie Endowment for International Peace.*

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Congressional Research Service
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Vietnam-U.S. Relations: The Missing-in-Action (MIAs) and the Problem of Cambodia

by Roger G. Sutter
Foreign Affairs and National Defense Division, March 4, 1991

SUMMARY

U.S.-Vietnamese exchanges over the issue of the approximately 2,300 Americans still missing-in-action (MIA) in Indochina and other bilateral concerns revived in mid-1987 after a hiatus of one year. Hanoi renewed discussions to resolve MIA cases and returned the remains of many MIAs; allowed U.S. representatives to resume interviews of prospective Vietnamese immigrants under the U.N.-sponsored Orderly Departure Program; and held talks with U.S. representatives on immigration to the United States of some Vietnamese children fathered by American servicemen during the war and of released "Reeducation Center" detainees and their close family members who wish to emigrate to the United States. The Vietnamese-backed government of Laos also renewed cooperation with U.S. officials to settle MIA cases. The Reagan Administration officially acknowledged U.S. interest in meeting some Vietnamese "humanitarian" needs stemming from the war; dispatched medical team to survey needs for rehabilitation of those crippled because of war injuries; and encouraged private U.S. groups to provide humanitarian assistance to the Vietnamese. Both Hanoi and Washington continued forward movement in these areas during the Bush Administration. Meanwhile, Vietnam withdrew most, if not all, of its military forces from Cambodia by late 1989.

These developments renewed debate in Congress and elsewhere between those who favor greater U.S. flexibility and forward movement in relations with Vietnam, and those who oppose such changes until Vietnam ends completely its military occupation of Cambodia, plays a constructive role in settling the Cambodian conflict, and accounts fully for U.S. MIAs. Advocates of these competing perspectives share generally similar goals for U.S. policy involving settlement of the MIA question and restoration of peace and stability in Cambodia and Southeast Asia. And they see the possibility that recent circumstances including changes in Vietnam's leadership, shifts in Soviet policy, Vietnam's withdrawal of troops from Cambodia, and intensified international efforts to settle the conflict over Cambodia may prompt Vietnam to change policy further in accord with U.S. interests. But they differ markedly in judging how the United States should respond to the current situation. The Bush Administration gave new attention to this issue when it announced on July 18, 1990, that it would seek contacts with Hanoi to discuss a peace settlement in Cambodia, and announced in early September 1990 that it would open official talks with the Vietnamese-backed government in Phnom Penh. On Sept. 29, 1990, the U.S. and Vietnamese foreign ministers met in New York. The Vietnamese foreign minister later met with U.S. officials in Washington and promised "new levels of cooperation" in resolving MIA cases. In October 1990 several Senators wrote to the Bush Administration urging a relaxation of the U.S. economic embargo against Vietnam. On Dec. 5, 1990, Assistant Secretary of State Solomon speculated that U.S. normalization with Vietnam could be accomplished in two years, given appropriate conditions. (See CRS Issue Briefs 88061, POWs and MIAs in Indochina and Korea: Status and Accounting Issues, by Robert Goldich; and 89020, Cambodia Crisis: Problems of a Settlement and Policy Dilemmas for the United States, by Robert Sutter.)

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Burma: a Key Test for Bush's 'New Order'

By John J. Brandon

PRESIDENT Bush has called for a new world order that incorporates human rights and universal standards of behavior for all nations.

It remains to be seen if the president is being sincere or if American foreign policy will continue its geopolitical business-as-usual as the Gulf crisis ends.

If the president's actions toward Burma are any indication of his intent, the dictators of the world have little reason to fear pressures for long-lasting change.

On May 27, 1990, the people of Burma went to the polls to vote for the first time in more than 30 years. Despite impediments to free campaigning imposed by Burma's military junta, the State Law and Order Restoration Council (SLORC), voting went along smoothly with little fraud, violence, and intimidation.

To the surprise of almost all Burma watchers, the major opposition party, the National League for Democracy (NLD), won 392 of the 485 seats contested in the election. The political party most closely allied with the SLORC, the National Unity Party (NUP), won a mere 10 seats.

The fruits of the NLD's election victory proved to be short-lived. The SLORC has nullified the May election by issuing an edict declaring that the SLORC possesses all legislative, judicial, and administrative powers. Furthermore, 18 of the 22 members of the NLD's central committee, as well as scores of elected parliamentarians, are now imprisoned.

Two of these parliamentarians, U Maung Ko and U Maung Win, have died in prison. Diplomats believe U Maung Ko died from torture (his body was returned to his family with both legs broken) and suspect that U Maung Win may also have died from torture, other than blood cancer, which the Burmese authorities announced as the cause of death.

In addition, Aung San Suu Kyi, the NLD's secretary general and daughter of Burma's independence leader, Aung San, has been held incommunicado and under house arrest for the past 18 months. Consequently, the NLD and all other political parties and organizations are largely dysfunctional. There are no real alternatives to the SLORC's iron rule.

In December, in an act that could be described as both courageous and desperate, eight of Burma's elected representatives fled to the Thai border to establish a provisional government called the National Government of the Union of Burma (NCGUB). No government has recognized the provisional government.

Last October, the United States Congress passed a law imposing sanctions on Burma if it did not release all political prisoners, transfer political power to the elected representatives of the Peoples Assembly, take significant steps in eradicating the drug trade in Burma's portion of the Golden Triangle, and make basic improvements in the human rights situation.

Burma has not complied with any of these conditions, though the U.S. government has yet to impose sanctions. It has been more than two years since Congress has held a hearing on human-rights violations.

Meanwhile, the torture of political dissidents and attacks on the ethnic groups that straddle Burma's border continue. Villagers are still being forced to work as porters for the army until they die of exhaustion, or are simply murdered in cold blood.

THE United Nations has expressed concern over the complete disregard of human rights in Burma. In November, Sadako Ogata was sent by the UN to Burma to investigate alleged human-rights abuses.

According to unconfirmed reports, Mrs. Ogata was unable to meet with any political dissidents; she saw only empty prison cells with recently whitewashed walls. It is believed that political dissidents who had been tortured were moved before she could meet and interview them. Ogata's findings are expected to be submitted to the UN later this month.

Fortunately, President Bush's reluctance to publicly speak out about the daily horrors in Burma is not shared by major human-rights organizations like Amnesty International.

Amnesty International is currently conducting a campaign to help bring to the world's conscience the plight of the Burmese people over the last two and one-half years. However, because of the crisis in the Middle East, human rights abuses in Burma and other nations have received little attention in the media.

The administration has gone on the record saying it is committed to fostering democracy and respect for human rights, but it seems to lack the political will to make good on its noble words. Saddam Hussein is indeed a barbarian, but Ne Win, the retired Burmese leader still believed to be in control of the army and the SLORC, is no less a barbarian.

It is time for the president to make good on his commitment to democracy. He should carry out the will of Congress and stop delaying the imposition of sanctions against Burma, unless of course the "new world order" is only intended to apply to our enemies in the Persian Gulf.

■ *John J. Brandon works for The Asia Foundation in Washington.*

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WORLD BANK Discussion Papers Number 111
Household Consequences of High Fertility in Pakistan
Susan Cochrane, Valerie Kozel, and Harold Alderman
1990

This paper reviews the theory and evidence on the consequences of high fertility in Pakistan. In addition, several data sets are analyzed to examine the effects of number of children on school participation and labor participation of men, women and children in urban Pakistan. Another data set is utilized to examine the effects of children on savings in urban and rural areas. Results show that the number of children negatively affects schooling of girls, but not boys. Number of boys and girls in the household have differential effects of women's labor participation while female children, but not males, affect adult male's participation. Children 6-15 have negative effects on rural savings, but less effect in urban areas. In general, the effects of high fertility for household's in Pakistan seem more negative than in many countries. This may explain the high proportion of women who say they want no more children. Why so few of these women do use contraceptive is more difficult to explain.

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Congressional Research Service

IB86125

India and Nuclear Weapons

by Warren H. Donnelly
Environment and Natural Resourcess Policy Division, February 11, 1991

SUMMARY

India probably could produce a small nuclear arsenal within a few years, and some analysts say it already has nuclear weapons. What India does will depend in part on what Pakistan does, on India's relations with China, and on its domestic political situation. The tension between India and Pakistan over Kashmir is cause for concern. If Pakistan tests or openly manufactures weapons or hints at their use, it will be difficult for the Indian government to resist political pressures to resume nuclear testing and perhaps to manufacture a small nuclear arsenal. If Pakistan's nuclear situation remains ambiguous, India may be content to remain just short of making them. Indian nuclear testing could damage India's relations with both the United States and the Soviet Union, antagonize China, and result in a cutoff of U.S. economic aid, although this is comparatively small.

At present it seems likely that India will continue its restraint as long as Pakistan does not cross the nuclear threshold. In January 1991 India and Pakistan agreed to formally implement a 2-year-old treaty banning attacks on each other's nuclear installations. Over the longer term, and assuming that India's civil use of nuclear power continues to grow, India's nuclear industrial base can be expected to outstrip Pakistan's in ability to produce the materials and parts for nuclear warheads.

A complicating factor is the effort by both states to develop missiles that could carry nuclear warheads.

While India opposes any spread of nuclear weapons, it continues its opposition to the Non-Proliferation Treaty and probably will argue against its extension in 1995. India prefers a general and complete treaty on disarmament that includes elimination of all nuclear weapons.

American Enterprise Institute for Public Policy Research

February 1991

Newsletter

The Chinese and Their Future

More than 250 scholars, journalists, diplomats, and business leaders met at the Vista International Hotel in Washington January 8–9 for AEI's conference "The Chinese and Their Future: Beijing, Taipei, and Hong Kong." Sixteen research papers were presented at the conference, which also featured luncheon addresses by Arthur Hummel, Jr., U.S. ambassador to the People's Republic of China (1981–1985), and Ding Mou-Shih, representative to the United States of the Coordination Council for North American Affairs, Republic of China on Taiwan.

The Army in Politics

The first day of the conference was devoted to panel discussions of political, social, and economic conditions in the People's Republic of China. Feng Shengbao, visiting scholar, Institute of East Asian Studies, University of California at Berkeley, presented a study of the relationship of the People's Liberation Army to the Chinese Communist party. He criticized observers for failing to foresee the coming of martial law before the Tiananmen incident, saying that the use of Western concepts like modernization and professionalization obscures the fact that the PLA is an army subordinate to the party commissars.

The Role of Ideology

Zhang Shuqiang, assistant professor of educational psychology, University of Hawaii at Manoa, described the ideological crisis of contemporary Chinese Marxism, saying that while socialism is stagnant, "capitalism refuses to die." Theoretical efforts to revise Marxism notwithstanding, "The party leadership has lost

Ding Mou-Shih

both the confidence in its intellectual invincibility and the appeal of a moral cause to justify its exclusive control of the state," he said. As Marxism becomes increasingly irrelevant, the prospects for liberal democracy in China remain dim, Mr. Zhang concluded.

Marxism-Leninism may be largely dead, agreed Donald J. Munro of the University of Michigan, but the appearance in the 1980s of Western-style nongovernmental institutions like labor unions and student unions makes the eventual development of a democratic regime more likely.

Such democratization would require a transformation of Communist party culture, according to AEI Research Associate Lin Zhiling, who called party control of work units, jobs, salaries, housing, and even personal activities like marriages a major problem for China. Too many Chinese have seen the modern West for them to believe what the party tells them, Ms. Lin said, adding that modern Western culture could coexist with traditional Chinese culture in a way that Communist party culture does not.

Living Standards and the Quality of Life

Fertility rates will be the key to China's population growth in the 1990s, according to Judith Banister, chief of the China Branch, U.S. Bureau of the Census, who described Chinese efforts to control population by raising the marriage age and limiting the number of children each family can have.

Yet the domain of family life scores highest in surveys of personal satisfaction, according to Duke University Professor of Sociology Lin Nan, whose study of Chinese cities compared personal attitudes toward housing, neighborhoods, and leisure opportunities with objective measures of dwelling space, salaries, and the availability of consumer goods.

The Economy

China is an "economy in shambles," and the next five-year plan (1991–1995), which aims to recentralize the economy, will exacerbate China's problems, re-

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ported Ellen Salem, regional research manager, Asia Equity, Hong Kong.

"What China needs," Ms. Salem said, "is a charismatic and effective leader who can garner popular support for a genuine period of austerity and reforms. At present, no one among the second and third generation of leaders appears equal to the task."

Jean Oi, a national fellow at the Hoover Institution, reported that a combination of lowered price supports, alternative employment opportunities, and increased fuel and fertilizer costs were leading many Chinese peasants to scale back grain production, a disturbing trend for Chinese agricultural planners.

The Future of Taiwan

The transition from authoritarianism to a more open and democratic system is never easy, according to Wei Yung, professor of political science, National Chiao-tung University, Taiwan, who spoke on the second day of the conference, devoted to Taiwan and Hong Kong.

Mr. Wei attributed Taiwan's social stability and economic progress to well-conceived government land reform and education policies rooted in the teachings of Taiwan's founder, Sun Yat-sen.

Despite this progress people in Taiwan are increasingly concerned with juvenile delinquency, crime, prostitution, political corruption, transportation, environmental pollution, and other social problems, according to Chiu Hei-yuan, professor of sociology, National Taiwan University. And yet it is an exciting time in Taiwanese history, said Representative Ding Mou-Shih in his luncheon address, describing constitutional reforms that will bring greater political participation and prosperity to Taiwan. Mr. Ding said his country, now the sixth largest U.S. trading partner, looked forward to greater American investment, and he expressed his government's willingness to accept additional immigrants from Hong Kong as 1997 approaches.

What's Ahead for Hong Kong?

The reversion of Hong Kong to Chinese control in 1997 is already creating problems in governing the former British colony, according to Lau Siu-kai, professor of sociology, Chinese University of Hong Kong. "Political radicalism was difficult to nourish during colonial rule," Mr. Lau said, because independence was not a practical alternative and the British bureaucracy was generally perceived as fair. Now, with civil servants afraid for their future and others scrambling for foreign passports, residents of Hong Kong face China with what Mr. Lau calls a mixture of "fear, hostility, condescension, and aversion."

"The political side of the picture looks gloomy but the economic side is bright," said Sung Yun-wing, senior lecturer in economics, Chinese University of Hong Kong, who noted that a feared brain drain has not materialized. Immigrants outnumbered emigrants by 35,300 in 1989, and the flight of capital as native businesses move abroad has been replaced by foreign investors wanting to participate in the Hong Kong economy.

The Three Chinese Entities

"There is no question that more and more cooperation among China, Taiwan, and Hong Kong will become possible," said Byron S. J. Weng, professor of government, Chinese University of Hong Kong, concluding a theoretical analysis of five stages of Chinese political development from 1949 to 1991. But Huan Guocang, an economist with the Deutsche Bank Capital Corporation, said that uncertainty over the future leadership of China will hamper closer political relations in the short term. While China suffers from a stagnant economy and a bankrupt ideology, it continues its efforts to isolate Taiwan, which itself now finds possibilities of improved relations with the Soviet Union and the former East Bloc countries.

Thomas W. Robinson

The end of the cold war in Asia means that old alliances will become less important or will disappear altogether, according to Thomas W. Robinson, director of AEI's China Studies Program and organizer of the conference. With no new security system set to replace the cold war matchups, a new series of bilateral developments will likely be the central force for diplomatic and security activity in Asia for the foreseeable future, he said.

Conference papers and audiotapes are available upon request from Tom Skladony, 202/862-5914.

THE NEW YORK TIMES, SUNDAY, FEBRUARY 17, 1991

Break Up the Chinese Gulag

By Robert L. Bernstein

China's sentencing last week of two dissidents to 13 years in prison is the ultimate demonstration of the failure of so-called quiet diplomacy. Wang Juntao and Chen Ziming were champions of freedom, and their names deserve to be known to the world. Their arrest and convictions are an outrage, and the Chinese Government needs to hear it, in the strongest terms.

Wang Juntao, now 32, was a teenager when he was jailed by the Gang of Four for writing a poem to mark Zhou Enlai's death in 1976. The same year, Chen Ziming, now 38, got out of prison long enough to make a rousing speech in Tiananmen Square, only to be arrested again and sent to a labor camp. Three years later, as college students, they joined the Democracy Wall movement. After graduation Mr. Wang was relegated to a low-level job at a remote physics laboratory as a result. In 1985, the two men set up a think tank that conducted unprecedented opinion polls on issues of democracy and social justice.

In 1989, they were advisers to the students in Tiananmen Square and went into hiding after the June massacre. Mr. Chen and his wife were arrested that October trying to escape to Hong Kong; she was six months pregnant and had a miscarriage in prison. She is now free. Mr. Wang was arrested about the same time. Both men have been in solitary confinement.

The West's task is to make Wang Juntao and Chen Ziming a moral cause as Andrei Sakharov and Natan Sharansky were before them — and to get the same recognition for the hundreds of others who face prison terms.

To this end, Asia Watch, a division of Human Rights Watch, has formed the Committee to End the Chinese Gulag. It is headed by the Chinese dissidents Fang Lizhi and Liu Binyan; Yuri Orlov, the former Soviet political prisoner, and myself.

Punish Beijing on all fronts.

We urge the boycott of professional conferences held in China until these men and women are released. (American Bar Association officials have been considering a visit to China to set up links with official law societies; they shouldn't go.) Nor should conferences held outside China include Beijing's hand-picked representatives.

We will protest any high-profile visits to China — by executives, musicians, writers and Government officials — unless these people raise the dissidents' cases. We will press for an end to the trading privileges the U.S. grants China as a most favored nation until those dissidents are freed. We demand that their release be as high on the Bush agenda as freedom for Soviet prisoners was for the Reagan Administration.

China has been completely let off the hook for the Tiananmen crackdown. Economic and political sanctions imposed by the U.S. and other governments have vanished into thin air.

In November, President Bush received China's Foreign Minister, Qian Qichen, a gesture that removed much of the force from the visit to Beijing a few weeks later of Assistant Secretary of State Richard Schifter. He took a list of 150 prisoners, but the names were never made public. The trials started just after he returned.

We have to change China's disdain for human rights. Constant attention worked for the Soviet prisoners. We have to make it work for the students, workers and intellectuals swallowed up by the Chinese gulag.

Simple justice demands it — and so does any hope for the "new world order" we hear so much about these days. □

Robert L. Bernstein is chairman of Human Rights Watch.

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Journal of Commerce, March 14, 1991

FMC Barrier-of-the-Month Club

WASHINGTON — The Federal Maritime Commission has been firing warning shots across the bows of foreign governments that impose restrictions on U.S. shipping — partly for the benefit of other governments that might contemplate doing so.

The commission has been targeting a host of barriers allegedly imposed on U.S. ship lines within China, South Korea and Taiwan. The allegations of branch office restrictions, tariff filing and rate collection difficulties and freight handling problems are serious in themselves, according to FMC Chairman Christopher L. Koch.

WASHINGTON

Tom Connors

The series of actions announced by the commission over the last several months against such barriers — a sort of barrier-of-the-month club — in part reflects "the magnitude of those trading partners," he said in an interview last week.

But the commission also is particularly concerned with the allegations of restrictions by China, Korea and Taiwan on shoreside operations. They "indicate a type of practice . . . that's potentially fairly widespread and serious," Mr. Koch says.

The commission's chairman has called ending such practices a priority since his Senate confirmation hearing last year and clearly hopes the rest of the maritime world will note his emphasis.

He says there is concern now that similar restrictions might be a part of the European Community's move toward a unified market in 1992.

"We see no indication of that being the case at this point . . . We have an excellent dialogue with the EC and we are very hopeful that we won't have those kind of problems. But should we not be vigilant with our major Asian trading partners, then there's a perception that we are going to tolerate this kind of stuff and that could be an incentive for anybody to . . . do it," he stresses.

In the Chinese case, the commission decided in late November to begin gathering information on barriers that seem to have survived a U.S.-China bilateral shipping agreement aimed in part at ending them.

The FMC cited reported restrictions on U.S. carriers' branch offices; the non-recognition of the U.S. carriers' lawfully filed tariffs, port and intermodal service restrictions, and other "exorbitant" costs for doing business in China.

Mr. Koch says that given those allegations, the Chinese case "probably embodies the best example of the problems we are facing with 'doing-business' restrictions" of the sort also at issue in the Korean and Taiwanese cases.

He says the barriers attributed to China would make it hard for U.S. carriers to make truck or rail arrangements, leave local officials without real functions and prevent them from collecting their own freight.

U.S. carriers in China "are having difficulty collecting, as we understand it, the tariff rates they have on file here because they have to go through somebody else and whatever they get back that the third party collected, that's what they get," he says.

In a statement released with the FMC's January order for information in the case, the commission chairman said that all foreign barriers hurt both the U.S.-flag merchant marine and U.S. shippers. But "they are particularly troublesome when that foreign country operates its own merchant marine in our trades and does not have to operate under the same restrictions," he said then.

He notes that China Ocean Shipping Co., a Chinese-flag carrier, has several new vessels in the U.S. trade, plus double-stack train arrangements, exceptional port facilities and sales offices here. The reports coming to the commission suggest, meanwhile, that "our guys over there, who are competing head to head, are sitting there with the handcuffs on," he says.

The commission's action and Mr. Koch's comments sound like a vote of no confidence in Chinese adherence to the bilateral agreement and also like a warning of a general U.S. determination to end such practices one way or another.

There was a clear admonition as well in the commission's decision last week to pursue a formal investigation of the fees that the Japan Harbor Transportation Association assesses on all cargo moving through Japanese ports. The revenue goes into a fund to provide import distribution centers and to help stabilize the supply of port labor.

Unofficial accounts say the fund supports non-shipping activities of the harbor association's members and that the fee schedule favors Japanese carriers and container cargo over bulk shipments.

In announcing the investigation, Mr. Koch said the fees are "a practice which allegedly costs U.S.-flag carriers millions of dollars annually with no apparent maritime-related benefit" to them.

That same announcement stated the FMC's concern that, while the fund is due to expire March 31, it should not be renewed or replaced with a similar fee system.

More action will follow in all four cases this spring after regulatory deadlines pass. The question is whether the commission, having lobbed several warning rounds, will not only find unfair practices in many of the cases but also use the heavy ordnance that U.S. shipping laws give it.

Those laws authorize suspension of the tariffs or agreements of the country's flag carriers, denial of access to U.S. ports or penalties of up to $1 million a voyage — ammunition the commission has never fired.

Tom Connors is chief of The Journal of Commerce's Washington bureau.

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EASTERN EUROPE QUARTER 1, 1991

WASHINGTON ECONOMIC WATCH

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EASTERN EUROPE

Camdessus, M. Managing Director of the International Monetary Fund to the Council on Foreign Relations, March 20, 1991. (remarks)

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AS PREPARED FOR DELIVERY

Remarks by M. Camdessus
Managing Director of the International Monetary Fund
to The Council on Foreign Relations
New York, New York
March 20, 1991

It is a privilege to have this opportunity to discuss with you one of the most exciting and historically significant challenges of our time--the transformation of the economic systems of the countries in Eastern and Central Europe.

Some of these countries, notably Hungary and Poland, had attempted partial and gradual reforms over a period of many years. And of course the Yugoslavs had developed their own unique type of economic system. More recently three other countries, Bulgaria, Czechoslovakia, and Romania, also decided to discard central planning and move toward a market-oriented system. Each of these countries has adopted its own approach. One of the important things they have in common, however, is that they decided in 1989 or 1990 to accelerate radically the process of economic transformation, and adopt a more far-reaching approach. In practice, what these countries are undertaking is a fundamental transformation of their economic, social, legal and political systems.

A common feature of these countries is that they have begun the transition to a market economy in a relatively unfavorable macroeconomic and external environment. The policies pursued previously have left them with a legacy of large domestic and external imbalances, including in some cases a substantial amount of excess liquidity. At the same time, regional trade has begun to decline. This reflects the impact of economic dislocations in most countries in the region, notably the Soviet Union, and the dissolution of trade arrangements among the members of the Council for Mutual Economic Assistance (CMEA). These initial conditions are complicating the process of transition. They require tight financial policies to avoid a rapid acceleration of inflation and unsustainable external deficits.

In each case the IMF has been assisting the governments with a combination of help in designing their programs, large scale technical assistance, and financial assistance (including the catalyzing of support from many other sources, both bilateral and multilateral). I expect the IMF will extend up to $5 billion of its own resources to these countries in 1991, so catalyzing somewhat more than $15 billion of support from other sources. This figure is based on the financial arrangements we already have with some of these countries (Bulgaria, Czechoslovakia, Hungary and Romania) and other arrangements to be discussed by our Board before the end of April.

What I would like to do, in the brief time we have today, is to explain how the IMF is trying to assist these countries, and what are the most important challenges.

Note that I will not touch on the subject of reforms in the Soviet Union, tempting though that is! The Soviet Union has also embarked on the road to reform, although in a much more cautious and partial way. Like the countries of Eastern Europe, it faces difficult problems of economic structure and political system; if anything the problems are even more daunting. As you know, the Soviet Union is not a member of the IMF, but at the request of the Houston Summit, the Fund, together with three other institutions, has made a study of the Soviet economy and offered some preliminary suggestions on reforms in that country.

Why, you may wonder, has the IMF been asked by these reforming countries--and by the wider membership--to play a leading role at the outset? I think the main reason has been the widespread recognition that fundamental reforms of the economic system to create a market-style of economy will only succeed if they are accompanied by firm and consistent macroeconomic policies to deal with the immediate problems (budgetary and monetary imbalances, and the attendant ills of high inflation, external payments difficulties, poor growth, etc.). Clearly the success of structural and systemic reforms would be seriously undermined by the persistence of macroeconomic instability Such an approach has been part of the daily bread and butter work of the IMF for several decades, with what are now 155 industrial and developing country members. Our experience with them is proving to be truly relevant to Eastern Europe.

I mentioned already that the programs of each of these countries is unique. The IMF is careful to tailor its advice on program design, and its financial and technical assistance, to the particular circumstances of each country. In an ideal situation, countries would introduce all the major reforms immediately--because the parts of an economic system are interlocked and because there are even higher transitional costs if the reforms are spread out over time. In practice, however, it is not possible to make all the changes at the outset. So important and difficult questions arise, about which reforms have priority, and about their speed and sequencing.

I think it is now generally agreed--and this is a common element of most of the programs introduced recently--that it is desirable to introduce a market-determined price system, to open the economy to foreign trade (and hence, inter alia, to competitive pressures) and to move toward currency convertibility, as early as possible.

But it is likely that price liberalization, together with the reduction or removal of subsidies and an initial correction of the exchange rate, will spark off a substantial initial jump in prices--the necessary "corrective price adjustment." There is then, however, a serious danger that this initial jump in prices could trigger an inflationary spiral. This explains the special importance, in each of the programs, of strict fiscal and

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monetary policies, to try to ensure that the "corrective" jump in prices is a once-for-all episode. Another common element of the programs is that they have aimed at a change in the role of the State, including, in practice, reduction in the size of the state enterprise sector, to make room for the emergence of a growing and more dynamic private sector.

One important area where there have been notable differences in the programs is in the choice of exchange rate regime and policies. Czechoslovakia, Yugoslavia, and Poland, for example, have opted for pegged rates in order to provide nominal anchors. Other countries have preferred to operate somewhat more flexible arrangements, in part because of the low initial level of their international reserves, or the need for a rapid improvement in the balance of payments, or greater uncertainties about the appropriate initial exchange rate.

A judgement of the best combination of policies has been made more difficult because of the uncertainty about the immediate supply response to reforms. We have attempted to take account of those uncertainties, as well as of the urgent need for these countries to build up their external reserves to support trade liberalization and their moves toward currency convertibility.

Let me provide now a brief account of Poland's experience with reforms in 1990, and then a brief encapsulation of the others, to illustrate the main objectives, the main policy tools they have used, the most interesting achievements, and the areas where problems arose. I should perhaps stress immediately that we, like the authorities and people of these countries, have simply been doing our best to produce workable strategies, in situations of great difficulty, complexity, and uncertainty. None of us would claim to have a blueprint for systemic reform. Rather, we are applying, where possible, the lessons learned from many other countries, and are learning a lot from experience.

Poland has been a dramatic and important example. To go back a couple of years, you may recall that in late 1989, Poland was in a crisis of major proportions. It was burdened with $40 billion of convertible currency debt; high inflation (30 percent or more <u>per month</u> in the last quarter of 1989) which threatened to escalate to hyperinflation; falling output and spreading shortages; and an unsustainable and widening current account deficit. In sum, the economic situation was deteriorating rapidly and the country was on the verge of disaster. The government that came into office in late 1989 introduced a major program of systemic economic reforms. It became, in effect, the test case for this kind of bold approach. This package of reforms was accompanied by--buttressed by, I should say--an equally courageous macroeconomic program, designed to stabilize the economy rapidly. The program aimed to bring down inflation quickly, after an initial upward adjustment when prices were liberalized and the official exchange rate was devalued, and to elicit an early supply response to eliminate shortages.

The bold strategy to achieve these objectives included the following main elements:

- a pegged exchange rate, and a tight incomes policy to control wages, as nominal anchors; and
- tight fiscal and monetary policies.

The most important elements of systemic reforms were:

- the immediate freeing of domestic prices,
- the opening up of the foreign trade system,
- and a wide range of measures to reduce the many institutional rigidities that inhibited the greater market orientation of the economy. Among these, the Poles embarked on a break-up of monopolies, extensive reforms of the enterprise system, and progressive privatization of state-owned enterprises.

Now, what were the initial results of this bold approach?

The most encouraging gains were with respect to the fiscal position, inflation, and the balance of payments. The pace of inflation decelerated sharply from the previous year, producing a noticeable break in inflationary expectations. Both the budget and the balance of payments showed substantial surpluses. Another notable success of the program was the almost complete elimination of shortages and lines outside shops, as a result of the liberalization of prices and foreign trade. The most disappointing results--even if not unexpected--were the significant fall in real output, and the rise in unemployment. These were probably inevitable, however, in view of the existence of many enterprises that were simply not viable, and the large structural transformation that was under way in the economy.

The Polish experience in 1990 also revealed the persistence of deeply-embedded problems in a number of areas. These will need to be addressed in the period ahead.

In particular, it is clear that implementation of major institutional changes, such as privatization of large state enterprises and the creation of a modern and competitive financial sector, are required, but these will take time. And in the meantime the responsiveness of the economy to liberalization and to macroeconomic policies may not be as efficient as we had hoped. For example, the decision to free prices (at a stage in the reform process when large state enterprises had not yet been either privatized or split up into competitive units) may have allowed some state enterprises to exercise the monopoly power they already had. This may explain why prices rose more than expected in 1990, despite tight monetary policy. Of course, we know how difficult, and slow, the process of privatization has been in other countries--for example the industrial countries of Western Europe--so we should not be too surprised by the slow progress on this score.

On balance, and despite some slippage, I would rate the Polish experience in 1990 a very encouraging one. The Polish government is designing an ambitious program of further reforms for 1991. I expect to submit soon to our Executive Board for their approval an Extended Fund Arrangement, to support a program for the next three years. Its financing has been significantly improved as a result of the far-reaching debt reduction operation agreed in principle by the Paris Club last week.

Having discussed Poland in such detail, I shall describe only briefly the programs of the other countries. Hungary's program aimed at improving the current account in convertible currencies to preserve external solvency. In practice, the current account improvement exceeded the initial expectations, but output and inflation performance were worse than programmed. In Yugoslavia, the key target of the program was to reduce the monthly rate of inflation to 1 percent by mid-year, using the exchange rate and a temporary wage freeze as anchors. The program was initially successful in stabilizing prices, but a breakdown of incomes policy and slippage in monetary policy to accommodate the resulting pressures led to a flare-up of inflation in the second half of 1990. Output also fell by more than expected. Bulgaria, next, has very recently introduced a reform program, and IMF support for this was approved only a week ago; their program aims at price liberalization and adjustment in those prices that were still controlled, together with a tightening of financial policies to stabilize the economy quickly. Czechoslovakia also began to introduce reforms in 1990, including an overhaul of legislation, dismantling of the planning system, and reform of the banking system. For 1991 they are combining major structural reforms, especially price and trade liberalization, with measures to protect the external position, including a devaluation, and tight financial policies to prevent the initial price jump from starting an inflationary spiral. And Romania, also, is in the process of introducing far-reaching systemic reforms, including price and trade liberalization, while simultaneously implementing macroeconomic measures to stabilize prices and move towards a viable balance of payments situation.

Now, where do we stand with these programs? It is too soon to draw very firm conclusions, but we are reasonably satisfied with the first results, as reflected in the early experiences of Poland and Hungary, and the first few months' results of Czechoslovakia's program. Also we are impressed by the determination of the governments of these countries in implementing their reforms, and the broad public acceptance.

There are three areas which deserve particular comment:

First, the fall in output in 1990, although inevitable, was substantial; it exceeded 5 percent in all these countries except Czechoslovakia.

These falls reflect a combination of unfavorable factors, most of which were temporary. The introduction of reform, and expectations of reform, generated large changes in actual or expected relative prices, as well as

heightened uncertainty; either way, these induced a widespread suspension of forward-looking spending decisions regarding investment and durable consumption. Another factor was that the change in relative prices, following liberalization, made some of the output unmarketable. And then the reduction in output probably also was partly due to the breakdown of the previous system of central planning. Next, the contraction in CMEA trade also contributed to the reduction of demand and the disruption to the productive system. And finally I would add that the official statistics probably overstate the decline, because they give undue weight to the traditional socialized sectors that are contracting, and give insufficient weight to the private sector activities that have arisen in their place.

In sum, the fall in output was an inevitable result of the initial phase of the transition to market economies. It was not, in general, the direct consequence of the macroeconomic stabilization policies.

A second matter for comment and indeed concern, is the relatively slow pace at which structural reform can actually be achieved, despite major efforts by the authorities in these countries. This is because these reforms are complex and far-reaching, and it inevitably takes time to design them carefully, reach agreement on them in parliaments or other political forums, and have them implemented. Many of them require new institutions, or fundamental changes in basic legislation, or new work practices. For example, it must be a major task for a newly-elected legislature, with virtually no experience of the working of a market economy, to legislate on property rights and bankruptcy or collective bargaining! And to take another example, progress in privatization, introducing genuine competition, and in really reducing state intervention in major enterprises, has been very uneven.

One of the unfortunate consequences of the slow pace of structural reform has been to complicate the task of macroeconomic policies. This is especially noteworthy in the way that incomplete reform of the financial sector has hindered the application of firm monetary policies. Three aspects of structural rigidities and deficiencies may be stressed; the weakness of banks' balance sheets, the lack of competition in financial markets, and the segmentation of markets. Each of these has tended to make monetary policy less effective than in a competitive and properly functioning market economy.

Third, I would note the persistence of high levels of inflation. The reforming countries will need to persevere with firm policies, if they are to succeed in making an orderly transition to a market economy, while maintaining social cohesion. They need to speed up the pace of structural reform so that financial discipline will be more effective.

These three areas of difficulty show that these countries face a daunting challenge in the period ahead. These problems can be surmounted, provided the countries persevere with their reforms, and provided they

receive sufficient support from the international community in the fields of finance, debt, and trade.

External finance and debt. It is apparent that the reforming countries will need substantial assistance for several years to come. In 1991, out of the approximately $20 billion of financing requirements that we can estimate for East and Central Europe, we can expect about two-thirds to come from official sources; this will include some $5 billion from the IMF, new lending from the World Bank and other development banks, and debt relief from official creditors, such as that which the Paris Club has just announced for Poland.

As regards the IMF's contribution, I would expect the Fund's involvement to continue to be substantial in some cases, depending on the situation in each country and the strength of their programs. It might follow the pattern of one or more stand-by arrangements followed by an EFF for three years, as with Poland and Hungary. In most of these countries, the pressing problem of macroeconomic stabilization will undoubtedly remain an issue; but I would expect an acceleration of progress on structural reforms, and with this one could expect the relative contributions of institutions such as the World Bank, the EBRD, and the EIB to increase.

Finally, trade liberalization is an essential element of systemic reforms, as it helps the countries to break down domestic monopolies and reap the efficiencies from the international division of labor. As I mentioned earlier, the reforming countries have rightly put trade liberalization high on their priorities. But this requires also that the rest of the world extend an appropriate welcome to these countries, as they seek this closer involvement in trade. Provided the domestic and trade reforms by the East European countries lead to market-determined prices and the introduction of nondiscriminatory tariff structures, this should pave the way for a suitable basis for their full integration into the GATT. This in turn will allow the abolition of the special safeguard clauses that are presently maintained by other GATT members in the face of the nonmarket prices of state-trading systems. Clearly the external trade restraints that exist in many markets, especially in agriculture, soft goods, and high technology exports, where East Europe has (or could attain) a comparative advantage, are a serious impediment to the eventual success of their reform efforts. Reduction of these impediments will be important, if these countries are to achieve the increase in their exports that will be necessary to finance their large import-intensive requirements, achieve strong growth and establish a viable balance of payments.

To my mind it is essential that the industrial countries, in particular, promote more open trading relations with these countries. It would be tragic if Eastern Europe, after abandoning a "bloc" mentality because they recognize that it leads to inefficiency and a lack of progress, would now be forced back into thinking defensively by a failure of the industrial countries to observe market principles.

* * * * *

I hope that this account of the experiences of Eastern European countries has shown their diversity of approach, the courage such far-reaching programs require of the authorities, and the tremendous difficulties that they face.

Clearly these countries will need sizeable assistance as they transform their economies and seek a closer integration into the global trading and financial networks. They realize that it will take a sustained effort on their part, over many years, to bring about the far-reaching changes needed to create a modern and competitive economy. They need not only economic changes, including restructuring of production, and substantial investment, but also a major effort of institution-building, and in many cases the development of new attitudes and entrepreneurial spirit.

I think that all of us who are supporting their reform efforts--in particular the governments of the industrial countries, the multilateral financial institutions, and private creditors--are keenly aware that we will need to stay committed. For my own part, I can state categorically that the IMF understands its mandate. The IMF will continue its three-pronged approach; by giving advice on the design of economic policies and reforms; by providing technical assistance in the areas where we have expertise; and by extending financial assistance on a conditional basis to those countries whose programs hold out the promise of economic and financial viability in the medium term.

The Atlantic Council of the United States
Strategies for Facilitating East European and Soviet Transformation
Consultation Policy Paper
John P. Hardt, Chairman and Co-Rapporteur
Jean F. Boone, Co-Rapporteur
November, 1990

EXECUTIVE SUMMARY

In 1990, the countries of Eastern Europe[1], including the Soviet Union, embraced the principles and spirit of post-World War II Western development embodied in the Bretton Woods institutions, the General Agreement on Tariffs and Trade (GATT) and the Marshall Plan—principles of democratization, marketization, modernization, and integration into a liberal, global commercial community. At the Bonn Conference on Economic Cooperation of the Conference on Security and Cooperation in Europe (CSCE), acceptance of these shared objectives was expressed formally in the detailed concluding document signed by all thirty-five member nations.

Responding to the new environment and consensus on objectives, Western multilateral institutions have begun to expand their scope and programs to include and assist the transforming countries. In addition, bilateral programs, aimed at fostering the flow of Western private capital into Eastern Europe and increasing East-West commerce, are moving forward. As this substantial assistance indicates, Western governments, including the United States, consider successful European transformation to be a high priority, worthy of attention and resources.

CAN EUROPEAN TRANSFORMATION SUCCEED?

Nevertheless, despite the far-reaching changes already initiated in the transforming countries and the impressive support programs marshalled by the West, the prospects for successful transition to freedom and prosperity in Eastern and Central Europe remain quite uncertain. Failure is threatened by two critical gaps between the anticipated (and needed) results of reform and actual performance. For the populations of the transforming countries, there is an **expectation gap:** the revolutions of 1989 and elections of new governments offered great promise for freedom and prosperity. But instead of new economic opportunities and higher living standards, these populations are now faced with the prospect of massive unemployment, starkly falling economic performance, and deteriorating quality of life. Without some narrowing of this expectation gap, reform is not likely to be politically

[1]For the purposes of this paper, the term "Eastern Europe" will be taken to include Poland, Czechoslovakia, Hungary, Bulgaria, Romania, Yugoslavia, and in most cases, the Soviet Union. The five new states of unified Germany may likewise be considered part of Eastern Europe for the period of transformation. Although no single term is fully satisfactory for encompassing all of these countries, we have chosen to employ "Eastern Europe" for simplicity, based on its usage by the U.S. Congress in the "Support for East European Democracy" programs.

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sustainable. Furthermore, the economic sustainability of reform is jeopardized by the **investment gap:** foreign investment into the transforming countries, expected to be a primary engine of economic reconstruction, has in fact been rather limited. Without a narrowing of this investment gap, modernization of the East and Central European economies and their integration into the global economy will be significantly constrained.

These critical shortcomings—the need to ameliorate popular expectations and assure the conditions for private investment—have become evident in spite of the substantial and well-conceived Western assistance provided to date. Without action to bridge these gaps, Western aid may be ineffective and ultimately wasted as European transformation efforts collapse.

However, the critical gaps may be narrowed if Western institutions and governments direct their attention and work collectively to **encourage comprehensive and simultaneous transformation programs** within the transforming countries and **remove external constraints** that inhibit East European success. The United States has the opportunity and obligation as a global power and leader in the multilateral institutions to improve Western assistance efforts through better targeting and increased coordination.

NEED FOR COMPREHENSIVE TRANSFORMATION PROGRAMS

Lack of comprehensiveness and simultaneity in the domestic transformation programs of these countries leaves critical needs unaddressed. Transformation, involving simultaneous marketization and democratization, produces difficult policy trade-offs and potentially conflicting purposes and goals. Moreover, in the wake of electoral revolutions, popular expectations are high, despite the likelihood of economic hardship in the transition. To ensure that these tensions and painful choices do not destabilize the reform process altogether, the transforming countries need to balance conflicting objectives and create stable mechanisms for building social consensus in support of change. Thus, although monetary stabilization must be a high priority, it could be balanced **from the start** with plans for coping with unemployment, the sharp decline in production and living standards likely to occur in the process of stabilization, and pressing needs in infrastructure, housing, environment, and health care. Building the basic institutions of market and democratic systems is also an urgent requirement because they serve as mechanisms for resolving recurring policy trade-offs. If social needs are deferred in favor of partial, rapid adjustment and democratic processes are avoided in favor of decisive executive action, transformation is less likely to be successful or sustained.

Targets for Western Assistance

Clearly, it is neither possible nor desirable for Western institutions and nations to establish the underlying social pact for change in the transforming countries, or to decide how the inevitable trade-offs should be resolved. However, the West can assist in identifying the trade-offs of alternative strategies and can then target its assistance to complement the domestically-selected programs so that, as steps are taken toward marketization and modernization that create painful dilemmas, Western programs could help to facilitate and ease the transition. In this way, Western assistance might be more effective in narrowing the dangerous expectation gap that threatens political stability; moreover, by enhancing stability, it would improve the environment for foreign investment.

Specifically, urgent needs the West could address include:

- **Technical assistance and expertise for assessing the economic and social impact of alternative reform programs.** Tests of "strategic consistency" could be developed and applied to proposed programs that consider together fiscal balance, monetary growth, labor constraints, foreign exchange constraints, and political constraints. Through such concrete technical assistance, for which Western multilateral institutions (particularly the new OECD Centre) have substantial capability, the West could promote greater comprehensiveness and simultaneity in country-specific transformation programs and help to identify the crucial gaps likely to arise in the process.

- **Technical assistance in building basic market and democratic institutions**, for example, development of central banking institutions through IMF programs and development of legislative institutions through interparliamentary exchange, coordinated potentially through the CSCE.

- **Targeting financial assistance to critical, transitional needs** that cannot be adequately met by domestic governments or by private foreign investment. For example, support for infrastructure, environment, and health care could provide for social needs and absorb labor released from military production; such programs have been successfully provided by the World Bank elsewhere.

NEED TO MITIGATE EXTERNAL CONSTRAINTS

External constraints over which the transforming countries have little control

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could overwhelm their prospects for economic growth and integration into the global economy even if domestic market and democratic systems begin to function successfully. These constraints also inhibit the inflow of private foreign investment, contributing to the investment gap and further damaging the prospects for economic development. The obstacles could be reduced through coordinated action among the Western nations and institutions; furthermore, if coordinated, Western action to alleviate these constraints could be linked to progress within the transforming countries toward shared objectives of marketization and democratization.

- **Market Access.** Developing modern, competitive economies will not be enough for Eastern Europe if external markets are limited or substantially closed to competition, especially in agriculture. The results of the current GATT talks on expanding the scope of GATT rules, reducing non-tariff barriers, and strengthening GATT sanctions, are therefore critical to East European transformation prospects.

- **Debt Burden.** Even if Western loans for development spur industrial modernization and increased trade, some countries, especially Poland, Hungary, Bulgaria and Yugoslavia, will find it difficult to carry their debt servicing through the medium- or long-term and get necessary access to the financial market in the near-term.

- **Technology Transfer.** Slow and uneven lifting of export controls and continued lack of protection for intellectual property will add uncertainty to technology transfer, needed in the earliest stages of reform to support modernization of productive capacity and infrastructure.

- **Regional Cooperation.** The deterioration of the Committee on Mutual Economic Assistance (CMEA) and the shift of all Soviet energy trade to convertible currency (at sharply rising world prices) in January, 1991, could cause serious dislocations and substantial unemployment in Eastern Europe. These changes could place unbearable pressure on the transforming economies. Building on the Marshall Plan experience, regional cooperation could be made an element of Western assistance to the East; e.g., assistance to the USSR might be conditioned on developing a plan that moderates price increases and assures adequate continued supply to Eastern Europe.

ROLE OF THE UNITED STATES

The United States, while expressing support for East European reforms, has appeared hesitant to become fully engaged in the transformation process.

Several important steps have been taken: three advisors on Eastern Europe were named by the U.S. administration; a coordination mechanism for the Group of 24 was proposed at the 1989 Paris summit; some direct assistance has been approved. But these efforts fall short of the potential leadership the United States could provide. Assuring a peaceful and sustainable transition in Europe does not depend only on the volume of material resources; the United States has an important role to play in influencing how resources are used. The United States can exercise leadership by directing Western attention to the dangers inherent in the expectation and investment gaps. Western multilateral institutions and governments have undertaken many valuable programs; the problem is not one of generating new programs of assistance. Rather, **the challenge for the United States is in coordinating existing efforts and targeting them to meet the most urgent needs of the transforming countries at the most crucial times, and in encouraging Western cooperation to remove the external constraints, despite the real political costs these actions may entail. This is a role that the United States is uniquely positioned to fill.**

Working through Multilateral Institutions

A new kind of leadership bears consideration, in which the United States acts as *primus inter pares* among the developed nations. The United States should work **through the existing multilateral institutions** to advance the shared objectives of democratization, marketization, modernization, and global integration. Drawing on its long investment and leadership in the Western multilateral institutions, the U.S. can reap an "alliance dividend" by emphasizing a combination of financial and technical assistance funded primarily through these organizations and strengthening coordination among them.

Promoting Structured Dialogue

More specifically, the United States should generate and participate in structured dialogues in the transforming countries and between them and external actors. Structured dialogues are officially organized debates, hearings or discussions that address problems of strategic policy; they should comprehend all transformation objectives, give voice to a spectrum of viewpoints, apply tests of "strategic consistency" to policy decisions, and seek balance in resolving the problems of transition. With use of democratic processes such as public parliamentary hearings a necessary process of comprehensive, simultaneous domestic transformation that balances monetary stability, employment, output and social needs in a social pact is likely to make transformation more likely and sustainable.

Structured dialogue is a useful mechanism for addressing the particular short-

comings of transformation outlined herein, because it can establish stable underpinnings for action based on consensus among all affected parties. Such dialogues can be fostered by individual institutions (for example, among the IMF, the World Bank, the EC, and/or the OECD and a transforming country) or by individual countries (for example, bilateral interparliamentary exchanges aimed at developing legislative structures and parliamentary procedures). Coordinated dialogues, however, are also needed; the OECD and the CSCE are potential forums for developing such dialogues and adding incrementally to the effectiveness of Western assistance. The new OECD Centre for Cooperation with European Economies in Transition and the expanded monitoring and consultative role of the CSCE will provide new opportunities for coordinated dialogue among transforming and aid-providing countries.

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release March 20, 1991

FACT SHEET

American Business and Private Sector Development Initiative for Central and Eastern Europe

U.S. trade and investment can play a major role in supporting political and economic reforms in Central and Eastern Europe. The American Business and Private Sector Development Initiative is designed to promote the growth of U.S. investment, participation by U.S. firms in infrastructure development, and increased involvement of small and medium sized U.S. companies in bilateral trade.

This initiative is a $45 million two-year project carried out by AID, the Department of Commerce, the Overseas Private Investment Corporation and the U.S. Trade and Development Program in partnership with the private sector.

Primary emphasis will be on five key sectors identified by the Central and Eastern European countries and ourselves as of key importance: agriculture and agribusiness, energy, environment, telecommunications and housing.

The six elements of the program are:

An American Business Center in Warsaw, Poland which will make available office space and technical business services on a user-fee basis in cooperation with the private sector.

Consortia of American Businesses in Eastern Europe which will support groups of mainly small and medium sized U.S. companies wishing to enter the East European market. Grants will assist U.S. trade and business associations in selected sectors in establishing a presence in the region.

Expansion of Commerce's Eastern Europe Business Information Center to develop information and provide assistance to U.S. and East European companies interested in trade and investment.

An AID Capital Development Initiative designed to provide assistance to Eastern European governments and private sector firms in designing infrastructure projects in ways that will encourage the involvement of U.S. companies.

Additional funding for feasibility studies by the Trade and Development Program related to the five sectors described above.

We are also seeking legislative authority to expand OPIC's pilot equity investment program to include Eastern Europe, so that OPIC can make direct investments in promising joint ventures.

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THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release March 20, 1991

FACT SHEET

Trade Enhancement Initiative for Central and Eastern Europe

From the beginning, U.S. support for political and economic reform in Eastern Europe has emphasized not only aid but trade. The U.S. has led the way in extending increased access to its own market and in encouraging the European Community and others to do the same. Listed below are additional initiatives in the trade area that the U.S. is undertaking at this time.

(1) GSP Duty-free Benefits

The President is expected to approve shortly a significant expansion of duty-free benefits covering $182 million in Central and Eastern European country exports under the Generalized System of Preferences (GSP). Czechoslovakia will be added to the list of beneficiaries which already includes Poland, Hungary and Yugoslavia. These increases are in addition to $500 million in duty free imports from Central and Eastern Europe at this time. In addition, the President has decided to speed up implementation of $176 million in benefits to May 1 from the traditional July 1 date.

-- Over half of the expanded Eastern European GSP benefits will go to Poland -- $93.3 million of the $182.4 million. This action will more than double the amount of Poland's duty-free exports under GSP.

(2) Overcoming Informational Barriers to Trade:

The Administration will sponsor a series of seminars designed to ensure Central and Eastern European countries': a) understanding of U.S. trade laws including anti-dumping and countervailing duty provisions (AD/CVD); b) familiarity with the GSP program and procedures; c) access to data on trade flows, and on U.S. quota fill rates; d) familiarity with open procurement laws and procedures.

AD/CVD: The Department of Commerce will conduct seminars for Eastern European officials on U.S. anti-dumping and countervailing duty laws. These seminars, to which interested enterprise representatives will be welcome, will focus on the methodology used to analyze dumping in non-market economic cases. The Commerce Department will also discuss the implications under AD/CVD laws of the move towards greater market orientation.

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GSP: Commerce, State and USTR representatives will conduct a series of GSP seminars in eligible Central and Eastern European countries to ensure that enterprises are familiar with GSP benefits and procedures for taking full advantage of the program. The next seminar series is scheduled for late March in Prague, Budapest and Warsaw.

QUOTAS: Embassies in Central and Eastern European countries will be kept informed on quota fill rates and ensure, in cooperation with responsible host government officials, chambers of commerce, etc., that this information is available to local producers.

PROCUREMENT: Commerce and OMB are prepared to organize a series of seminars for Central and Eastern European countries on recommended government procurement laws and transparent procedures which, if adopted, would result in savings, purchase of improved products, and fair competition, and would also enable these countries to seek accession to the (GATT) Agreement on Government Procurement.

(3) Regional Economic Development Initiative (REDI):

The Administration is developing a program to promote new commercial ties between companies and business organizations in comparable economic regions of the United States and Central and Eastern Europe, with a particular focus on promoting trade with the region's burgeoning private sector.

-- The Commerce Department program will match companies in complementary economic regions in the United States and Central and Eastern Europe. The program, using existing Commerce Department resources and facilities (e.g., the Eastern European Business Information Center and U.S. Foreign Commercial Service offices), will focus on building a data base of regional and local business leaders and groups in the United States and Eastern Europe. This information will be particularly useful in matching small and medium-sized U.S. companies with counterparts in Eastern Europe's burgeoning private sector and in promoting new trade and investment ties among these entities.

(4) Removal of Impediments to Trade Expansion:

The President is prepared to send to Poland and other reforming Central and Eastern European countries a team of experts, led by the Office of the U.S. Trade Representative, to conduct a prompt and intensive review of internal and external barriers to expanded trade with the region, and to propose specific solutions to problems identified.

(5) Access to the European Community

The President is challenging the European Community, Central and Eastern Europe's largest market, with the largest potential for trade expansion, to re-double its efforts to open its markets to Central and Eastern European countries and to open all sectors (including agriculture) for liberalization under the free trade area agreements now under negotiation with Poland, Hungary and Czechoslovakia.

The Atlantic Council of the United States
Poland on the Road to Reform: Challenges and Opportunities for U.S. Foreign Policy Policy Paper
Willis C. Armstrong, Co-Chairman
Jan Z. Nowak, Co-Chairman
William H. Cooper, Rapporteur
November, 1990

EXECUTIVE SUMMARY

The United States faces a drastically new geopolitical and economic situation in Europe and is now in the process of reexamining its national interests and redefining its policies in light of the radical changes now taking place in Europe. In doing so, it must discard the old assumptions which formed the foundation of its policies during the Cold War. Soviet domination of East Central Europe is now a thing of the past, and a new balance of power is taking shape that will affect Europe and the world. The United States must forge new policies based on new thinking and a new long-range policy framework different from the guidelines formulated at the onset of the Cold War almost a half century ago.

Poland remains strategically important to the rest of Europe and the United States. It lies between a reunified Germany and a changing, albeit politically and economically diminished, USSR. With a population of 38 million and a land area of over 300 thousand square kilometers, Poland is the largest of the East Central European countries.

The Atlantic Council's Task Force on Poland concludes that the Solidarity-led government has made great strides towards establishing a democratic government and a market economy but it faces some rough terrain ahead. The Task Force believes that the United States and the West have a strong interest and role to play in helping to ensure the long-term viability of the reforms.

Since the beginning of 1990, the government has drastically reduced a rate of inflation that had been crippling the economy, restored a degree of economic stability that has permitted food and other necessities to return to store shelves, and devalued the *zloty* to a realistic exchange rate that has restored it as an acceptable means of exchange. The government is now pursuing privatization to demonopolize industries and eventually make them competitive.

But Poland confronts immediate and long-term economic problems that, if not correctly addressed, could undermine its accomplishments. Stabilization has come with the price tag—unemployment. Poland faces the possibility of having one tenth of its labor force unemployed. A $45 billion foreign debt promises to strangle economic reform even before it has had a chance to get underway unless Western creditors seriously consider some form of debt relief. Poland is suffering from dislocations resulting from severely reduced oil and natural gas supplies from the Soviet Union and from reduced or eliminated markets in East Central Europe, as Germany has unified and the other members of the Committee on Mutual Economic Assistance (CMEA) members pursue economic ties with the West.

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The government has established a political structure that permits the transition from a Communist dictatorship to democracy. Poland is poised to undertake its first freely democratic presidential elections in November, to be followed later by free elections for the parliament. The Mazowiecki government had made great strides in replacing the *nomenklatura* with non-communists in policymaking positions at all levels.

Poland now faces long-term domestic political challenges. The consensus that overthrew the Communist government has split and new parties are emerging from all points on the political spectrum. Poland will have to be able to forge a working consensus among the various political forces to maintain political stability and allow democracy to succeed.

In terms of its foreign policy and national security interests, Poland has achieved much in a short time. Polish concern over its border with the newly unified Germany has apparently been resolved with German assurances. The Mazowiecki government has taken steps towards the removal of Soviet troops from Polish soil within two years, if not sooner. Poland's task will now be to forge new relationships that allow it to become part of a restructured Europe and to play an important role in the international community in general.

IMF WORKING PAPER

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This is a working paper and the author would welcome any comments on the present text. Citations should refer to an unpublished manuscript, mentioning the author and the date of issuance by the International Monetary Fund. The views expressed are those of the author and do not necessarily represent those of the Fund.

WP/91/13

INTERNATIONAL MONETARY FUND

Research Department

On the Sequencing of Reforms in Eastern Europe

Prepared by Hans Genberg *

Authorized for Distribution by Bijan B. Aghevli

February 1991

Summary

Transforming Eastern European economies into market economies requires unprecedented reforms. After identifying the main features of these reforms, this paper analyses their sequencing, that is, whether an optimal ordering of their introduction can be discerned.

A clear statement about the intended end results of the reforms is indispensable for their success and to smooth the transition path. Not only do the final objectives of the reforms condition the nature of the required policies, but also private sector responses are more likely to reinforce government action if the ultimate objectives of the reforms are clearly understood.

The various aspects of the reforms are interdependent. Issues of macroeconomic stabilization, for instance, are not easily distinguished from structural reforms, nor is it always correct to propose, as is common in the context of developing countries, that the former should precede the latter. Similarly, price reform is ultimately linked to currency convertibility, and problems associated with privatization, decentralization, and enterprise management are interrelated.

This interdependence implies that a reform strategy should be as broadly based as possible. At a minimum, the first phase of a reform package should contain measures to achieve macroeconomic stabilization by removing open-ended subsidies to enterprises, price reform by introducing external convertibility to make the economy more competitive, and rapid but prudent privatization of state enterprises.

The paper also gives a number of reasons for preferring a rapid to a more gradual reform process. Finally, it recommends that in the early phase of the reforms a social safety net should be established to defuse opposition to the reforms.

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Financial Reforms Essential In Eastern European Economies

The Eastern European nations must restructure their financial markets if they are to become successful market economies, according to Lawrence J. Brainard, an international economics consultant. Brainard won first prize in the 1990 Amex Bank Review awards for his essay entitled "Reform in Eastern Europe: Creating a Capital Market." The awards, which were launched in 1987 to promote new analysis on current international economic and financial issues, are given in memory of Robert Marjolin, the first Secretary-General of the Organization for Economic Cooperation and Development.

In his essay, Brainard discusses why reform efforts in Eastern European economies have not succeeded, reviews the state of banking and finance in socialist economies, and makes recommendations for financial reform.

Why Reforms Haven't Worked

The reforms in Hungary, Poland, and Yugoslavia have generally not been successful, according to Brainard, because there has been an overriding emphasis on radical economic stabilization measures before key structural reforms were ready to be implemented. Moreover, the structural reforms were misguided, for, although they included privatization, financial reforms—in particular, banking reforms—were inadequate. Notably, the financial reforms focused on eliminating losses associated with subsidies and credit flows. They did not address the balance sheet losses of banks and enterprises, which "lie at the heart" of Eastern Europe's financial market ills.

Conditions in Eastern Europe

Brainard points out that the state-owned commercial banks in Eastern Europe "are engaged in a misallocation of resources of massive proportions." Many of them started operating with an inherited overhang of troubled assets; they face restricted competition; they never put their own capital resources at risk because any potential losses would accrue to the Ministry of Finance or the central bank; and they have limited leverage over their borrowers. Thus hobbled, these banks simply cannot play a role in the allocation of capital that is similar to the role played by sound banking institutions active in Western capital markets. They should be viewed more as fiscal agents of the treasury than as banks in their own right.

Brainard: financial reforms should focus on cleaning up balance sheets.

Recommendations for Change

Brainard maintains that the creation of a capital market in which resources are allocated efficiently is an essential component of Eastern Europe's economic transformation. Creating such a market calls for two major types of reform: banking reform—because the bulk of savings will flow through the banking system—and privatization of enterprises, because it is essential that users of investment capital be responsible for its effective application. He stresses that the two types of reform must go hand in hand: privatization without banking reform would fail to ensure that capital is allocated to firms that can use the resources most effectively. And banking reform without privatization would only perpetuate the accumulation of bad loans in banks' portfolios.

In his recommendations for financial reform, Brainard suggests that the focus should be on cleaning up the balance sheets of firms and banks. The mechanisms for doing this include bankruptcy, rehabilitation, and/or privatization. Governments should pursue these options but at the same time carefully monitor their costs with a view to minimizing their fiscal impact; otherwise, inflation will result. In addition, sound accounting principles and practices should be used.

Brainard says that cleaning up banks' balance sheets should not be done by pushing them into bankruptcy. Given their pivotal role in the financial system, this would have little social value. The only viable option, he says, is to restructure the banks. The best way to do this is to recapitalize them, first, by lifting the bad loans out of their portfolios, and then, by providng a mechanism for injecting new capital.

One approach is for the government to purchase the banks' bad loans with long-term bonds, paying a positive interest rate spread over the banks' cost of funds. The capital of the

banks could then grow over time, thanks to the elimination of problem loans and the positive net income flow from the government bonds. With improved accounting practices and prudent supervision, the banks could be made profitable fairly soon. They could then form the core of an emerging capital market.

Brainard notes that such an operation could be fiscally costly: the government would have to absorb losses on the banks' bad loans as well as transfer new resources to banks through interest payments on the bonds. But the operation would be a one-step exercise, with fiscal costs spread over the life of the bonds. As such, it is likely to be "less costly than doing nothing."

The Role of Foreign Banks

Finally, Brainard considers the role that foreign banks could play in accelerating the creation of new capital market institutions in Eastern Europe. He suggests that, in the short term—especially during the transition to market-based economic systems—foreign banks are likely to perceive "substantial risks" in domestic lending, and their activities would not come close to matching those of local banks. Eventually, however, the rapid creation of a modern banking system in Eastern Europe would require the transfer of skills and know-how quickly and on a significant scale. Such a transfer is unlikely to occur "unless countries are willing to grant interested foreign banks a significant domestic banking franchise without the legacy of past bad corporate debts." This would suggest, according to Brainard, that financial market restructuring in Eastern Europe "is a necessary precondition" for the successful and rapid transfer of Western capital into commercial banking in these economies.

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THE WALL STREET JOURNAL TUESDAY, JANUARY 8, 1991

In Eastern Europe: The People vs. The Socialist Elite

By MILTON FRIEDMAN

A few months ago, my wife and I spent a week in Poland. Our experience in Warsaw illustrates strikingly the central point that this newspaper made in its splendid Dec. 24 editorial "Uh, Oh, the People"—namely, the tendency for intellectual elites to denigrate ordinary people and to believe that they should run the government.

In the course of our visit, I gave a talk to Club Europa, an organization of the leading intellectuals in Poland, most of whom had been members of Solidarity's intellectual faction and had participated actively in the anti-communist campaign. Many are currently serving in the government of Tadeusz Mazowiecki, now the caretaker prime minister.

I chose as my topic "Why the United States is Not the Right Model for Poland," even though the talk had been arranged by the U.S. Information Service. My point was that during the century and more preceding extensive government involvement in the economy, the U.S. had become wealthy enough so that we could now afford to support large and wasteful governments, together (federal, state and local) spending more than 42% of our national income and imposing regulations and controls that distort the economy. I argued that the right model for a country currently as poor as Poland was Hong Kong (before the Chinese takeover) or the U.S. of a century ago, not the U.S. of today.

The predominant sentiments of the audience quickly became evident once the talk was followed by questions. My wife and I were immediately transported back a decade or more, to similar confrontations with American "liberals"—i.e., socialists.

The first question was strictly out of that era, when I was under continual attack for having lectured in Augusto Pinochet's Chile and for supposedly directing the actions of the so-called Chicago boys in reforming Chile from my office in Chicago. To paraphrase, the first question was "How do you justify having served as consultant to Gen. Pinochet when he was the dictator of Chile?" The short answer, "I never did." But more important, it is years since I have been bedeviled by that question in the West, since Chile has turned into a success story, having successfully achieved a transition to political democracy, and having become the strongest economy in Latin America.

The initial question was followed by more substantive ones that made it clear that most of the intellectuals, while strongly anti-communist, were still socialist. They were bending to the current fashion by talking about the need to resort to the market, but their concept of the market was strongly influenced by the Lange-Lerner vision of a socialist market economy—i.e., one run by them. They did not trust the people, they knew better what was good for them. A few participants differed, and agreed with my free private market sentiments, but they were clearly in a minority in this elite group.

This meeting sharply contrasted with one we had had a day earlier with a group of legislators at the Parliament, a meeting that had been arranged for us by a Warsaw libertarian group. The atmosphere was hospitable, not hostile, directed at promoting greater understanding of what a free private market required and how it worked, not at making debating points and questioning motives. Had that been my only exposure to the intellectual climate of Poland, I would have departed with wholly unjustified optimism about forthcoming events.

The socialist intellectuals do not have a monopoly of the intellectual community. There are strong and dedicated groups of libertarians, both in Kracow and in Warsaw, and presumably elsewhere as well. All of the libertarians we met, all strong proponents of rapid movement to a true free private market economy, were backing Lech Walesa rather than Mr. Mazowiecki in the then forthcoming presidential election.

The split between the proponents of a socialist market economy, or—to use language they would prefer—social democracy a la Sweden, and proponents of a true free private market economy is by no means limited to Poland. We experienced the same phenomenon in Czechoslovakia.

On the one side, Vaclav Klaus, the current finance minister, and his followers want to convert state property to private property promptly and let the market rule. On the other, veterans of the Dubcek attempt to achieve "communism with a human face," both returned exiles and survivors at home, remain convinced that their program could have worked if it had not been so rudely interrupted by the Soviet invasion. They have the support of many younger intellectuals, particularly in the humanities and the media, who might label their version of essentially the same program "Capitalism with a human face." I believe that neither the one nor the other is compatible with economic prosperity and human freedom.

What happens in Eastern Europe depends very much on which of these intellectual movements carries the day.

If the intellectual planners carry the day, I fear that Eastern Europe will settle down to something like many Latin American countries: an economic level decidedly higher than under Communist rule, but without any internal dynamic sources of growth and with severe limitations on personal freedom.

On the other hand, if the proponents of truly free private markets carry the day, Poland, Czechoslovakia and the other East European countries could duplicate the "economic miracles" of Germany, Hong Kong, Taiwan, Chile and Japan. They could become the most rapidly growing area in Europe. After all, they lack neither human nor natural resources, only the economic institutions required to bring them to life.

Mr. Friedman, 1977 Nobel laureate for his work in monetary economics, is a fellow at the Hoover Institution.

THE WHITE HOUSE

Office of the Press Secretary

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FACT SHEET

U.S. Assistance to Poland

Recent Economic Developments

In 1990, Poland adopted and implemented a comprehensive program of economic reforms more extensive than that of any other country in Central and Eastern Europe. The new government of President Walesa is taking important steps to further the development of a market economy by placing special emphasis on speeding up the pace of reform in general and the process of privatization in particular.

Responding to requests for assistance from the Polish Government, the U.S. government provided over $300 million in grant assistance in 1990, and offered substantial credits from the Export-Import Bank and the Overseas Private Investment Corporation. The United States has begun projects in agriculture, privatization, technical training, and labor training, and concentrated ventures in clean fossil fuels, and air and water quality in the Krakow region.

All of these activities will continue in 1991, but U.S. technical assistance will expand considerably as we begin new efforts to help restructure the Polish economy. The United States will also substantially increase the amount of funds available for equity investment through the Polish-American Enterprise Fund, and will initiate new programs to encourage U.S. private sector investment in Poland.

ASSISTANCE ACTIVITIES

1. Democratic Initiatives. U.S. programs in this area will provide:

Equipment and training for the national legislature, focusing primarily on the establishment of parliamentary procedures and the development of effective research and information systems.

Training for local and regional legislatures, city and regional managers, and other local public administrators in the basic skills of governance and administration.

Support for independent media, including the establishment of a Media Resource Center in Poland.

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2. Food Aid

In 1990, the United States provided over $90 million in food aid to Poland. This assistance was intended to help stem Poland's declining standard of living and ease the budget crunch by improving the efficiency of private agriculture. Thanks in part to the effect of the market on supplies, major food aid will not be needed in 1991.

3. Stabilization Fund. The U.S. granted $200 million to the Polish Stabilization Fund in 1990 as part of a U.S.-led multi-donor hard currency reserve in support of the transformation of the economy. The fund made possible limited convertibilty of the Polish zloty by creating a reserve to be used by the Polish Government if additional foreign exchange is needed. Poland has not had to draw on the fund to date, and has earned substantial interest that the Polish government may use in support of its economic programs.

4. The Polish-American Enterprise Fund, to be capitalized at $240 million, received $35 million in FY 1990, and will be given an additional $69 million in FY 1991. This privately managed investment fund can take equity or debt positions in new businesses or recently privatized firms, leveraging private capital and often facilitating joint ventures. For instance, the Fund is already financing private banking, new housing construction, and agribusinesses.

5. Environment and Energy. U.S. programs carried out by AID, the EPA, and the Department of Energy will provide equipment and technical assistance for clean fossil fuels, technical assistance for air and water quality, and technical assistance to redress decades of environmental degradation. The United States is also providing assistance in improving energy efficiency.

6. Labor Market Transition. The U.S. Department of Labor is providing help in the development of unemployment insurance, job re-training, the creation of regional unemployment centers, and other "safety-net" mechanisms to assist those most disadvantaged during the transition to a market economy. The AFL/CIO is helping with the strengthening of trade unions and the retraining of the labor force.

7. Peace Corps. Approximately 100 volunteers are in Poland teaching English, working on environmental projects, and assisting with small businesses.

8. Trade and Development Program (TDP). TDP is financing over $4 million in feasibility studies, consultancies, and training programs for major development projects with large export potential for the U.S. private sector.

9. International Financial Institutions. The United States as lead shareholder, has encouraged the World Bank (IBRD) to provide strong support to Eastern Europe's redevelopment. The Bank already has plans to lend $9 billion to countries of the region. We have also led the way in obtaining an additional $7.5 billion

in funding to Eastern Europe by the International Monetary Fund (IMF).

10. The U.S. Agency for International development is launching a number of new activities which will focus on the development of the private sector in Poland. Some of these projects are:

Privatization and Enterprise Restructuring will provide technical assistance to prepare state-owned enterprises for privatization, to assist private firms operate more efficiently, and to help government agencies put in place the policies, laws, and regulations necessary to privatization.

The American Business and Private Sector Development Initiative will stimulate the transfer of U.S. technology and the flow of U.S. capital to Eastern Europe by promoting business opportunities in the region for American firms.

The Competition Policies, Laws, and Regulations project provides technical assistance in rewriting laws and regulations regarding taxation, antitrust, and the ownership and transfer of private property.

In the Financial Services sector we will assist in the critical development of a competitive banking industry and help create new financial institutions.

Management Training and Economics Education will help develop the technical, management, and economics skills necessary to operate a market-oriented economy.

In the Housing sector we will provide technical assistance for development of housing markets and a competitive housing construction industry.

In Agriculture and Agribusiness we are helping to develop a true cooperative system and create the framework for further privatization.

In the Humanitarian sector, we are assisting with the improvement of health care and the creation of an improved social safety net.

11. In addition, the Citizens Democracy Corps, a private voluntary organization created with the assistance of a U.S. government grant, is helping to mobilize the resources of the private sector to assist in the Polish transition. CDC Chairman Drew Lewis is directing a major effort to modernize the Polish transportation and distribution system. Hundreds of private U.S. organizations are mounting their own programs in Poland as well.

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THE WALL STREET JOURNAL FRIDAY, MARCH 8, 1991

Yugoslavia: Breaking Up Is Good to Do

By ANNE APPLEBAUM

ZAGREB, Yugoslavia – To some, the armed policemen outside the presidential palace here in the capital of the republic of Croatia are a disturbing sign. Brandishing their recently acquired Kalashnikovs, the policemen guard the leaders of a new kind of Croatian regime, one that promises to use violence to protect its interests.

But one man's nationalism is another man's patriotism, and one man's threatening gesture is another man's self-defense. Many Croatians welcome the new militia as a symbol of national pride. They say the much criticized guns may even be necessary if the Yugoslav central government in Belgrade ever threatens the democratically elected government of Croatia. With good reason, they fear it might.

The dilemma should be familiar to observers of the Soviet Union. A small republic decides to break away from a larger, Communist-dominated federation. Wanting its own national flag and national anthem, its own economic policy – and, of course, its own army – the small separatist state trumpets its will to secede. Nationalist-patriot leaders buy weapons and stock armories. Threats are made, suspicion grows on both sides. Advocates of "international stability" fear civil war, accuse the small nation of belligerence, and set about trying to hold the federation together.

But before we revert to the classic lingo and start talking about "a second Balkanization" or "another Lebanon situation" it is worth it to take a look at what is really going on in Central and Eastern Europe.

In Yugoslavia, as in the Soviet Union, the trouble is not separatism itself, but the confusion that results from dual lines of authority. Much like the Soviet constitution, Yugoslavia's federal constitution grants the six republics a theoretical autonomy. Much like the Soviet document, the Yugoslav charter also fails to imagine the practicalities of secession.

Permanent Conflict

As a result, Yugoslavia now has two legal systems, republican and federal. The systems are equally legitimate, yet come into permanent conflict. The state of Yugoslavia, for example, is perfectly justified in calling for the arrest of the Croatian defense minister, who is accused of importing those shiny new Kalashnikovs from Hungary. But the Croats are equally justified in refusing to give the man up. Their minister is a member of a legitimate government, and they feel he has the right to maintain his small armed force, anyway.

Croatians, however, have a reasonable hope that the difficulties of transition from unhappy federation to independent or semi-independent states can be temporary. Separatism, whether it is called nationalism, patriotism, or the fight against big government, may eventually improve life for everyone.

The distinctions here may be obscure to foreigners – this confusing country has six languages and two alphabets. But Croats feel themselves to be thoroughly different from their neighbors – just as Lithuanians feel themselves to be different from Russians or Estonians. Slovenes to the West of Croatia speak another language, while Serbia, the republic to the East, is Eastern Orthodox rather than Roman Catholic, historically Ottoman rather than Austro-Hungarian.

Certainly Croatian local patriotism, an amusing phenomenon to inhabitants of more settled nations, seems real enough in Zagreb. Nearly half a million people celebrated when the city resurrected the bronze statue of a 19th-century Croatian hero. Bearded vendors are still doing a good business, selling history books, reproductions of medieval maps, and tiny national flags beneath the hooves of his impossibly muscular horse.

Such enthusiasm is always preferable to the soggy boredom of communist internationalism, and not only for aesthetic reasons. Croatians, like other post-communist Europeans, will need tremendous stamina to get through the next few years of harsh economic reform. Successful privatization will require energy and enthusiasm, faith in the future. Sovereign or semi-sovereign Croatia would be much more conducive to such sentiments than an unhappy Yugoslav federation. While small entrepreneurs would find it easier to plan for the future in a country that they think of as their own, no one invests in a country that is constantly on the brink of disaster.

Even leaving such intangibles aside, national differences can lead to real problems in planning federal policy. Recently, Serbia elected a communist government, while Croatia (virtually unanimously) elected Christian Democrats. Now, one republic calls for progress toward capitalism, while the other wants to maintain central planning. As a result, Yugoslavia's overgrown, inefficient economy, for many years considered the "best" in Eastern Europe, is now lagging the reforms of others.

Distrust between the republics is running so high that a coordinated federal economic reform is nearly impossible. The Yugoslav prime minister may make a speech, but not all of the republics see fit to transmit it. He may pass a law, but not everyone sees fit to obey it.

Monetary policy has suffered worst of all. Over at the Croatian National Bank, a subsidiary of the Yugoslav Central Bank, the bank governor despairs of ever maintaining the tight controls his country needs to fight inflation, which has risen as high as 2,000% in the past. He throws a thick document onto his desk, an account of how the Serbian Parliament managed to steal $1.3 billion from the federal budget without anyone finding out until it was too late.

The Serbs, unapologetic and uninterested in monetarism, wanted to use the money for farm subsidies. "The federal budget has simply become an endless source of funds; each republic wants to take as much as possible," the Croatian banker complains. Before World War II the bank building, with its neo-classical facade, was the Croatian stock exchange. Zagreb was an international financial center. It could be again, but won't be in the current atmosphere of distrust.

Undoubtedly, the financial costs of division are high. If Croatia does get a real separation, and not merely a new form of confederation, it will need a new currency, an independent central bank, a diplomatic service, a border patrol, and many other tools of sovereignty more expensive than a tiny militia. Yugoslavia's national debt will have to be divided up among republics, contracts will have to be rewritten, laws and taxes changed. Even so, when the potential of economic reform is weighed soberly against the status quo, the costs of staying in are greater than the costs of leaving.

After 'Another Sarajevo'

There will still be problems with unclear borders, local ethnic conflicts, differences over how to divide. But the old geopolitical reasons for keeping the federation together have melted away along with the Cold War. Yugoslavia is not a bulwark of independence in the region, or a thorn in the side of Moscow. To the rest of Europe, the division of Yugoslavia can hardly make any strategic difference. Much of the Western opposition to a Yugoslav breakup is based on a fear of "another Sarajevo" – fear that nationalism in Europe will cause war. But that specter is really a false one – even fearful West Europeans do not usually argue that Croatian independence will cause World War III.

The important thing here is to consider the language we use. Not long ago, "stability" in Eastern Europe was a euphemism for continued Soviet domination. Now, "stability" in Yugoslavia is a euphemism for big government, central planning and the repression of small nations. So perhaps stability should, this time around, be sacrificed to change.

Ms. Applebaum is based in Warsaw for the Economist.

The Atlantic Council of the United States
Hungary on the Road to Reform: Challenges and Opportunities
for U.S. Policy Policy Paper
Joseph I. Lieberman, Co-Chairman
Lionel H. Olmer, Co-Chairman
Francis T. Miko, Rapporteur, February, 1991

EXECUTIVE SUMMARY

The United States and the West have a strong interest in Hungary's successful evolution. As one of the first East European countries to embark on major reforms, Hungary can serve as a model and affect developments throughout the region. Failure by Hungary to make a successful transition would have an unsettling effect. Hungary's structural, institutional and legal reforms as well as its progress toward privatization are further along than those of other East European countries because of an earlier start. Hungary has moved to full-fledged multiparty pluralism. Despite the good start, Hungary's political structures are still fragile.

As in other East European countries, the new government faces the immediate and difficult task of dismantling the communist system. Hungary's economic situation has continued to deteriorate as the country moves to make the difficult transition to a market economy. To the government's inherited problems of economic stagnation, a $20 billion debt, a crumbling infrastructure, and severe environmental degradation, new ones have been added. The country has been hit by one of the worst droughts of the century and by the Persian Gulf crisis, reducing agricultural export earnings and raising energy prices and cutting off Iraqi oil supplies at a time when the Soviet Union is sharply curbing energy supplies to Hungary. Furthermore, important markets for Hungarian goods in the USSR and the former East Germany have been sharply reduced or cut off.

There have been some positive trends to balance this gloomy economic picture. Hungary's export performance improved in 1989 and its hard currency account improved significantly during the first nine months of 1990. While overall industrial output declined, private sector production increased by some 25 to 30 percent in 1990. Furthermore, Western investors are showing some confidence by embarking on ventures in Hungary. The enactment of new laws has either removed or significantly reduced long-standing regulatory and bureaucratic obstacles to the promotion of enterprise formation and foreign investment in such enterprises.

The Hungarian government now bases its foreign policy on new concepts and is working to develop new security arrangements. As recently articulated, the country hopes to become part of an enlarged European/Atlantic community of nations, including the United States and Canada as integral players. In early 1990, Hungary and the Soviet Union reached an agreement calling for the total withdrawal of Soviet forces. Hungary is seeking to end its military role in the Warsaw Pact in 1991 and favors the eventual dissolution of the organization.

For the West, the question of how much we should do in Hungary and Eastern Europe depends on our assessment of the cost of the failure of the region to make a successful transition. The cost of failure for the United States and, especially, Western Europe (in defense, security, social, and budget terms) would be far greater than the resources contemplated to help the region. The biggest threat at present to a stable democratic Hungary, in which the rights of all citizens are protected and which is at peace and cooperating with its neighbors, would be a major economic crisis. This could trigger a political crisis, which, in turn, could exacerbate tensions among groups within Hungary and relations with neighboring countries over conditions of Hungarians living there.

Therefore, the first United States and Western priority is to provide economic and moral support that will ease and shorten the pain of transition to a market economy and help to instill public confidence that the economy can be turned around in a reasonable time. The second priority is to help strengthen democratic political institutions and to help establish effective civilian control over the internal security and military establishments. The third priority is to help integrate Hungary, along with its neighbors, into the Western community of nations.

The basic elements of U.S. policy toward Hungary include:

- normalization of bilateral trade and investment relations;
- assistance to help support the transition toward democratic pluralism and the rule of law;
- steps to promote Hungary's transition to a market-based economy, including the establishment of the Hungarian-American Enterprise Fund;
- U.S. participation in multilateral adjustment assistance programs for Hungary;
- programs in scientific and environmental cooperation;
- elimination of stringent export control restrictions that hamper access to high technology; and
- promotion and coordination of U.S. private sector efforts to assist Hungary.

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The new U.S. policy reflects the view that the needs of Hungary and other East European countries are better served through the transfer of technology and skills, as well as by assistance in developing private enterprise and market infrastructure, than through large infusions of money—especially through large scale government-to-government grants—which in fact are difficult for the United States to provide under current conditions of budgetary stringency. U.S. assistance can only provide a small contribution toward Hungary's need. The United States must do its fair share, nevertheless, so that it can encourage other countries to do more bilaterally and multilaterally and recognize that what Hungary does will be the most decisive factor for success.

Hungary has taken impressive first steps to transform its political and economic system in a short period of time. Much more needs to be done, and there are serious obstacles along the way. The biggest threat to Hungary's continued positive development is the deterioration of the economy.

The Atlantic Council of the United States
Czechoslovakia on the Road to Reform: Challenges and Opportunities
for U.S. Foreign Policy Policy Paper
Doug Bereuter, Co-Chairman
Sharon L. Wolchik, Co-Chairman
Louise S. Armstrong, Rapporteur
February, 1991

EXECUTIVE SUMMARY

In June 1990, in their first free elections in forty years, the Czechoslovak people clearly endorsed President Havel's Civic Forum and its Slovak counterpart, Public Against Violence (PAV), insuring continuity of leadership and policies. A governing coalition, which includes Slovakia's Christian Democratic Movement, commands the necessary two-thirds majority in the federal parliament to adopt a new constitution. Winning a strong third place in the elections, the Communist Party remains a significant factor in Czechoslovak politics. Despite some division within its ranks, the Party will benefit from any hardship and political unrest produced by economic reform. Local and regional elections on November 23-24, 1990, found the Party a force to be reckoned with, but the results did not undermine the governments at the federal and republic level.

With national, local and regional elections over, constitutional revision has emerged as the most portentous issue on the political scene, largely because of its link with ethnic nationalism. A states' rights issue, constitutional revision will transfer much of the power centralized in the federal government to the Czech and Slovak Republics, raising concern as to the adequacy of authority at the federal level. Slovak politicians have been aggressive in their insistence on an early and drastic redistribution of the spheres of competence. This issue has absorbed time and energy that might otherwise have been directed toward economic reform.

Decentralization could have the side benefit of breaking up the stranglehold of the communist bureaucrats within the government structure and of facilitating the move toward private enterprise. Increased autonomy at the regional level could likewise improve the environment for economic change. It will not diminish the dynamics of ethnic politics. Ethnic nationalism has proved to be more of a threat to the new democracy than communism. The important Hungarian minority in southern Slovakia is making the same use of free political expression to articulate national aspirations as are the Slovaks, providing the potential for serious ethnic strife. In the Czech lands, Moravians are making their own jurisdictional claims. Czechoslovakia's transition to democracy has been stormier than anticipated.

Czechoslovakia's transition to a market economy promises to be equally difficult. At the very point at which it has begun the removal of subsidies and price controls and has drastically devalued the crown, the country has experienced a sharp cutback in shipments of oil and other raw materials from the USSR and will henceforth have to pay for such imports with hard currency and at higher prices. Iraq, which is in substantial trade debt to Czechoslova-

kia, was to have been a standby source of oil. Czechoslovakia's largest trading partner, the USSR, has reduced its purchases of Czechoslovak exports, and industries in the former East Germany have canceled outstanding contracts with Czechoslovakia, many of which were for machinery ordered to specifications and not saleable elsewhere.

Czechoslovakia will require multilateral assistance in establishing reserve funds to help stabilize the crown and to offset a loss of revenue during a period of unfavorable balance of payments, economic recession and tax reform. Under a trade agreement with the U.S. signed in November 1990, Czechoslovakia now enjoys most-favored-nation (MFN) status and may qualify for additional benefits under the Generalized System of Preferences (GSP). An investment treaty with the U.S. is in progress. Czechoslovakia has concluded a ten-year trade and cooperation agreement with the European Community (EC) and has been promised EC funds for currency stabilization, environmental clean-up and support for infrastructure projects.

Privatization in Czechoslovakia is proceeding slowly, impeded by the inertia of the old order, the problem of demonopolization, the lack of competent personnel, proper accounting records, banking and financial services and by the reluctance of the Havel government to appear to "sell out" the country's assets to foreigners or to former communist "insiders." Czechoslovak officials see their industry as capable of becoming internationally competitive in precision engineering and in machinery for the textile, printing, paper and glass industries.

For the country's leadership, the light at the end of the long, dark tunnel ahead is the prospect of duty-free association with the EC and the European Free Trade Association (EFTA) and of participation in an evolving community of European nations, collaborating in conflict resolution and in economic, environmental and humanitarian affairs. At the November 1990 Conference on Security and Cooperation in Europe (CSCE) Summit in Paris, in the first institutionalization of that process, Prague, with U.S. support, was selected to be the site of a small CSCE Secretariat. Czechoslovakia has cut back its military budget for 1990 and 1991 by 25 percent, is reducing its armed forces by a third and has curtailed its armaments production. It has remained a member of the Warsaw Pact solely to accelerate the process of European disarmament and will be pleased to see the Pact disbanded. In condemnation of the Iraqi invasion of Kuwait, Czechoslovakia has deployed an anti-chemical warfare unit to the Persian Gulf. Its relations with Cuba have cooled to the point that it will no longer represent Cuban interests in Washington.

At a time when the role of NATO is undergoing change, when the U.S. military presence in Europe is being reduced and when the Soviet system is in some turmoil, stability in Central and Eastern Europe is more than ever a major U.S. objective. Czechoslovakia sits astride this Central and East European region of peril and promise, its borders flanking the USSR, Poland, Hungary and the West. With U.S. and Western encouragement, Czechoslovakia could become a cornerstone of progress toward democracy and market economics. Without such support, including a lively U.S. commercial and cultural presence, it could provide one more setting for turbulent politics, ethnic nationalism and economic despair.

Moral support is important along with material and technical help. The people of Czechoslovakia were cut adrift by the West at Munich in 1938. Today, alarmed by the situation in the Baltic Republics and by the failure of *glasnost* and *perestroika* in the Soviet Union, they see Western attention focussed on the Persian Gulf. At no time should they be given the impression that success of their struggle for political and economic reform is less than a high priority for the United States.

WALL STREET JOURNAL, March 11, 1991

A Divorce That Could Save the Czech Economy

By John H. Fund

PRAGUE – For months Czechoslovakia has been chided for the slow pace of its transition to a market economy. That may change now with last month's approval by Parliament of a sweeping privatization law that will make 4,500 large industrial enterprises valued at $130 billion available for purchase by domestic or foreign investors. A law was also passed that will return as much as $10.7 billion of nationalized property to private owners.

The privatization law is the work of Czechoslovakia's hard-charging finance minister, Vaclav Klaus, who has been called his nation's Milton Friedman. The Klaus plan means to follow up the Velvet Revolution for political freedom with an economic one: a giveaway of 20% of the nation's capital to its citizens.

This people's capitalism would mean that every Czechoslovak, for a token fee, would receive a voucher giving him or her the right to buy shares in state companies. The remaining 80% will be offered to Czech and foreign investors, with employees in state firms and the former owners of nationalized firms offered a discount price. Poland also plans an aggressive use of vouchers to shift assets into the private sector.

It is ironic that the landmark privatization bill passed at the very time that the simmering disputes between factions in Civic Forum, the movement that led the inspiring Velvet Revolution, broke into the open. On Feb. 23, Civic Forum formally split into two parties. The umbrella movement that ended 40 years of communism can no longer contain the policy debates and everyday conflicts of a normal society.

The two factions divide roughly into free market and social democratic groups. The free market group that won control of Civic Forum at its January meeting is led by Mr. Klaus. His opponents, clustered around such figures as Foreign Minister Jiri Dienstbier, would be comfortable as liberal Democrats in the U.S. Both sides support the rule of law and the creation of a modern economy, but they differ on how much freedom to allow market forces.

Although his plans have been delayed by months of bureaucratic infighting, Mr. Klaus's vision for Czechoslovakia is clear. He wants "a market economy without any adjectives." Yet for someone offering such stern economic medicine, he still enjoys popular support. In the June 1990 elections won by Civic Forum, he won more votes than any other candidate. (President Vaclav Havel was not on the ballot.) In October, Civic Forum delegates elected him chairman with 70% of the vote. A recent TV poll put him only five percentage points below President Havel in popularity.

But many intellectuals in Civic Forum abhor "Klauskrieg" economics. In December, seven of the 10 ministers in the Civic Forum government formed a Liberal Club to support policies "that lessen the effect of the economic reforms on socially weak groups." They wanted Civic Forum to remain a social movement with a blurred, humanistic vision. The two sides had a showdown at a conference in January.

There Mr. Klaus won support from surprising quarters. Students from Charles University circulated a letter to Mr. Klaus that said: "Is it not noteworthy that we, students, are turning to you and ideas of the right? In all industrialized countries students are mostly to the left. They, of course, can afford this view, since they have not lived through 40 years of plundering, 40 years of a leftist utopia. We see that followers of the left are uneducable. . . ."

After a spirited debate, Mr. Klaus won roughly 70% approval for his plan to turn Civic Forum into a real political party with a firm, anti-socialist platform. By European standards, it is a strongly free market document. "We intend to totally depart from socialism in all its forms," it proclaims. "A symbiosis of central planning and the market is not possible. . . . We reject 'perestroika' types of regulated market economics."

The platform goes on to say that its vision of Czechoslovakia is a society, the "pillars of which are individual citizens, families, townships, counties and the state, in the above order. Free citizens are the source of political, economic and moral initiative." It calls for help to "the poor, sick, old or otherwise handicapped individuals," but also says such help should not destroy individual initiative. In foreign policy, the document is proudly pro-Western: "The principal guarantor of freedom and peace in Europe has been and continues to be the NATO alliance."

The platform also contains a rousing endorsement of "radical privatization in all fields of industry, agriculture and services." "Those who seek a Third Way between the market and socialism should realize it leads to the Third World," Mr. Klaus told the conference.

The size of Mr. Klaus's victory shocked the Liberal Club members. Foreign Minister Dienstbier mourned the loss of Civic Forum's political virginity. "We have come once again to having a party run by people who issue membership cards and advocate adherence to an ideological program," he told me. Klaus partisans replied that a normal democracy needs political parties that stand for something.

It was thus inevitable that Civic Forum would wind up in political divorce court. The Klaus group will become a formal party, and the Liberal Club will try to retain the flavor of an umbrella social movement. President Havel says he won't choose sides now, though he is closer to the Dienstbier group. Neither faction will have the right to the prized Civic Forum name, but both will remain in government until new elections are held next year.

Democracy is a fragile flower in Eastern Europe, even in Czechoslovakia where it has pre-war roots. It will likely flourish only if the economies of Eastern Europe start to produce real economic growth. While the arrival of genuine party politics in Prague is welcome, one hopes that the key economic reforms are solidly in place before political passions begin to rule.

Still, the two halves of Civic Forum have enough in common that there is a chance their debates will mostly concern conflicting visions of how to make the economic pie bigger. If their debate is primarily over how to divide an economic pie that hasn't been allowed to grow, that is a recipe for political as well as economic instability.

Mr. Fund is a Journal editorial writer.

TRANSITION

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Socialist Economies Unit • Country Economics Department • The World Bank

Transforming the Ownership System in Eastern Germany

As part of a shared legacy with Eastern Europe, what was formerly East Germany now faces the formidable task of transforming its ownership system. On the eve of unification, East Germany's public sector, including cooperative farms, accounted for about 95 percent of total employment and output. Specifically, the public sector comprised 126 national *kombinats* (vertically-integrated groups of enterprises with similar product lines and under common management) covering 3,300 enterprises. Each *kombinat* employed an average of 24,000 workers. The public sector also included 95 regional, multi-unit *kombinats*, each employing about 2,000 workers, and some 4,000 agricultural production cooperatives, virtually state owned.

The state trustee agency Treuhandanstalt (Treuhand) was set up in June 1990 to handle the management of this vast empire. Treuhand is *de facto* the largest and most diversified holding company in the world, with a portfolio of some 8,000 enterprises, many of them multi-enterprise units, and reportedly holds 40 percent of the total area of eastern Germany. At its inception, Treuhand also assumed all public debt.

Although formally subordinate to the Ministry of Finance, for all practical purposes Treuhand acts autonomously, with its own management and supervisory boards. Most of these boards' members and chairmen are top managers of West German enterprises and banks.

Treuhand's mandate is to assume ownership of state enterprises and to carry out their privatization, reorganization, or liquidation. The number of such operations has been estimated at 30,000-40,000. Treuhand is empowered to make all the necessary financial transactions, including selective assumption of debt and envi-

ronmental obligations, and can borrow funds as needed.

Treuhand initially faced severe difficulties assembling a qualified staff. Eventually in October 1990, West German banks and corporations, after some political arm twisting, agreed to assign several hundred middle managers and experts from their own staffs temporarily to Treuhand. But staffing problems continue in the 15 regional offices. Although the head office in Berlin handles the 1,000 biggest units, all other enterprises are overseen by the regional branches.

By the end of October 1990, all state enterprises were formally converted into joint stock and limited liability companies; about 200 privatizations had been negotiated; and about 60 privatization arrangements — some involving very large enterprises — had become effective, with proceeds of DM1.5 billion realized. Financial statements are expected shortly. Negotiations over another 500 enterprises are under way. In addition, some 2,000 local public utility units and all housing units have been transferred to local communities to be managed or disposed of according to Treuhand guidelines.

This unprecedented task was begun by a new organization under enormous political and administrative pressures. Some widely-publicized cases of corruption and incompetence and a stormy settling-down period have marked the brief history of Treuhand. It is not surprising under these circumstances that the operational policies and practices are still forming.

Treuhand's statutes and government pronouncements list the familiar catalogue of privatization objectives:

- introduction of competition;
- promotion of private entrepreneurship;
- collection of revenues from sales of assets;
- control over the fiscal drain from illiquidity;
- improvement of productive and allocative efficiency; and
- stimulation of inflow of technological and managerial know-how and capital.

Treuhand's emerging philosophy implicitly rejects any "giveaway" privatization patterns. Specifically, Treuhand will remain the only agency, with some devolution to local branches dealing with smaller units. No other holding companies or mutual funds will be created. The agency will move with due speed, constrained only by the principle of financial prudence. Prudence excludes any free front-end distribution of ownership to citizens in the form of vouchers or shares. The citizens merely have a claim in the unlikely event that a surplus remains after Treuhand has completed its tasks. Furthermore, assets can be given away only if they are deemed worthless. In extreme cases even "negative" prices are conceivable. To the extent possible, ownership and control will be passed on to individuals and organizations that have sufficient resources and competency.

... Emphasis is clearly ... to avoid squandering East Germany's precarious patrimony through haste or spectacular give-aways

For financial and managerial reasons, only West German or foreign firms normally will qualify as buyers for the large units. These will be broken up as much as possible, and debts will be written off as necessary to ensure solvency. No further restructuring will be carried out by Treuhand just to achieve quick privatization. Viable large firms that do not attract buyers who can offer a reasonable price will be reorganized under Treuhand as "mixed enterprises" and run by Treuhand-appointed managers and boards (as was once the case in West Germany with firms such as Volkswagen, Lufthansa, and Salzgitter). Such firms will have to be sold later through the stock market once a realistic market value is established; the speed of such privatization will be matched to the capacity of the stock market to absorb the increment of capitalization without a slump. At the same time, small service enterprises and retail shops are to be sold off or leased out quickly, if possible, to qualified local operators.

Treuhand's mandate is to move at a speed commensurate with economic conditions and financial prudence and without the constraint of deadlines.

Proceeds from the sale of enterprises will be used to cover costs of other units' liquidation. In addition, Treuhand's revenues can be spent on selective debt write-downs or write-offs, assumption of external risks, such as claims from former owners, and accumulated environmental costs.

As implied before, Treuhand does not follow any particular procedural doctrine beyond choosing an approach on a case-by-case basis. Several forms of contractual arrangements, either applied or considered, further illustrate this pragmatic approach:

- Privatization can be accomplished through "incomplete contracts" if the process becomes stalled in the absence of realistic accounts — as no reliable asset evaluation of a firm is possible — or if the "risk premium" to prospective buyers would have to be very large because of the unpredictable requirements of rehabilitation. These incomplete contracts allow asset valuation by auditors to be postponed until after the status of the firm is normalized. On the basis of such a valuation, the appraised price of the firm is shared between the buyer and Treuhand.

- If heavy debt prevents the acquisition of an otherwise viable firm by qualified buyers, Treuhand can assume servicing and amortization of part or all of the debt.

- In addition to agriculture, where large-scale leasing seems to be the only type of conversion feasible in the short- to medium-run, leasing is also applicable in the manufacturing and

service sectors. Given the lack of sufficient funds on the part of local investors and operators, leasing is a useful approach for promoting local entrepreneurship.

• To ensure fairness of opportunity and to maximize public revenues, conversion is to be carried out on a competitive basis. For small units, this would be through auction. For large units, offers can be solicited by invitation. Unsolicited offers will be made public, with an announcement of intent before the legal procedures are completed.

Few conversions have been concluded so far, but the size of several currently under way is substantial. After much public debate and threats of legal intervention by the monopoly control agency, the power generation and distribution facilities were sold to nine West German power companies. Local distribution grids were transferred free of charge to the local communities. A controlling minority share of East Germany's gas distribution company was sold to the leading West German distribution company. Most of the remainder will be sold to former East German states and to other European gas distribution companies. These latter have a stake in the outcome because of the hook-up between the Soviet Union and the Western European pipeline, which goes through Germany. One of the largest East German cement companies was sold to a French firm, and equally large contracts have been signed in the automotive field.

Transformation of the agricultural sector, consisting of large specialized production cooperatives, is expected to be particularly difficult. The enforced collectivization in the 1950s was followed by massive emigration of the farm population to West Germany. Former ownership records were destroyed after the collectivization. For political and social reasons, selling land to West German or foreign investors on a large scale is not considered a feasible option. On the other hand, few members of the present cooperatives are interested in becoming independent farmers, and even fewer have the financial resources to purchase land. In any case, it is unlikely that the legal uncertainty can be disentangled except through a drawn-out process. Therefore, Treuhand must devise a legal framework for large-scale leasing of land to individual farmers or to small voluntary cooperatives and for settling questions of ownership.

Treuhand's approach and activities suggest a few partially overlapping, tentative generalizations about its divergence from the prevailing thinking elsewhere in Eastern Europe:

• The approach is a pragmatic mix of conventional measures implemented on a massive scale rather than being radically new.

• The expected flow of transfer payments within Germany from the western to the eastern part of the country is anticipated to be well in excess of $3,000 annually per capita for the next decade (in addition to large inter-regional capital flows). However, the emphasis is clearly on economizing the process to avoid squandering East Germany's precarious patrimony through haste or spectacular giveaways.

• The political economy of Treuhand's approach does not seem to be encumbered by considerations of whether it is buying legitimacy through the free distribution of wealth, nor is it markedly affected by considerations of distributional equity or locus of control.

• Concern for economic and financial prudence and the preference for pragmatic over radical approaches may lead to trade-offs between speed and efficiency. One possibility is to devise an open-ended schedule for the completion of the program. Another possibility arises from the presence of a potentially sizeable commercialized public sector, or mixed sector, which will only gradually be privatized through conventional stock market operations.

Martin Schrenk
World Bank, CECSE

Among sources used: paper by Gerhard Pohl, Geneva Office of the World Bank, November 1990, and Claus Schnabel's paper Structural Adjustment and Privatization of the East German Economy, *presented in November 1990 at a conference at Johns Hopkins University's School for Advanced International Studies, Washington, DC.*

Help on Hold

Efforts to help the Soviet Union move to a market-based economy have been put in abeyance as the Gorbachev regime appears to be trying to reverse the movement toward political liberalization.

BY BRUCE STOKES

Late last year, several World Bank officials visited Leningrad and met with the city's leading economic experts. The talk soon turned to the Soviet practice of "state orders," through which the central government frequently purchases nearly all of a factory's production.

Soviet and Western economists agreed that state orders were economically debilitating and removed all incentive for a manufacturer to control costs and improve quality.

"State orders have to go," one of the Leningrad economists vigorously asserted. "We'll replace them with municipal orders."

This innocent comment, relayed by a dismayed World Bank official who attended the Leningrad meeting, exposed the fundamental challenge facing the Soviets as they try to develop a market-based economy. "There is an appalling ignorance of basic economic concepts" in the Soviet Union, the official said.

But economic illiteracy is only one of many problems now bedeviling the country. Its economy is contracting, inflation is spiraling out of control and unemployment is on the rise. And, until recently, political liberalization had undermined central authority at the very time that decisive action was required to carry through needed economic reforms.

Now, Soviet President Mikhail S. Gorbachev appears to be trying to reverse the movement toward liberalization. But his success would still leave open the question of whether he would use his power to carry out economic reforms.

The chaotic situation in the Soviet Union cries out for Western help. But the Soviet economic vortex also threatens to sink even the most well intentioned foreign aid and technical assistance projects.

"The Soviets are in a state of economic civil war," Robert D. Hormats, vice president of Goldman Sachs & Co. and a former State Department official said, "making it harder and harder to help them."

At the moment, plans for even such limited assistance are on hold. *(See box, p. 266.)* In the wake of Moscow's bloody repression in Latvia and Lithuania, the Senate and House approved nonbinding resolutions urging the Administration to withhold trade and other economic benefits from the Soviet Union until the

Goldman Sachs & Co. vice president Robert D. Hormats "The Soviets are in a state of economic civil war."

crackdown ends. The European Community (EC) temporarily suspended its aid program. And the major industrial nations have indefinitely delayed plans to provide technical assistance to the Soviets through the World Bank and the International Monetary Fund (IMF). *(See box, p. 264.)*

In the long run, however, "we still have a stake in the outcome" of developments in the Soviet Union, said Harald B. Malmgren, an international consultant whose advice has been sought by both Moscow and the governments of the Soviet republics. "We still want a continued decline in arms spending. We have an interest in facilitating the transformation of the Soviet Union into a more Western society."

"With all our other problems," said William Danvers, a member of a recent task force on Eastern Europe and the Soviet Union organized by the Atlantic Council, a Washington think tank, "how the Soviet Union eventually transforms itself is still the monumental foreign policy question confronting the world. And it is incumbent on the United States to try to play a role." *(See this issue, p. 258.)*

But what, if anything, Washington can do to help the Soviet Union reform its economy is not clear. And it is the West's impotence in the face of the Soviet Union's economic turmoil that troubles many experts on East-West relations.

DECLINING LIVING STANDARD

Gorbachev won his Nobel prize as a peacemaker. He never could have won it as an economist. Six years after launching *perestroika*, Gorbachev's restructuring of the Soviet economy clearly includes more rhetoric than reality. The vast majority of the Soviet people lived better under Leonid I. Brezhnev in the 1970s than they do today.

"The traditional centrally planned [Soviet economic] system has largely collapsed but has not been replaced by a functioning market system," said a December study by the IMF, the World Bank, the Organization for Economic Cooperation and Development and the European Bank for Reconstruction and Development. The study was done at the request of the leaders of the major industrial nations who gathered earlier in the year at the Houston economic summit.

With the old state economic controls in disarray and the marketplace providing little discipline, the Soviet economy is unraveling.

By official estimates, the Soviet Union's net material product (roughly equal to Soviet national income) fell by 4 per cent in 1990. The multilateral institutions conclude that it could fall by at least 5 per cent this year. The officially projected inflation rate of 12 per cent last year could well rise to more than 40 per cent in 1991, according to the December study. Unemployment, which stood at 1.5 per cent in 1990, could climb to 6 per cent in 1991, not high by American standards but still a dramatic increase in one year.

Internationally, the Soviet economy is not faring any better. Exports were down 12 per cent in 1990 and will probably drop further this year. The nation's foreign debt stood at $54 billion at the end of 1989, which is low by Third World or even Eastern European standards; nevertheless, large debt repayments are due this year. As a result, the study estimates, the Soviet Union this year will need international loans of $5.6 billion-$10.2 billion (depending on the world price of oil) to finance its expected balance-of-payments deficit.

Perestroika has left much economic reform undone. Despite Soviet declarations of belief in a market economy, most goods will still be produced under state orders in 1991. The defense industrial complex still corners the highest-quality labor and the best raw materials, severely retarding productivity growth in the civilian economy. Defense factories still make all of the country's television sets and most of its refrigerators. With no competition, quality remains low and prices high. Even when reform is attempted, the defense establishment often perverts the process. The ministry in charge of nuclear weapons has been given the job of modernizing the dairy industry, for example, leading to new dairy equipment made out of titanium.

Possibly even more damaging to the Soviet economy in the long run is the lack of a legal framework for a market economy. Private property rights are ill-defined or nonexistent. It is almost impossible to enforce contracts. And there is institutional anarchy. All 15 Soviet republics have declared their independence or sovereignty. The resulting tug-of-war between Moscow and local governments over economic policy strangles regional trade and hobbles foreign investment.

A HALTING HELPING HAND

The United States, well aware of deteriorating economic conditions in the Soviet Union, has extended a helping, if halting, hand. In December, with the press reporting the spread of Soviet food shortages, President Bush temporarily waived congressionally imposed restrictions on aid to the Soviets and granted Moscow $1 billion in credit guarantees to buy U.S. agricultural commodities.

At the same time, the Administration offered American companies wanting to trade with the Soviets $300 million in export insurance and loan guarantees from the Export-Import Bank of the United States. The Soviets are expected to use the Eximbank aid to buy locomotives, agricultural equipment and telecommunications products.

International consultant Harald B. Malmgren "We still have a stake in the [Soviet] outcome."

Though they applaud Administration efforts as a step in the right direction, some business lobbyists in Washington are questioning how meaningful the current American aid package is in light of the Soviet Union's economic difficulties. The $300 million Eximbank ceiling is a once-and-forever limit, not a rolling figure that permits new guarantees after old loans have been repaid. And Congress set the dollar limitation in 1974, with no provision to adjust it for inflation. Measured in current dollars, the Eximbank should be allowed to offer at least $1 billion in support.

That U.S. assistance falls short of demand is apparent: By mid-January, less than a month after it was announced,

NOT YET FOR WORLD BANK, IMF

Until Moscow's crackdown in the Baltics, the Bush Administration looked to the World Bank and the International Monetary Fund (IMF) to quarterback Western efforts to help the Soviet economy. Multilateral assistance was seen as the best way to depoliticize such efforts, and it fit nicely into the Administration's vision of a new world order. But Moscow's relationship with these institutions is still ill-defined and is likely to become increasingly controversial, raising questions about whether the Bank and the IMF will ever be able to play their intended role.

Although the Soviet Union attended the postwar Bretton Woods Conference that established the Bank and the IMF, the country never became a member of either institution, in part because of the IMF's stringent admissions requirements. Moscow did, however, send observers to the two institutions' annual meetings last year. And Soviet officials recently told Bank president Barber B. Conable Jr. that they intend to join. They did not, however, say when the Soviet Union would submit its application and implied that it would not do so until it was certain it had the votes to get in. A majority vote is required, and several European countries already support Soviet membership.

Last fall, President Bush proposed that the Soviet Union have a special association with the Bank and the IMF to give Moscow access to their expertise. The White House envisioned the IMF doing an annual review of the Soviet economy and providing advice on fiscal and exchange-rate policies. The Bank could provide technical assistance, such as experts to advise the Soviets on how to make their oil facilities more productive.

But problems abound. Consideration of the Soviet special association status had been expected at the Bank's and the IMF's interim meetings in April. Now, the subject is likely to be postponed at least until the fall meetings.

Technical assistance is inexpensive, and so financing such aid is not an issue. But if the Soviets become full members, they could be a major drain on available resources. Bank officials think the Soviets could easily qualify to borrow $3 billion-$4 billion a year, which would make Moscow one of the bank's largest borrowers.

If the Soviet Union breaks up into a number of smaller countries, as more than one Sovietologist predicts, some of its Asian republics might even qualify to borrow from the International Development Association, the Bank's facility for easy loans to poor countries. But this is now unlikely.

To meet this demand without denying funds to Third World nations would require an increase in the Bank's capital. The last time this had to be done, in the late 1980s, congressional opposition almost scuttled it.

Soviet membership could also shift the balance of power in the Bank and the IMF. The two institutions just went through a wrenching realignment in voting shares to give Japan and Germany clout comparable to the size of their economies. "Great Britain and France may not want the Soviet Union to have more voting power than they do," a Bank spokesman said. And the United States is increasingly wary of losing its veto over changes in the institutions' governing articles. "It would be a complicated shell game, possible but diplomatically dicey," the official said.

So if Moscow is looking to the Bank and the IMF for a quick economic fix, it may be sadly disappointed.

most of the farm commodity loan guarantee program was already committed and the Eximbank plan was already oversubscribed.

Moreover, some cynics question whether new commodity loan guarantees were motivated by a desire to help the Soviets or to support American farm exports. Moscow has pledged to buy a minimum of six million tons a year of U.S. wheat, feed grains and soybeans. But this year, with the Soviet Union short of hard currency, some U.S. farm experts doubt that the Soviets could live up to their commitment. The commodity credit guarantees will enable the Soviets to make their minimum purchase and thus avoid turning a bad domestic food situation worse. But the extension of guarantees does not necessarily increase the amount of American food reaching hungry Soviets.

Finally, unless the Soviet government defaults on its grain or equipment payments, current aid programs for the Soviet Union will cost American taxpayers nothing. "After years of spending billions of dollars on military hardware to keep the Soviets at bay, the Administration is now unwilling to spend a dime on economic assistance as insurance against a return of the Cold War," a Democratic critic of Administration policy said. The Administration blames budget constraints for its parsimony, but many Democrats suggest that the White House fears a conservative backlash against a substantial Soviet aid package.

If it's any solace to the Administration, Tokyo has been even less responsive to Moscow's plight. Embroiled in a long-running dispute over Soviet occupation of four Japanese islands off Siberia, Japan has offered minimal help: $7.7 million in food and medical assistance and $100 million in export loan guarantees, primarily for foodstuffs.

Europe, on the other hand, grateful for the Soviet pullback from Eastern Europe, facing the prospect of turmoil on its borders and worried about millions of Soviet economic refugees fleeing West, has offered far more aid. In December, the EC agreed to provide the Soviets with $1 billion in emergency food aid and $500 million in technical assistance in 1991, a decision that was put on hold in January in response to Gorbachev's policies on the Baltic states. Germany has provided the most help: about $20 billion, including $10 billion to cover the costs of relocating Soviet troops from the former East Germany and $3.3 billion in balance-of-payments support.

In the short run, Soviet repression of the Baltic independence movement has placed all Western aid in jeopardy. But in the long run, both Tokyo and Bonn have made it clear, strategic considerations will drive their assistance plans.

Gorbachev is scheduled to visit Japan in April, and if he brings a solution to the island question, Japan is expected to reward him with substantial aid.

As for Germany, Count Hagen Lambsdorff, the economics minister at the German Embassy in Washington, said: "We are as unhappy with the steps Gorbachev is taking in Lithuania and Latvia as the United States. But in relations with the Soviet Union, we have special problems. Given our vital interests, we see [aid] as a logical step. We do not feel we are throwing money out the window. We think the money is spent in a worthwhile fashion. We would highly welcome stronger support from the U.S. side. And we would very much hope that given an end to the Gulf crisis, that the U.S. government would again see the high priority of a stable Soviet Union, not only as a political unit, but as an economically successful entity."

The White House and Congress are

not blind to the strategic arguments for greater economic aid to the Soviets. A high-level group of Administration policy makers is tracking Soviet economic needs to ensure, a White House aide said, that "what can get done does get done."

For example, Eximbank loan guarantees to the Soviet Union are limited by law to activities relating to oil and natural gas exploration. Guarantees for sales of production equipment are not permitted. Because Soviet energy production is bottlenecked, U.S. business lobbyists were pushing the Administration—before the troubles in the Baltic states—to provide all-purpose energy loan guarantees for the Soviet Union. The White House denies it will do that. But such a program might serve a dual purpose: earning the Soviets more hard currency through increased energy exports, and easing the West's dependence on Middle East oil, thus potentially defusing some conservative U.S. opposition to Soviet aid.

Congress, for its part, adjourned last year without passing the SEED 2 aid program for Eastern Europe. The Senate version of the proposal would have permitted support for projects in the Soviet Union, but the House bill would not. "We don't know if we will go back to the old bill or try to address the problem in another way," a House staff aide said. But whatever Congress does, the House aide warned, "we are not going to bail out their economy. We don't have the money if we wanted to."

All congressional plans for expanded aid to the Soviet Union are in abeyance. But before the recent Soviet internal clashes, there was considerable congressional support for more food aid and technical assistance, such as providing retired American business executives to help in privatizing Soviet state enterprises.

In addition, the House Democratic leadership, working closely with the business community, was wrestling with how to persuade the White House to seek congressional approval of a trade agreement that the government had negotiated with the Soviet Union. The pact would give Soviet goods greater access to the U.S. market and free up more export credits for American firms wishing to sell to the Soviets.

So far, the Administration has held the treaty back, hoping to pressure Moscow into passing a more liberal emigration law. Some Democrats say that codification of its emigration practices is an unnecessary hurdle for the Soviet Union. Emigration numbers are up, and as long as they stay up, business lobbyists argue, trade with the Soviet Union should be unencumbered.

Count Hagen Lambsdorff, economics minister at the German Embassy in Washington "Given our vital interests, we see [aid to the Soviet Union] as a logical step."

Faced with budgetary and political constraints on bilateral assistance from the United States, advocates of helping the Soviet Union are also looking to expanded multilateral aid.

"More money and more lending latitude seem to be increasingly appropriate" for the new European Bank, a Democratic leadership aide said.

And the World Bank and IMF could provide greater balance-of-payments support for Eastern Europe to enable countries in that region to buy more energy from the Soviet Union at world market prices; that would help the Soviet and Eastern European economies alike and avoid a politically divisive debate over whether to provide such support directly to the Soviets.

EYES ON THE BALTICS

Whether additional U.S. aid will be forthcoming depends largely on political developments in the Soviet Union.

For the moment, all eyes are on events in the Baltics. "There will be a strong effort to cut off any kind of assistance if there is a Tiananmen Square-type incident," the Democratic House leadership aide said, referring to the Chinese government's June 1989 massacre of students in Beijing's central square that led to a cutoff of Eximbank programs and World Bank loans.

"The Democrats are deathly afraid of being charged by the Republicans with having mismanaged the Soviet Union," a business lobbyist who supports an expansion of aid programs said. "If the Soviets shoot their own people, I don't think the Democrats will dare challenge the Administration" and attempt to expand economic aid in the near future.

Congressional Democrats are already reluctant to get too far out in front of the White House. "Having already addressed the issue [with the SEED 2 legislation last year]," the House aide said, "there is a feeling that we have put some issues on the table and that we want to wait and see the President's budget proposal and what foreign aid legislation the Administration comes up with before we charge ahead."

A more fundamental obstacle to greater economic assistance is the open disagreement among Western experts over whether the trajectory of political and economic reform in the Soviet Union is good or bad and whether aid should be used to accelerate or impede these developments

Most current Western aid programs are premised on the Soviet Union's remaining a coherent economic entity, with a single currency, common external tariffs, free inter-republic trade and a common monetary policy. Moreover, they assume that the Soviet central government will remain committed to creating a market-based economy.

But Gorbachev's recent government reshuffling has eased out many economic reformers and replaced them with conservatives interested in preserving the status quo. From Moscow's viewpoint, the Soviet Union is rapidly breaking apart. Republics block farm shipments. Some local governments think about issuing their own currencies. Further economic reform may only strengthen the hands of those wishing to dissolve the union. "And where does it stop?" a World Bank official asked. "There is talk of three Moldavias."

Those who worry that these trends portend chaos argue that aid should be

PRESCRIPTIONS FOR THE SOVIETS

In recent months, several major Western studies of the Soviet economy—by the multilateral financial institutions, the Atlantic Council and others—have all reached the same conclusion: Moscow's first order of business is to heal itself through price liberalization, privatization of state enterprises and other long-overdue internal economic reforms.

The reports agree that what the West can do to help remedy conditions in the Soviet Union is limited to such things as emergency food aid, technical assistance, "structured dialogues" and eventual project assistance. Here are the highlights of two of the reports.

G-7 report: At the request of the leaders of the major industrial nations (the Group of Seven, or G-7) who met at the Houston economic summit last year, the World Bank, the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development and the European Bank for Reconstruction and Development published a series of recommendations in December for reform of the Soviet economy and suggested appropriate types of external assistance.

"We stress the need for a significant and broad-based liberalization of prices in an environment of increased domestic and external competition, supported by a clarification of property rights and encouragement of private ownership along with the commercialization of the larger state enterprises," the report said.

The study's authors conclude that the cautious approach to economic reform that Moscow now seems to favor will ultimately collapse of its internal contradictions. The multilateral institutions favor radical reforms, but they hedge their bets. They do not advocate the "big bang" technique attempted in Poland, which transformed its economy overnight from socialist to capitalist, causing major problems.

The multinational experts advocate raising Soviet domestic prices to world market levels over a two-to-three-year period after a significant initial adjustment. Moreover, they call for only gradual privatization of state-owned businesses.

Mindful that their efforts in the Third World have been criticized as being insensitive to the needs of the poor, the Bank and the IMF encourage reforms with a human face. "To cushion the effects of the reform on the poorest segments of the society," the report argues, "these measures should be supported by an incomes policy and by an effective social safety net (including an adequate system of unemployment compensation)." These include continued subsidies for rents and for prices of a few essential consumer goods.

The report recommends that Western countries provide food and technical assistance to the Soviet Union but cautions against balance-of-payments support or project assistance until Soviet internal reform is well under way.

World Bank officials say the study could be taken up at the Bank's and the IMF's interim meetings in April and that the recommendations could be instituted in two to three months if the two institutions get the green light from the United States, Europe and Japan.

Atlantic Council: The report, "Strategies for Facilitating East European & Soviet Transformation," prepared by several American specialists drawn from business, academia and Capitol Hill, argues that the former Soviet Bloc countries do not need reform but transformation through institution building that supports "democratization, marketization and modernization."

"Institution building is crucial to create a secure basis for changes over time and to establish mechanisms that can manage the conflicts and dilemmas inherent in the transition process," the study said.

Rather than side with those who support Moscow or the Soviet republics in the current unraveling of the Soviet Union, the authors contend that a process of peaceful decentralization is not possible without strong new central institutions. They propose creation of a Soviet central bank and new regulatory agencies to replace central planning and management of the economy.

Without these new institutions, the report concludes, "the shift toward decentralization and privatization may produce instability, deterring entrepreneurs and foreign investors."

channeled through Moscow. "We have to deal with the center," Lambsdorff said. "Gorbachev is still running the country, and the center still commands the Red army."

Opponents of large-scale assistance share the view set forth by an aide to a Senator who has long opposed Soviet economic support. "Nothing should be done," the aide said, "to keep alive the increasingly obstructive superstructure that is blocking economic reform and democracy." If economic help is to be offered, these critics say, it should be routed through the republics.

This standoff on Soviet aid could be self-defeating, Hormats of Goldman Sachs warned. "We could be standing still for several years if we allow ourselves to be trapped by the current conundrum of whom to support," he said.

Hormats, Malmgren and others argue for increased Western assistance directly to the Soviet Union's republics and cities, with the threat that the aid will be cut off if the central government begins to backtrack on reform. "That would give reformers an argument against more-restrictive policies," Hormats said. The Canadian government is exploring just such an approach, working through traditional nongovernmental foreign aid agencies, such as church groups.

Moreover, the Democratic House leadership aide said, the United States cannot for long afford to ignore political and economic turmoil in the world's other nuclear superpower. "This is not to save Gorbachev or to preserve Moscow's control over the republics," he said. "But our interests are in maintaining the process of reform and in avoiding economic catastrophe that would have destabilizing effects throughout Europe. If we throw up our hands, say we can't do anything and that violent disintegration of the Soviet Union is irrelevant to U.S. interests, that is a dangerous example of sticking our head in the sand."

For the moment, that long-term strategic view of providing assistance to the Soviet economy has taken a backseat to concerns over Moscow's abuse of human rights. U.S. aid to the Soviet Union is a prisoner of relations between Moscow and the republics and depends on how those relations are sorted out and whether that process is peaceful or bloody.

Experience with U.S. financial assistance to China in the aftermath of Tiananmen Square suggests that economic sanctions have a short half-life. Eventually, the West must tackle the more difficult economic question of what, if anything, can be done from the outside to facilitate the Soviet transition to a market-based economy. ■

THE NEW YORK TIMES, MONDAY, JANUARY 21, 1991

Put Moscow in a Deep Freeze

Christophe Vorlet

By Orrin G. Hatch

Bush should link up with the republics.

WASHINGTON

Since U.S. economic aid and other manifestations of improving U.S.-Soviet relations have been based on continuing Soviet reform, President Bush needs to do more than reproach Mikhail Gorbachev.

After the Soviet use of force in Lithuania and, yesterday, Latvia, the U.S. should call off the planned summit meeting, and should terminate the $1-billion in agricultural credits and cancel the planned waiver of the Jackson-Vanik restrictions on most-favored-nation trade status. Mr. Bush should also foster direct ties with Soviet republics that hold genuinely free elections and adopt far-reaching market reforms.

While President Gorbachev and some Western leaders may reject explicit linkage of the Baltic question to other East-West issues, linkage exists as a political reality. Western public opinion, particularly U.S. Congressional opinion, will turn cold so long as Moscow tries to keep the Baltic states on a short leash.

Too often in debate about U.S. policy toward Lithuania, Estonia and Latvia, the issue has been framed as a choice between granting full diplomatic recognition to democratic governments or doing nothing — a false dilemma. The U.S. should undertake diplomatic steps short of full recognition that would advance Baltic independence and increase in Moscow's calculus the international political costs of coercive policies.

First, the U.S. should adopt a Baltic relations act basically similar to the Taiwan Relations Act of 1979, which governs relations with Taiwan in the absence of diplomatic relations. The primary objective of the act would be to establish with each Baltic state unofficial diplomatic liaisons similar to the American Institute of Taiwan and its Taiwan counterpart in the U.S.

These institutes, nominally independent of the U.S. Government, would upgrade U.S.-Baltic relations and serve as the point of contact between the U.S. and Baltic leaders. They would facilitate the kinds of normal international transactions, such as political communication and cultural exchanges, that routinely take place with Taiwan. And they would seek to encourage economic investment in the Baltic states, particularly through the Overseas Private Investment Corporation, as market reform is adopted.

Second, the U.S. should sponsor the Baltic states as members of international economic groups, like the General Agreement on Tariffs and Trade. After all, GATT has juggled the competing claims of China, Taiwan and Hong Kong, and its charter accommodates membership by governments with less than full sovereignty.

The key GATT membership requirement is that a government control its economy. The Baltic states have that power under Moscow's Declaration of Baltic Economic Autonomy in 1989, and have taken substantial steps in wresting control of enterprises from Soviet ministries, as well as negotiating independent trade pacts with other Soviet republics.

In any forthcoming U.S.-Soviet economic pacts, the U.S. should insist on provisions that recognize the international legal standing of the Soviet republics and permit more liberal economic relations for reformist republics like the Baltic states than for the rest of the Soviet Union, particularly in the areas of technical assistance and foreign investment.

While Mr. Gorbachev and his central Government hesitate in adopting even half-baked market reforms, the Baltic countries have expressed unequivocally the intention of adopting full-fledged market reforms, including the restoration of private property and free-market prices.

He understands that the old system, based on coercion, stifles economic progress. A new system based on consent requires transformation of the country into a loose confederation, and acceptance of the inevitability that some republics, particularly the Baltic states, will choose to secede, even if they keep close economic and political ties with Moscow.

President Bush is now obliged to pursue policies that make Mr. Gorbachev understand that he faces a choice between an isolated Soviet Union mired in poverty and paralyzed by national hatreds and a new Soviet confederation that can join the community of nations and achieve prosperity commensurate with its great natural wealth. □

Orrin G. Hatch, Republican of Utah, is a member of the Senate Intelligence Committee.

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FOR IMMEDIATE RELEASE

PANEL URGES NEW APPROACH TO EXPORT CONTROLS AS COLD WAR ENDS AND NEW THREATS TO WORLD PEACE EMERGE

WASHINGTON -- In the post-Cold War era, current restrictions on the sale of high-technology products to Eastern European countries and the Soviet Union should be changed, a blue-ribbon panel of the National Academies of Sciences and Engineering and the Institute of Medicine said* at a press conference here today. Export controls, it added, should be highly selective and fully multilateral in order to be an effective instrument of national security policy. The panel called on the United States government to move progressively toward the removal of export controls on dual-use items where the civilian end use can be verified.

While limiting export controls to a few "highly critical" items that are directly useful to the Soviet military, the 22-member panel wrote in its report,* this important national security tool also should be directed more systematically toward constraining the proliferation of weapons of mass destruction, such as nuclear, chemical, biological, and advanced conventional weapons to nations in politically unstable regions of the world, such as Iraq. To achieve this objective, the panel recommended that the United States should treat proliferation as an explicit element of national security rather than of U.S. foreign policy.

(MORE)

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*The committee's report, *Finding Common Ground: U.S. Export Controls in a Changed Global Environment*, is available for $34.95 (prepaid) plus shipping from the National Academy Press at the mailing address in the letterhead (telephone 202/334-3313 or 1-800/624-6242). The publication sales office is located at 2001 Wisconsin Ave., N.W., in Harris Building room 384. Reporters only may obtain a copy of the report from the Office of News and Public Information at the letterhead address.

The panel urged the United States to avoid the "serious economic disadvantages" of unilateral export controls, to strengthen export control policy-making through a presidential directive and an interagency coordinating committee, and to consolidate the routine administration of export controls under the U.S. Commerce Department's Bureau of Export Administration.

The study was requested by the U.S. Congress in the Omnibus Trade and Competitiveness Act of 1988 and funded by the U.S. Departments of Commerce, Defense, and State, with limited additional funding from the Industry Coalition on Technology Transfer. **Roland W. Schmitt**, president of Rensselaer Polytechnic Institute, Troy, N.Y., served as panel chair and retired Army **Maj. Gen. William F. Burns**, former head of the U.S. Arms Control and Disarmament Agency, Carlisle, Pa., served as vice-chair.

The Export Facilitation Act of 1990, which called for major changes in the current U.S. export control system, was pocket vetoed by President Bush in December, and new legislation on the topic is expected to be drafted by the 102nd Congress.

THE CHANGING WORLD ORDER

The members of the North Atlantic Treaty Organization (NATO), except Iceland, and with Australia and Japan, work through the Coordinating Committee for Multilateral Export Controls (CoCom), an unofficial, non-treaty organization established in 1949 to coordinate restrictions on export of sensitive technologies to the Soviet Union, other Warsaw Pact countries and the People's Republic of China. Sensitive technologies have included military items, "dual-use" items (or those with both civilian and military applications), and nuclear items.

According to evidence from intelligence sources reviewed by the panel, the Soviet Union, in general, has not succeeded in reducing the West's technology lead, despite a vigorous program to acquire restricted items through both legal and illegal means. The panel found that while the Soviet Union continues to be at least five to 10 years behind in most key technology areas, it continues to field highly capable military systems.

(MORE)

The recent dramatic changes in the democratization of Eastern Europe, and to a lesser extent the Soviet Union, have substantially reduced the offensive military threat to CoCom members posed by the Warsaw Pact, noted the panel. At the same time, the panel commented, "the Soviet Union remains the only country capable of destroying the United States with nuclear weapons." Moreover, recent events in Lithuania and Latvia make it clear that the future course of political developments in the Soviet Union remains highly uncertain.

Nevertheless the panel found that the Soviet Union now is generally "a far more transparent and penetrable society," making it possible for the first time to distinguish between commercial and military applications of technology, provided that unannounced site visits and other conditions are agreed upon to verify end uses. It argued on this basis that "it is now in the West's security interest to permit the flow to Eastern Europe and the Soviet Union of dual-use technology," while continuing to maintain restrictions on "a few highly critical items." Depending on the course of developments in the Soviet Union, the panel recognized the possible need to differentiate the level of exports to Eastern Europe from those to the Soviet Union itself.

It urged CoCom to adopt more dynamic and responsive strategies to shift the focus of trade with the Soviet Union and East Europe from denial to approval, to adopt a shorter "core list" of proscribed commodities, and to agree on verifiable end-use conditions.

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STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEES ON THE WESTERN HEMISPHERE AND
INTERNATIONAL ECONOMIC POLICY AND TRADE
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittees:

I want to thank you for the opportunity to discuss the status of the Enterprise for the Americas Initiative. I have found my previous appearances on the Initiative before these Subcommittees very valuable, and I look forward to similarly useful exchanges today.

Announced by President Bush last June, the Enterprise for the Americas Initiative (EAI) focuses on building more productive relations with our neighbors in Latin America and the Caribbean. The President cited the Initiative in his State of the Union address and will be submitting to Congress very shortly legislation providing for implementation of all of its elements. To underscore the importance the President places on this legislation, I want to quote what he said to President Gaviria of Colombia in their meetings on February 26: "I am absolutely committed to its passage."

The priority placed by the President on gaining necessary authorities and moving forward on full implementation of the Initiative is well founded. The United States economy is linked to these countries through a wide array of trade and investment ties, which the President's Initiative is uniquely positioned to deepen and expand for our mutual benefit. This is a region with which we share a common cultural heritage, and whose many new leaders have shown a strong commitment to democratic values, market-based economic reforms and measures to attract investment.

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These new leaders will help drive the successful implementation of the proposals contained in the Initiative. In his recent trips to Mexico and South America, President Bush was impressed with the commitment on the part of leaders in the region to pursue reforms that will improve their economic prospects and make them more competitive in attracting capital. To respond to this determination, we are committed to pressing forward on every front to make the President's vision for the hemisphere a reality.

The Initiative proposes action in three areas -- trade, investment, and debt -- thereby joining in a single endeavor the three economic issues of greatest importance to the region. I want to review these fundamental pillars with you briefly.

- Trade: The President set the goal of a hemispheric free trade system to increase trade and boost the economic potential of countries in the hemisphere. To work towards this goal, we are negotiating a series of trade and investment framework agreements with individual countries and groups of countries in the region. Successful conclusion of the Uruguay Round will also make an important contribution to this process.

- Investment: To help countries attract needed capital for growth, the President suggested that the Inter-American Development Bank (IDB) develop an investment sector lending program to encourage countries to liberalize their investment regimes. In addition, the President proposed the creation of a $1.5 billion multilateral investment fund, managed by the IDB, to provide additional support for countries undertaking investment reforms.

- Debt: The President recommended that the IDB join the IMF and World Bank in providing support for commercial bank debt reduction. He also proposed to reduce the bilateral debt owed to the U.S. Government by countries in the region which meet certain eligibility requirements. The stock of concessional AID and PL-480 debt would be substantially reduced, and remaining dollar payments would be applied directly to retire principal. Interest payments on this reduced debt would be made in local currency to support environmental projects in each country. A portion of non-concessional Eximbank loans and CCC assets would be sold, reduced or cancelled as part of an overall effort to facilitate debt-for-equity, debt-for-nature, and debt-for-development swaps.

Efforts to implement the trade, investment, and debt pillars of the Initiative began immediately after its announcement. Significant progress has been made to date.

Advancing Free Trade

We are engaged in discussions with countries throughout the region to liberalize trade and investment and move toward the goal of a hemispheric free trade system.

President Bush stated when he announced the Initiative that the United States stands ready to enter into free trade agreements (FTAs) with Latin American countries, in particular with groups of countries that have associated for the purpose of trade liberalization. Our long term goal is to establish a hemispheric free trade area. The first step in this process will be an FTA with Mexico and Canada. FTAs will progressively eliminate obstacles to the flow of goods, services and investment, provide for the protection of intellectual property rights, and establish fair and expeditious dispute settlement mechanisms.

Eventual free trade agreements will bring substantial benefits to the United States as well as the other countries involved. FTAs will result in increased U.S. exports, both in the short and long term. The U.S. labor force will experience significant job growth as a result of increased productivity and output of the U.S. economy. U.S. consumers will also benefit from improved access to low cost foreign imports, and U.S. producers will benefit from reductions in the cost of intermediate inputs. Our trading partners will experience a rise in real wages, increased investment, and increased export opportunities as a result of FTAs with the United States.

Presidents Bush and Salinas announced last June 11th that Mexico would be the first country in this process. Two weeks ago, Canada joined us in these trade talks, to negotiate a trilateral agreement. Such an agreement would foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. I should note that in order to achieve this agreement, we will need fast-track authority. Without such authority, our ability to negotiate such an agreement under the Initiative will be severely undermined.

Meanwhile, to advance towards our goal of hemispheric free trade, the Administration is negotiating framework agreements with individual countries and groups of countries in the region. Framework agreements establish fora for addressing and consulting on bilateral trade and investment issues. They contain immediate action agendas listing specific trade and investment issues of concern to both parties and areas in which liberalization is needed. Through these agreements, we can

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discuss the requirements for free trade agreements and facilitate negotiations when the appropriate time arrives. Chile has expressed an interest in FTA negotiations and we are using the framework agreement to explore this possibility.

Framework agreements have been signed since June with five countries -- Colombia, Ecuador, Chile, Honduras, and Costa Rica -- adding to those already in place with Mexico and Bolivia. Negotiations are underway with a number of other countries, including Jamaica, Venezuela, Peru, Nicaragua, Panama, El Salvador, Guatemala, and a group of countries composed of Argentina, Brazil, Uruguay, and Paraguay.

A successful conclusion of the Uruguay Round will make an important contribution to our goals of trade and investment liberalization under the Initiative. We continue to work with Latin American and Caribbean countries towards this end. We have made a special effort to propose tariff cuts on products of interest to Latin America in the context of Uruguay Round tariff negotiations.

Creating a Better Climate for Investment

While it will take time to open borders and extend free trade throughout the hemisphere, the potential for increasing investment flows to the hemisphere is more immediate. Latin American and Caribbean countries are already competing for capital with other dynamic economies, and they need to move quickly to attract private investment both from abroad and at home. The Inter-American Development Bank is developing an investment sector lending program to encourage countries to liberalize their investment regimes. The IDB has begun evaluating the need for reform in individual countries, and we anticipate the first investment sector loans moving forward in the next few months.

As an additional means to support investment policy reform efforts, the President outlined his proposal for a multilateral investment fund in his June statement. This proposal is under discussion with the IDB and other creditor governments. We see the fund supporting investment policy reform efforts, by making technical assistance grants for privatization and other investment-related reforms.

The fund should spur human capital development through grants for worker retraining and education in support of investment reforms. To combat micro and small-sized enterprises' lack of access to capital, the fund also could provide them with credit and equity financing channelled through arrangements to be developed with local non-governmental organizations and other financial intermediaries. We would envision the fund placing special emphasis on smaller countries in the region such as those in Central America and in the Caribbean.

Accordingly, we are asking that Congress authorize a U.S. contribution of $500 million, to be made available in five annual installments of $100 million each, beginning in fiscal year 1992. We expect other countries to contribute two-thirds of the fund's capital, to meet the goal of a $1.5 billion fund over five years.

Reducing Debt Burdens

Debt reduction is an important tool for encouraging countries in the region to sustain their efforts to reform their economies. The overhang of external debt has constrained the resources available for growth and tested the resolve of nearly every government in the region. By easing the burden of debt on their economies, we can help them attract new investment capital and make the rewards of reform more immediate.

The reduction of official bilateral debt proposed under the Initiative complements the international efforts under the Brady Plan to address countries' commercial bank debt problems. Bilateral debt reduction under the Initiative will be particularly important for the relatively small countries that owe a substantial portion of their external debt to official creditors, rather than to commercial banks.

The reduction of concessional debt under the Initiative aims to change dramatically the current situation in which countries must seek repeated Paris Club reschedulings to adjust their debt service payments to their ability to pay. The stock of concessional debt will be substantially reduced at the outset, depending on the individual circumstances of each country. Moreover, new dollar payments on this reduced debt will be applied to retire principal. As a result, a country's concessional debt will be eliminated within a designated and shorter period.

This new approach would result in significant benefits for debtor countries by making debt burdens more manageable, eliminating the debt overhang, and improving investor confidence. As a creditor, the U.S. Government would also be assured of repayment of a realistic sum, thereby maximizing its return in the medium term.

As you know, last year's Farm Bill provided the authority to reduce PL-480 (food assistance) debt for countries pursuing strong economic and investment reform programs, and to establish the mechanisms for channelling local currency interest payments to support environmental projects. The President will soon sign an Executive Order establishing the inter-agency procedures through which the Administration will implement this authority. Pursuant to this order, we will be discussing PL-480 debt reduction with individual countries as they become eligible.

We believe that Chile, Jamaica and Bolivia could qualify

for debt reduction in the next few months. Given their good standing with the IMF and World Bank, and their agreements with commercial banks, these countries' current eligibility depends primarily on their implementation of investment reforms. All three have liberal investment regimes and are discussing possible additional measures with the IDB. Other countries could also move to qualify for PL-480 debt reduction in the near future.

To implement fully the debt reduction elements of the Initiative, we need authority from Congress to reduce foreign economic assistance obligations to AID in the same manner as provided for PL-480 assistance in the 1990 Farm Bill. PL-480 debt constitutes only about one-fourth of the concessional debt owed to the U.S. Government by Latin American and Caribbean countries. A far larger share of this debt (some $5 billion) is owed to AID. Substantial debt relief for these countries, therefore, will need to involve action on AID debts as well.

We will also be seeking authority to sell, reduce or cancel a portion of assets held by CCC as a result of its credit guarantee programs and a portion of Eximbank loans to facilitate debt/equity, debt-for-nature and debt-for-development swaps in eligible countries. The Administration will propose legislation in the coming days to accomplish these objectives.

Support for the Environment:

In addition to substantial reduction of their concessional debt, and possible swaps of their Exim and CCC obligations, countries will benefit from U.S. willingness to direct local currency denominated interest payments on the reduced PL-480 and AID debt instruments to support environmental projects. These interest payments will be deposited in an environmental fund in the debtor country, created under the environmental framework agreement negotiated with the country. Local committees composed of debtor country and U.S. government representatives and local non-governmental representatives (who should be in the majority) will determine the use of these environmental funds.

By creating a dedicated stream of payments to support environmental projects, the Initiative will provide the continuity essential for sustained environmental progress. The absolute amounts provided to environmental projects under the Initiative will be significant in relation to current levels of environmental funding in most Latin American countries. If more creditor countries decide to provide comparable support, the total amount of environmental funds will increase substantially.

The Initiative will also play a crucial role in strengthening institutional development in the environmental area, by supporting local organizations active in the field.

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One of our key objectives here is to encourage grassroots efforts within Latin America to protect and preserve the environment. The active involvement of local non-governmental organizations (NGOs) therefore is an essential component of this initiative.

We will also create an Environment for the Americas Board in Washington. This Board -- composed of U.S. Government representatives and non-governmental representatives -- will advise the President on negotiations of the environmental framework agreements, ensure that local administering bodies are properly constituted and review countries' annual programs for use of the funds.

We worked closely with this Committee on the legislation passed into law last fall to authorize PL-480 debt reduction -- and on the authorization passed by the House on AID debt. We were pleased with the results of that process and look forward to working closely with you on new legislation. I think we agree on the importance of reducing the debt burdens of Latin American and Caribbean countries which are pursuing strong economic policies, while we also provide critical support for grassroots environmental projects in these countries.

Advancing Our Vision for the Hemisphere

While we have made significant progress in recent months in moving the Initiative forward, we cannot pause in our efforts. Expectations in Latin America and the Caribbean are high: they welcome U.S. recognition of the importance of its neighbors and the need to address their pressing problems. President Bush delivered this message directly to key Latin heads of state during his December trip to the region, vowing that the implementation of this initiative will not be tied up in bureaucratic red tape on our part. At the same time, he was impressed by the commitment of Latin American leaders to implement economic policies that will help them compete for scarce capital and achieve growth. Latin American and Caribbean leaders welcomed the Initiative, and I would like to submit their statements for the record.

Continued dedication of this kind in Latin America and the Caribbean is absolutely fundamental to the success of the Initiative. We, too, must follow through on our commitments and move together with countries in the region and the IDB to undertake the substantive work that must be done. We look to Congress to support this historic effort for the Americas by enacting the legislation necessary to implement the remaining debt and investment provisions, and as I noted earlier, fast-track authority will also be critical.

I value our continuing dialogue on these issues and hope I can count on your timely support for this important Initiative.

JOURNAL OF COMMERCE, March 3, 1991

Waiting for Europe and Japan

WASHINGTON — Richard Feinberg, executive vice president of the Overseas Development Council, a local think tank on international issues, may have put it best.

President Bush's Enterprise for the Americas Initiative, he told a House panel recently, "is appropriate for our Age of Diminished Expectations."

TRADE SCENE

Richard Lawrence

Government, he said, may "set the terms of discourse, but provide only marginal material support."

Last June, the White House surprised the world by announcing the Enterprise for the Americas Initiative — a set of trade, aid and investment proposals meant to help propel Latin America and the Caribbean toward economic prosperity.

The initiative was, and still is, widely lauded. The United States, it appeared, finally had lifted its hemispheric focus beyond Central America's killing fields.

But as people look more closely at the initiative's details, a certain anxiety and skepticism sets in.

Harold J. Johnson, director of foreign economic assistance issues at the General Accounting Office, the congressional agency that keeps a sharp eye on administration doings, cautions of a "danger that the initiative may be oversold."

There is a distinct chance of this, given the plan's proposed funding level, demands on would-be beneficiaries and uncertainties of execution.

The initiative would pare, by some as yet unstated amount, the $12 billion in debt Latin American and Caribbean nations owe the U.S. government. It would provide $1.5 billion over five years for an "investment fund," and it raises the hope of a hemispheric free trade zone at some distant time.

The $12 billion represents less than 3% of the region's total foreign debt. Even if the United States reduced it sharply, the region would be saved less than $400 million a year in debt payments. Only small countries, such as Jamaica, El Salvador and the Dominican Republic, might win substantial relief.

Even they, however, would not get immediate relief, the way the administration would manage the program. For the first year or two, they might have to make bigger payments to the United States.

But the region's debt relief could be much greater — quadruple or more — if Western Europe and Japan were to match the U.S. offer.

This, however, does not seem likely. The Europeans and Japanese appear to feel that Latin America is the United States' "ward." And they seem to resent the unilateral way the Bush administration conceived and announced the Enterprise for the Americas Initiative.

U.S. "unilateralism" threatens the initiative's proposed investment fund — to be administered by the Inter-American Development Bank — whose purpose is to help attract more capital to Latin America and the Caribbean.

For the proposed $1.5 billion fund, the United States would contribute $500 million. The plan envisions Europe and Japan putting up another $500 million each.

But the Europeans and Japanese are not electing to participate. Their reaction so far to the fund, says a senior official here, is "cold."

Not only are they apparently annoyed by the administration's lack of advance consultation with them on the proposal, but they resent U.S. resistance to their quest for a greater role in the Inter-American Bank.

Meanwhile, the very idea of an investment fund provokes skepticism. U.S. congressmen, among others, question its need. Could not the World Bank or Inter-American Bank lend from existing resources, they ask.

Mr. Brady, who says the administration thought "long and hard" about it, argues that a special fund will "highlight" the importance of open investment policies.

Yet, without European and Japanese contributions, the administration — if Congress approves the fund — may wind up with what it is trying to avoid: a perception in Latin America that Washington is "dictating" investment policy from "on high."

Mr. Feinberg is advising Congress to approve money for the fund only if Europe and Japan contribute — a reasonable suggestion.

The Enterprise for the Americas Initiative's trade policy plank is especially elusive. Latin America has reacted enthusiastically to President Bush's goal of hemispheric free trade, but how and when this would be forged is anybody's guess.

The potential for disillusionment in Latin America is great.

To improve the hemisphere's free trade chances, Mr. Feinberg suggests an "Americas Commission" to coordinate the exchange of trade policy information, examine trade policy impact and, eventually, to set the guidelines and provide the forum for hemispheric trade negotiations.

The Enterprise for the Americas Initiative may indeed help advance the hemisphere's welfare. But key to it is more multilateralism, involving not only Europe and Japan but the hemisphere's own member countries as well.

Richard Lawrence is senior correspondent for The Journal of Commerce in Washington.

STATEMENT OF
AMBASSADOR CARLA A. HILLS
U.S. TRADE REPRESENTATIVE
BEFORE THE
SUBCOMMITTEE ON COMMERCE, CONSUMER PROTECTION AND COMPETITIVENESS
COMMITTEE ON ENERGY AND COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 20, 1991

Madam Chairman and members of the Subcommittee, I am pleased to appear before you today to discuss the proposed negotiation of a free trade agreement (FTA) between the United States and Mexico and the decision of the United States, Mexico and Canada to seek a North American Free Trade Agreement (NAFTA).

As President Bush noted in announcing this initiative, a NAFTA will link the U.S., Mexican and Canadian economies in bold and far-reaching ways. Eliminating trade and investment barriers among our nations will stimulate the dynamism of our economies, enhance the competitiveness of our businesses and farmers, and set a standard for trade liberalization for the hemisphere and the world.

I would like to review with you where we stand in the process with Mexico and Canada and look toward what we hope to accomplish in our initiative.

Mexico's Commitment to Open Trade Leads to Increased U.S. Exports

Consideration of the FTA initiative is possible because of a reorientation in Mexico away from statist, interventionist policies toward a market-oriented system. These changes started in 1986, when Mexico joined the General Agreement on Tariffs and Trade (GATT). They have continued with Mexico's unilateral policies of tearing down trade barriers, privatizing industry, and opening doors to foreign investment.

The opening in Mexico has had a dramatic impact on U.S. trade with Mexico. U.S. exports to Mexico have more than doubled, rising from $12.4 billion in 1986 to $28.4 billion in 1990. Although trade deficits primarily are determined by macroeconomic factors, the surge of U.S. exports to Mexico has contributed to a two-thirds cut in our bilateral trade deficit with Mexico, from $5 billion to $1.8 billion. In fact, excluding petroleum, we now enjoy a merchandise trade surplus of about $3 billion with Mexico.

Some examples of how this expanded trade with Mexico benefits our economy are the following:

- o Mexico is our third largest agricultural trading partner, with U.S. exports totalling over $2.5 billion last year.

- o U.S. exports of consumer goods have tripled from $1 billion to $3 billion; our capital goods exports have grown from $5 billion to roughly $9.5 billion.

  - -- U.S. exports of telecommunications equipment have more than doubled since 1986, with exports reaching about $1.2 billion last year.

  - -- Transportation equipment exports have almost tripled since 1986, rising from $1.3 billion to $3.8 billion.

  - -- Our surplus in paper products trade has grown from $207 million in 1986 to $709 million.

  - -- We now have a surplus in iron and steel trade with Mexico exceeding $300 million; in 1986, we ran a $12 million trade deficit. This switch occurred at the same time that Mexico received a substantial increase in its steel quota under the President's Steel Trade Program.

  - -- We also enjoy a textiles and apparel trade surplus. Four years ago, we had a deficit of $91 million.

In sum, Mexico has been the fastest growing major market for U.S. exports. U.S. sales to Mexico are double those to either Korea or Taiwan, three times those to Hong Kong, four times those to China, and five times those to Brazil.

Why an FTA?

Recent substantial export growth to Mexico has meant jobs for our workers and sales for our companies. Through an FTA, we can consolidate and build on the progress to date and expand opportunities available for our firms and our farmers. Further Mexican liberalizations on goods, services, and investment will stimulate Mexican growth and increase Mexico's demand for U.S.-produced goods and services. Consumers on both sides of the border will benefit as increased competition leads to greater efficiency and lower prices for traded goods. For example:

- o Mexico still has an average applied tariff of about 10 percent, compared to about 4 percent in the United States. Moreover, while Mexico's top applied tariff

rate is 20 percent, it has the legal right to raise its tariffs unilaterally to 50 percent, the rate bound under the GATT. An FTA would lock in a schedule to reduce and ultimately eliminate tariffs and other barriers to market access, creating new business opportunities for American exporters.

- In agriculture, a restrictive import licensing system still applies to about 40 percent of the value of U.S. agricultural exports to Mexico, including such commodities as grains, dairy products and certain fruits and vegetables. Licenses are granted or withheld in an arbitrary manner and often act as import bans. FTA talks would provide an avenue through which these restrictions might be dismantled.

- While Mexico has liberalized its investment regulations, much more could be done. We seek an open, nondiscriminatory investment environment in Mexico, free of performance requirements and investment restrictions that distort trade and investment flows. Investment is an issue we have agreed to address in our FTA negotiations.

- In services, we seek additional openings in many areas, including banking, securities, insurance and professional services. In these areas in particular, market entry is restricted, and in some sectors U.S. firms are totally denied access to the Mexican market. We could use the FTA negotiations to seek needed liberalization in these sectors.

With respect to intellectual property rights, we expect action even before FTA negotiations. In January 1990, Mexico announced a program to overhaul and modernize its patent and trademark regime. While the Salinas Administration introduced a new industrial property law in December 1990, this law was not enacted. Although we were disappointed that the law was not passed in 1990, given the assurances we have received from Mexico, I expect these laws to be enacted soon after the Mexican Congress reconvenes in April. We also have had indications that Mexico will modernize its copyright laws to protect producers of sound recordings and computer software.

Mexico must provide effective protection and enforcement of intellectual property rights, with reforms offering immediate commercial benefits to intellectual property rights holders. Embodying intellectual property rights protection in the FTA will make such reforms secure for Americans and Mexicans alike.

While the FTA will yield important benefits to the U.S. economy, we recognize the concerns in certain sectors over

increased competition from Mexico. We want to work with the Congress and the private sector to ensure that our negotiating objectives take these concerns into account.

Let me make clear that where there are sensitive areas, nothing we negotiate will be implemented overnight. Business, labor and agriculture on both sides of the border will need time to adjust. We will ensure that any agreement will be phased in over time and will provide an effective mechanism to protect against import surges.

In sum, the FTA would secure much of the liberalization that Mexico has conducted unilaterally and would provide avenues for additional liberalization. The FTA would be a catalyst for economic growth and development in Mexico and the United States. Both countries would obtain significant mutual benefits from increased trade, investment flows and jobs. The FTA would help strengthen the Mexican economy and create a firm foundation for Mexico's future economic growth. Lower trade barriers and faster economic growth in Mexico will spur U.S. exports and help the U.S. economy expand. Reduced barriers will improve the efficiency and productivity of U.S. and Mexican industries and enhance their competitiveness in international markets.

Mexico also is important as the cornerstone of a comprehensive Western Hemisphere policy. An FTA would be the first step toward President Bush's longer-term goal of hemispheric free trade. And Mexico's example of market-oriented economic reform is a significant role model for other countries in the region.

Finally, Mexico is a close neighbor and a good friend. There are extensive cultural, historical, familial and language ties that link us. Our two Presidents are committed personally to maintaining excellent relations based on mutual respect and cooperation.

Progress in the trade area will support and reinforce progress in our broader bilateral agenda with Mexico. Long before there was any talk about an FTA with Mexico or a North American FTA, the United States and Mexico were discussing and acting upon an extensive array of issues reaching far beyond trade.

Our countries share a common goal of an improved way of life, both economically and socially, for our peoples. Agencies such as the Environmental Protection Agency and the Departments of Justice, State, and Labor are working in their areas of expertise to promote our broader bilateral agenda. We have been working with Mexico to support and enhance its own efforts to address pressing social needs.

Progress in free trade negotiations with Mexico can stimulate progress in our broader agenda. Conversely, failure to advance in trade would undermine progress in other areas.

The Free Trade Agreement - First Steps

The Mexican government first broached the idea of a bilateral free trade agreement between the United States and Mexico about a year ago. Following some very preliminary discussions, last June, Presidents Bush and Salinas strongly endorsed the goal of a comprehensive free trade agreement between our countries. They directed the Mexican Commerce Secretary, Dr. Jaime Serra, and me to begin the preparatory work and consultations needed to start FTA negotiations and to report back to them as soon as practicable.

Following that announcement, the Administration held a series of meetings with Congress and the private sector, seeking advice on the idea of an FTA with Mexico. While there were some concerns, there was a good deal of interest in and support for negotiations.

Based on this preliminary work, in August Dr. Serra and I jointly recommended to the Presidents that the United States and Mexico formally initiate negotiations on a comprehensive, bilateral FTA. We agreed that an FTA should lead to the progressive elimination of impediments to trade in goods and services and to investment, as well as to the protection of intellectual property rights, and the establishment of fair and expeditious dispute settlement mechanisms.

Both Presidents welcomed this recommendation, and on August 21, President Salinas wrote to President Bush proposing that the United States and Mexico negotiate a free trade agreement, a step required under the fast-track provisions of the Omnibus Trade and Competitiveness Act of 1988. On September 25, in accordance with the 1988 Trade Act, President Bush wrote to the Chairmen of the Senate Finance and House Ways and Means Committees notifying them of his intent to negotiate an FTA with Mexico. President Bush also notified them in that letter of Canada's interest in participating in the FTA negotiations and our intent to consult trilaterally about that prospect.

This notification was the first step in the process toward negotiating an FTA under U.S. "fast-track" laws and procedures. It triggered the 60 legislative day clock, during which time the House Ways and Means Committee and the Senate Finance Committee could review our proposal and, if either Committee so chose, disapprove fast-track procedures for the negotiations.

Beyond Mexico - A North American Free Trade Agreement

In his letter of September 25 notifying on the Mexican initiative, President Bush noted that the Canadian government had expressed a strong interest in expanding the U.S.-Mexico talks into a three-way negotiation. The President welcomed the chance to work with Canada and Mexico toward this end and noted we would be exploring the possibilities for a trilateral negotiation.

Between September 25 and the end of January 1991, I met with my Mexican and Canadian counterparts three times, and my Deputy, Ambassador Julius L. Katz, met with his counterparts four times, to consider the issue of a trilateral negotiation. In addition, there were numerous meetings at the staff level to consider various aspects of a negotiation. We also consulted with the Congress and the private sector to seek advice on whether to proceed trilaterally.

Based on our work, the three governments decided to proceed with trilateral negotiations -- that is, to negotiate a North American Free Trade Area (NAFTA). The President so informed the Ways and Means and Finance Committees on February 5.

An agreement among the United States, Mexico and Canada would be a dramatic move forward. It would create an enormous free trade area, with 360 million producers and consumers and a total output of almost $6 trillion. Eliminating trade and investment barriers and achieving common rules among our countries will harness the energies and talents of three great nations, helping them to meet the global economic challenge. A NAFTA would be a bold step toward establishing free trade in the Western Hemisphere and would create a solid foundation for North American growth and prosperity into the 21st Century.

Our consultations have shown that all three governments have the will and determination to make these negotiations a success. In considering how a trilateral negotiation might take place, we have agreed that the negotiation will proceed along the same lines as originally agreed by the United States and Mexico. We have agreed that if, for any reasons, it proves unfeasible to reach a trilateral negotiation, the parties can proceed bilaterally.

Finally, both the United States and Canada agree that the trilateral negotiations will give us an opportunity to improve and expand the existing U.S.-Canada free trade agreement; the negotiations will not be a vehicle for retreating from the trade and investments disciplines or liberalization achieved in the U.S.-Canada FTA.

The time is right to pursue this negotiation. All three governments share a vision of a North America freed of barriers to trade and investment, where economic success is based on complementary competitive strengths. A North American FTA can

establish a model for broader hemispheric integration in the future.

The FTA - Next Steps

The 60 legislative day clock has expired with respect to our notification on Mexico. A similar notification with respect to Canada was sent to the Chairmen of the Committees on Ways and Means and Finance on February 5.

On March 1, the President requested extension of the whole of the fast track procedures for the consideration of implementing legislation with respect to trade agreements entered into after May 31, 1991, and before June 1, 1993. In his report to Congress, the President said he would use the fast track extension for such initiatives as the Uruguay Round, the proposed North American free trade agreement, and the pursuit of the trade objectives of the Enterprise for the Americas Initiative.

Fast track plays a critical role in our trade policy. It preserves the important role the Congress in shaping trade policy, ensures close cooperation between our trade negotiators and the Congress, and strengthens the hand of our negotiators in dealing with their foreign counterparts.

Clearly, extension of fast track is essential for our negotiations with Mexico and Canada. With the fast track extended, we would expect formal negotiations to begin sometime in late Spring.

As we have been doing since before the joint Presidential announcement last June, we will continue to consult and widely with this Committee and others in the Congress. We will continue to seek the advice of our statutory advisory groups from agriculture, industry, and labor, as well as others in the private sector with an interest in any such agreement. We also will consult with state and local governments. The best way to develop a trade agreement that benefits our nation and our people is through a partnership among the Congress, the private sector and the Administration.

Conclusion

At no time have the United States, Mexico and Canada jointly shared such a firm commitment to opening markets and expanding trade and investment. We should seize this opportunity and build a firm foundation for growth throughout North America into the 21st Century. We look forward to working with you as we take this opportunity and make it into the reality of free trade in North America.

TRADE

Democrats Weigh the Politics Of Battling Bush on Mexico

Traditional constituencies oppose policy, but is it the right issue for a fight?

Which Dick Gephardt looms over the Bush administration's plan to negotiate a free-trade agreement with Mexico? The one who ran for president by promising protection to farmers and blue-collar workers menaced by foreign competition? Or the House majority leader loyal to his party and its free-trade heritage?

The Missouri Democrat has not decided.

"Sure I want a Mexican trade treaty," Gephardt said recently, "but I'm not for negotiation of a treaty that doesn't recognize the legitimate rights of American workers and American jobs."

R. MICHAEL JENKINS

Ways and Means Chairman Rostenkowski greets Carla Hills at start of hearing on the fast track.

His caution illustrates the difficulty Democrats in Congress are having at forging a unified position on the Mexico negotiations: Rank-and-file opponents worried about jobs and environmental issues want an all-out effort to reject the administration's proposal to unite Mexico, the United States and Canada in a free-trade zone. But some Democratic leaders think this may not be the right moment — or even the right issue — for a battle with President Bush over trade, particularly when their party runs the risk of appearing protectionist.

"My inclination is to be supportive" of the administration, said Dan Rostenkowski, D-Ill., chairman of the House Ways and Means Committee, which has jurisdiction over trade. "But I see the storm brewing out there."

Breaking a Partnership?

Political barometers began fluctuating wildly when the administration on March 1 asked for a two-year extension of the so-called fast track procedure, which commits Congress to consider trade agreements quickly and bars amendments once they are submitted for approval. *(Box, p. 661)*

Without the fast track, U.S. officials say, the talks are doomed even before they begin, because Mexico would never agree to negotiate down trade and investment barriers, knowing that Congress could subsequently alter the terms to protect certain U.S. industries.

Most Democratic leaders — including Rostenkowski, House Speaker Thomas S. Foley, D-Wash., and Lloyd Bentsen, D-Texas, chairman of the Senate Finance Committee — have indicated support for granting the administration's request. In part, that reflects their free-trade instincts. In Bentsen's case, there is an element of political self-interest; the Mexico negotiations are highly popular in Texas.

But there is also a tradition — inspired by Congress' woeful attempt at setting trade policy with the 1930 Smoot-Hawley tariff — of granting the administration broad power to negotiate with foreign governments.

"The downside of not obtaining fast track is so steep that I can't bring myself to believe that Congress would destroy a partnership that has stood for 50 years," said U.S. Trade Representative Carla A. Hills in an interview.

But opponents say the fast track is more like a mugging than a partnership. "Fast track operates like a gun to our heads — no amendments, no reservations," said Sen. Ernest F. Hollings, D-S.C.

The Democratic leadership is being pressured by lawmakers, particularly in the House, to break with the president. Opponents' first choice would be to get Gephardt to lead the campaign against a fast-track extension, in hopes that his cachet on trade could overcome support for the administration's position among Kennedy-era free-traders, such as Rostenkowski and Foley.

Waiting for Gephardt

"It really depends on how high profile Gephardt wants to make it," says Rep. Terry L. Bruce, D-Ill., an opponent of the Mexico talks.

In his 1988 presidential campaign, Gephardt argued for a retaliatory trade posture and greater attention to the economic woes that he said the United States brings on itself by not being tough enough abroad. Those are themes that dovetail nicely with critics' arguments that free trade with low-wage Mexico will cost many low-skilled American workers their jobs, and that Mexico's lax enforcement of environmental laws will induce companies to locate there.

Unlike other members of the Democratic leadership, "Gephardt is more inclined to take an aggressive stance on this because it's more in line with his views," says a top leadership aide.

If Gephardt joins the attack, opponents say, it could transform what is now a procedural hurdle into a major political confrontation with the Bush administration over trade.

Gephardt's staff says no decision on strategy has been made and that it will rest on how forthcoming the administration is in dealing with congressional concerns about job loss and the environment.

There is also the question of whether opposing free trade with Mexico makes good politics for the Democratic Party — and for Gephardt personally. He is widely assumed to be interested in running for president again, and any campaign against Mexico would please a host of interests with close ties to Democrats — labor unions, farmers, environmentalists and human-rights groups — that want the administration to broaden its negotiating goals.

But, with Bush basking in postwar popularity, opposing him on trade is a dicey matter. "There is concern about

By David S. Cloud

On the Fast Track

The fast track is a special set of procedures that expedite congressional consideration of a bill implementing a trade agreement. Once an agreement is reached, the administration and Congress informally negotiate legislative language to implement it, after which the bill is formally introduced and the fast track kicks in.

The fast track provides that:

- Committees have 45 days to consider the bill; they cannot amend it.
- Each chamber must vote on the bill within 15 days after the committee deadline.
- A motion to proceed to the bill in either chamber must be acted on without delay or debate.
- Debate in each chamber is limited to 20 hours, and amendments are not in order. In the House, the time is divided equally between those who favor the bill and those who oppose it. In the Senate, debate time is divided equally between the majority and minority leaders.

whether this is the right issue to take [the administration] on with," said Byron L. Dorgan, D-N.D., sponsor of a House resolution to disapprove the fast-track extension. "The question is not only whether Gephardt plays a role, but how."

"Dick Gephardt has his agenda. He's testing issues for his presidential campaign," said Bill Gradison, R-Ohio. "But I'm at a loss to understand how the Democrats think there is political capital in opposing economic growth."

A majority vote in either the House or Senate is sufficient to deny the administration another two years of the fast track. But doing so would ripple far beyond Mexico. Because the procedure applies to all trade agreements, killing the fast track would probably doom not only the Mexico talks but also negotiations under way in Geneva to liberalize world trade by broadening the General Agreement on Tariffs and Trade (GATT) to include agriculture and other non-manufacturing industries, such as financial services.

"At bottom, this is a question of whether the president has the authority to negotiate," said Gradison, a member of Ways and Means.

Opponents of the Mexico talks do not intend a broadside against the president's negotiating authority. As a price for keeping the fast track intact for the GATT negotiations, they are hoping for a separate House vote on rejecting it for Mexico. If successful, that would kill the Mexico talks, administration officials say.

If the vote were simply on rejecting the fast track for all trade agreements, strategists say, support for continuing GATT would be strong enough to override the deep congressional misgivings about a free-trade pact with Mexico. "My political assessment is that we're better off not to mess with GATT," said Bruce, who is preparing a resolution to disapprove the fast track solely for Mexico.

The administration is clearly unwilling to sacrifice the Mexico talks to get GATT on the fast track. "Why a half a loaf, instead of a whole loaf?" asks Hills.

The same question is being asked by lawmakers who would like to kill the GATT talks. A GATT agreement — if there is one — will almost certainly require protected U.S industries such as textiles and agriculture to relinquish barriers that shield them from foreign competition.

The best shot for lawmakers sympathetic to these industries is to lock arms with opponents of a Mexico agreement to vote down the fast track.

Hollings introduced a resolution March 13 to kill the fast track. Dorgan introduced his measure in the House on March 6.

But as the administration has begun lobbying members, and opposition to the Mexico agreement has grown, rejecting the fast track altogether has lost some appeal. Hollings could muster only 14 cosponsors for his resolution; a similar resolution last year attracted 37 supporters.

Explaining the drop in cosponsors, Hollings said, "The Carla Hills bazaar opens, and she goes around to my colleagues and says, 'I will take care of you if you get off that resolution.'"

Democratic leaders who support a fast-track extension will be doing some dealing of their own in coming weeks to muster support. Danger seems to be greatest in the House, where the issue is how to best allay concern in the rank and file about Mexico. According to leadership aides, one possibility under consideration is a non-binding resolution expressing Congress' desire that a Mexico agreement include protections for displaced workers and for the environment.

If Rostenkowski does not have the votes for a blanket extension of the fast track, he is inclined to strip off Mexico and give opponents a separate floor vote on that. He does not want to go to the floor and lose. ■

WASHINGTON POST, March 22, 1991

Bill Richardson

Free Trade With Mexico, Sí!

A powerful and energetic coalition opposes the U.S.-Mexico free trade agreement. It has been strengthened by the legislative situation in Congress, where the administration seeks fast-track procedures for both the U.S.-Mexico agreement and the stalled Uruguay Round of negotiations on the General Agreement on Tariff and Trade (GATT). Under this procedure, only one vote would be necessary to grant authority for conducting both negotiations.

This has spawned a broad alliance of opposition groups ranging from labor, textile and environmental interests to those concerned about Mexico's internal political situation. Thus, a U.S. border state congressman well disposed to free trade with Mexico could end up voting against fast track because of his unhappiness about the administration's agricultural policy in the GATT round.

If, as he has stated, the president attaches personal importance to regional and global trade and the U.S.-Mexico FTA in particular, he needs to use some of his substantial political capital to sway Congress. A bipartisan coalition is going to be indispensable to the successful negotiation and approval of a free trade agreement with Mexico. So far, supporters of the agreement, including American business, have been deafeningly silent.

In addition, a special independent high-level negotiator should be appointed with sufficient national stature to assuage congressional concerns, particularly those in the Democratic majority. Ambassador Carla Hills and her negotiating team at the U.S. Trade Representative's office are understandably focused on the Uruguay negotiations. A special negotiator concentrating solely on the Mexican agreement, could strengthen the administration's ability to conclude effective trade talks while giving much-needed visibility to the Mexican agreement.

The administration needs to assure Congress that the United States and Mexico are seriously addressing issues raised by opponents, such as the dangers of wage disparities under a free trade agreement, working conditions in Mexico, illegal drug flow and the need for stricter environmental regulations in Mexico particularly compliance with clean-air standards at the border. These deliberations should not be tied to the free trade agreement itself, but they need to be the subject of bilateral discussions, obviously involving a variety of agencies such as the Department of Labor and the EPA, and be coordinated with the FTA negotiations.

Mexico is now announcing new environmental regulations for the *maquila* (twin assembly plant) industry, which will begin the process of defining and enforcing specific environmental laws. If the United States is serious about wanting a cleaner home, hemispheric and global environment, it should work for stronger environmental controls on both sides of the border.

Similarly some in the United States claim that a free trade agreement will exacerbate the flow of drugs into this country. The fact is that Mexico under President Carlos Salinas de Gortari greatly strengthened its cooperation with the United States on the drug front.

The Bush administration needs to develop a long-range strategy for free trade throughout the hemisphere. Caribbean countries are already concerned that a U.S.-Mexico FTA will jeopardize trade benefits obtained under the Caribbean Basin Initiative. Other Latin nations are viewing the proposed U.S.-Mexico trade connection jealously and suspiciously.

The positive consequences in concluding a free trade agreement with Mexico far exceed the negatives. There will be better access to a growing Mexican export market, a more reliable source of petroleum, increased American ownership of Mexican subsidiaries and other assets, and expanded access to parts and labor. Tangible political benefits include a potential reduction of Mexican immigration to the United States because of augmented economic activity as well as enhanced political stability in Mexico. Finally, with the evolution of trade blocs in Asia and Europe, the FTA assists the United States and the Western Hemisphere in effectively competing in an irreducibly altered commercial environment.

Should the fast-track authority be defeated in Congress, U.S.-Mexico relations in particular, and U.S. international economic policy in general, will be severely hampered. Unless the administration acts now, the war we have won on the Persian Gulf battlefields for a new world order will be eroded by a battle lost right here at home.

The writer is a Democratic representative from New Mexico.

Poverty Indices and Poverty Orderings: An Application to Mexico

by Nora Lustig

Brookings Discussion Papers Number 85, January 1991

Abstract

This paper uses Atkinson's and Foster and Shorrock's approach to generate poverty orderings for different population groups in Mexico. Following this approach, poverty is measured using a range of poverty lines valued from zero to an arbitrary maximum. The selected range of poverty lines includes those used in other Mexican studies. Poverty is estimated using three poverty measures: the head-count ratio, the normalized poverty gap, and the "distribution sensitive" Foster et al P_3 index. The latter two are estimated to increase the ranking potential beyond that given by the head-count ratio. For the comparisons undertaken here the head-count ratio yields an unambiguous ordering. The results show that individuals have a higher incidence of poverty than households, and that poverty among rural and agricultural households is unambiguously higher than poverty among urban and non-agricultural households. Also, poverty among agricultural households is unambiguously higher than poverty among rural households. The poverty estimates are compared with other available estimates based on the same data, and the same poverty lines. The differences turn out to be significant, and some explanation as to the reasons is provided. Finally, the contribution of rural/urban and agricultural/non-agricultural poverty to total poverty is calculated for a selected number of poverty lines. All estimates are based on the 1984 Income-Expenditure Survey.

PREPARED STATEMENT OF JAMES H. MICHEL
Assistant Administrator
Latin America and the Caribbean Bureau
Agency for International Development
before the
Subcommittee on Foreign Operations
Committee on Appropriations
U.S. House of Representatives
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Mr. Chairman, Members of the Committee, I appreciate the opportunity to discuss one of the most serious challenges facing the Western Hemisphere. The production, trafficking, and consumption of drugs affects every corner of the Hemisphere. It not only wreaks havoc on millions of lives and families who come in contact with illicit drugs, it threatens the ability of nations throughout the Hemisphere to attain stable, democratic societies and broadly-based economic growth.

As this Committee knows, in September of 1989 President Bush approved expanded narcotics-related military, economic, law enforcement, and intelligence assistance for Peru, Bolivia, and Colombia to support their counternarcotics efforts. The President's Andean Counterdrug Initiative focuses on these three countries because Bolivia and Peru produce approximately 90% of the coca leaf in the world and Colombia remains the predominant refiner of the world's supply of illicit cocaine.

The President's Initiative is a comprehensive one involving a number of departments and agencies in the U.S. Government, coordinated by the Director of the Office of National Drug Control Policy. A.I.D.'s primary role is to help strengthen legitimate economic activity and promote alternative development.

The Andean countries need to strengthen their legitimate economies in order to enable them to move away from economic dependence on cocaine. As part of President Bush's overall Andean Counterdrug Initiative, A.I.D. is requesting an additional $250 million in ESF resources for narcotics-related economic assistance.

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Narcotics-related Economic Assistance

The narcotics-related economic assistance will be used in a number of ways as outlined by the Declaration of Cartagena:

- o balance of payments assistance to finance productive imports and/or service of debt to the U.S. Government or international financial institutions;
- o alternative development in coca-growing areas and surrounding areas which have supplied permanent and seasonal migrants to the coca zones;
- o trade and investment/programs projects and policy reforms to produce alternative sources of jobs, income, and foreign exchange throughout the economy;
- o drug-awareness and information efforts to help mobilize public sentiment and political will against cocaine production and trafficking; and
- o improvements in the administration of justice and judicial security to enhance prospects for effective prosecution of drug traffickers.

By providing both macro-economic and alternative development assistance, A.I.D. seeks to offset the loss of foreign exchange inflows resulting from counterdrug activities, while helping to stimulate legitimate economic growth which will produce the jobs necessary to replace the drug-related ones. Alternatives must be available to the growing, producing, and processing illicit drugs.

The overall goal of the Andean Counterdrug Initiative is to disrupt and dismantle the multinational criminal organizations that support the production, processing, transportation, and distribution of cocaine to the United States and to other nations. It is only within this overall context that alternative development and income-substitution programs will have any chance of success. Sustained, vigorous law enforcement can successfully disrupt the coca market and lower the farm-gate price of coca leaf. Alternative economic opportunities then become viable.

But the corollary is true as well: it will be hard for Andean governments to sustain law enforcement and interdiction efforts without the availability of alternative economic opportunities for those individuals employed in the cultivation of cocaine, the vast majority of whom are poor.

Results of the Initiative to Date

While it is clear that A.I.D.'s efforts to strengthen legitimate economic activity and promote alternative development will be a long-term process, progress is already being made. Through some success in law enforcement and interdiction, the price of coca leaf fell significantly over the past year in Bolivia, from $100 per hundred pounds in the fall of 1989 to about $40 in early 1991. The price has been below or near the cost of production for nearly eight months.

As a result, for the first time there was a net reduction of coca cultivation in Bolivia of 2,600 hectares in 1990. Alternative crops are becoming more attractive. Recently, 16,000 pineapples were bought from Chapare Valley farmers and shipped to Buenos Aires, the first major non-coca shipment from that major coca production center in five years. More shipments of pineapple and bananas are expected this year. A.I.D. has been helping encourage the development of alternative crops by funding research on a number of crops such as cacao, coffee, tea, citris, pineapple, palm heart, rice, and non-traditionals such as spices and fragrances.

In the associated high valley communities where A.I.D. has been providing critical irrigation and agriculture assistance, few workers are migrating to the Chapare Valley. The A.I.D. assistance has allowed farmers to cultivate a second crop providing them additional income. The population in the Chapare has dropped dramatically. A recent study by the Bolivian Coca Eradication Directorate (DIRECO) estimates that the population in the Valley fell from 350,000-400,000 in May 1989 to approximately 200,000 today.

In Peru, the legacy of a severe economic crisis over the past few years, a serious security problem, poor infrastructure, and a lack of marketing facilities, all have hindered progress to date. However, in spite of these severe constraints, progress is being made. The price of coca has also fallen, though not as far as in Bolivia. The Fujimori Administration is beginning to implement their new Economic Recovery program, which has the potential to stop the economic slide and boost opportunities for alternative development.

A.I.D. research shows that there is a great potential for diversified agriculture in the Upper Huallaga Valley, Peru's principal coca growing area. Products such as rice, corn, plantains, cacao, cassava, citris, and coffee can be produced in the valley. Palm oil, tea, certain spices, and cattle are already being raised there.

During the six month period ending September 30, 1990, A.I.D. project workers in Peru planted 132 demonstration plots in different villages, distributed 23,300 kilograms of seeds to farmers, repaired and rehabilitated 53 kilometers of roads, and conducted 256 training courses.

Recognizing the need for short-term employment opportunities to help ease the transition from coca production, A.I.D. has supported a number of social emergency programs in Bolivia. This has resulted in employment for more than 100,000 laborers in short-term jobs in road maintenance and other community development projects. Many of these jobs were in the Chapare Valley. Fifty-four community projects such as water systems, community meeting halls, schools, and health posts, have been provided in communities where at least 30% of the farmers have eradicated coca.

In addition to economic assistance and alternative development and income generation, A.I.D. also is providing resources for narcotics education and prevention, administration of justice, and other democratic initiatives focused on the special challenge of drugs. For example, last year in Peru, drug education programs were implemented in 17 high schools, and 11,500 students received drug education through the Ministry of Health. The substantial increase in our administration of justice program for Colombia this year recognizes the priority need to strengthen the judicial system so that narco-traffickers can be brought to trial in Colombia's own courts.

Broadening Support Through Trade and Investment

The presidents of Colombia, Bolivia, and Peru and President Bush agreed to work together to combat illicit narcotics production, trafficking, and consumption at the Cartegena Summit. They also agreed that one of the most useful ways to do so was to help the Andean countries open up trade. Through liberalized trade and investment relations under the Andean Trade Initiative and the Enterprise for the Americas Initiative, the U.S. can help generate alternative sources of jobs, income, and foreign exchange throughout the economy. Economic incentives are needed to replace the unfortunately lucrative narcotics trade.

The Andean countries also want to work together to dismantle barriers to greater intra-regional trade relations. Expanded trade should not only be with the United States, but also with other countries in the region and the world. Part of A.I.D.'s strategy for the narcotics-related assistance is to enable the Andean countries to capitalize on a more open trading system.

A.I.D. also is attaching high priority to involving the local private sector in mobilizing investments that will provide jobs and new sources of income to those formerly dependent on drug production and processing. This includes commercial credit institutions, agribusinesses, farm supply companies, and private transportation, marketing and storage enterprises. In both Peru and Bolivia, the legitimate private sector has expressed its concern about being overwhelmed by the resources of drug traffickers, and its interest in helping develop legitimate enterprises.

A team lead by Ambassador Edwin Corr has just completed a report on how the United States can strengthen its cooperation with the Andean countries on agricultural export issues. A.I.D. is working closely with U.S. Department of Agriculture and the U.S. Trade Representative's Office to develop a plan of action for implementing the Corr Report recommendations. Those recommendations include obtaining quick passage of the Andean Trade Preference legislation, providing phytosanitary and zoosanitary assistance, assuring funding for A.I.D. export and investment promotion projects, addressing infrastructure problems, and providing investment incentives.

Other Programs in Latin America

Because the effects of illicit drugs are not limited to the Andean countries, A.I.D. has narcotics awareness and education programs in ten Latin American and Caribbean countries. These projects help develop a recognition of the dimensions of the problems caused by drug production, trafficking and use. They help build a domestic constituency supporting more aggressive enforcement measures along with greater cooperation with the United States.

Activities are carried out primarily by private organizations at the community level, calling attention to the corruption, economic, and social threat that drugs can bring. I believe that the success of these activities can be measured by the increasing acceptance by Latin American leaders and a growing segment of the public, of the fact that illicit narcotics are not just a problem for the United States, but also profoundly affects their societies.

A.I.D. will also continue with its administration of justice and other democratic initiatives focused on the special challenge of drugs. The application of the rule of laws needs to be strengthened. A.I.D.'s programs focus primarily on judicial training, court administration, and improving access to justice.

In conclusion, we understand that $250 million in A.I.D. funds alone will not solve the drug problem. All of the other pieces need to fall into place. Sound economic polices need to be in place to create jobs, income and foreign exchange. Reliable markets need to be in place for non-traditional products of alternative income systems. Political commitment needs to be in place to move vigorously against drug trafficking. Law enforcement needs to be in place to bring major traffickers to justice. Local police and military forces need to be in place to deal with insurgent groups which control drug producing areas or impede effective drug enforcement work. Security forces need to be in place to protect senior political, police, military, and judicial officials so that they will not be intimidated in performing their jobs. And demand for drugs must be curtailed, particularly in the United States.

None of these changes can occur overnight. A coca-dependent economy cannot quickly be transformed into a broadly-based legitimate economy. It will take a long-term commitment by all the governments in the region, including our own. It will take a concerted effort by all societies to create a climate that makes drug use unacceptable and unattractive. It will take the willingness of businesses and investors to take risks to provide alternative jobs and new sources of income. And it will take the willingness of thousands farmers and processors of coca to seek alternative means to providing for their families a decent living.

Mr. Chairman, I look forward to answering your questions. Thank you.

The Washington Times WEDNESDAY, FEBRUARY 6, 1991 / PAGE G3

WESLEY SMITH

Down an uncertain path in Peru

Latin America's most ruthless guerrillas, the Sendero Luminoso, or Shining Path, are preaching a new ideology to Peruvian peasants.

The Sendero guerrillas are still devout communists, but the gold chains, rings and watches they now wear over their fatigues tout a philosophy called "narcopopulism," a radical Latin American version of the Robin Hood saga. In this violent fairy tale, drug-traffickers are heroes who take from the rich (Americans who buy cocaine), and give to the poor (peasants who sell coca leaves to the traffickers). The drug trade gave birth to narcopopulism in the remote jungles of Bolivia, Peru and Colombia, but now the movement threatens to strangle Peru's democracy and defeat U.S. drug interdiction in Latin America.

Peruvian economist Hernando de Soto has devised a revolutionary plan to destroy narcopopulism with the same weapon that has made it a multibillion-dollar industry — the free market. He says the only way to win the war on drugs is to deny the drug generals their foot soldiers: the more than 200,000 peasant families who grow coca — from which cocaine is produced — in the vast jungles east of the Andes.

Unlike many previous Marxist movements in Latin America, narcopopulism is not occurring on the fringes. The guerrillas serve as liaisons between the peasants and the drug barons, who buy legitimacy by supporting national soccer teams and development projects in poor neighborhoods. At the same time, coca growing brings Peru $1 billion in foreign currency, about a third of its total in legal exports.

The way to undermine the drug trade is to free up legitimate markets now strangled by government regulation, Mr. de Soto says.

There is, of course, a dark side. As in the United States, drug-trafficking in Latin America is controlled by violent crime syndicates — people who are willing to murder, kidnap and wage war to ensure the survival of their industry. Human rights groups documented 3,000 politically motivated disappearances and murders in 1989. In the first three months of 1990, there were 700 political killings alone (half attributed to government forces, the other half to the narcopopulists).

Mr. de Soto's economic plan would destroy drug-trafficking (and with it narcopopulism) by turning the twisted success of the drug entrepreneurs on its head. "There is only one free market in Peru," Mr. de Soto says, "and that is in the production and processing of cocaine."

To grow coca and process it into cocaine, Peru's peasants do not need to obtain permits, bribe government officials or wade through years of bureaucratic red tape — like they do to operate other businesses.

"It's a highly efficient entrepreneurial system," Mr. de Soto says.

The way to undermine the drug trade is to free up legitimate markets now strangled by government regulation, Mr. de Soto says. Studies show that pound for pound, crops such as coffee and macadamia nuts could be at least as profitable as coca growing for most farmers. His thesis is this: If farmers can earn a living legitimately, and are penalized for growing coca, they will not grow coca.

But Peruvians "are actually prevented from making a living legally because they have no title to their land, no access to credit and no access to markets where they can sell the goods they grow," Mr. de Soto says.

Nothing short of an economic revolution can save Peru, which now grows more than one-half of the world's coca. In 1989, inflation hit 2,700 percent, and President Alberto Fujimori's austerity program has raised the price of food 500 percent to 1,000 percent. (In America, that inflation rate would put bread at $25 a loaf.)

A quintessential pragmatist, Mr. de Soto understands there is more to the drug trade than economics. Counterinsurgency and police action are vital to prevent drug-traffickers and guerrillas from destroying the program through economic sabotage and intimidation. Since the military and police often cooperate with the traffickers, however, Mr. de Soto and Mr. Fujimori propose an entirely new security and military command under civilian control — one that will fail without U.S. help.

In March, the Congress will likely "decertify" Peru — and thus deny it international loans — for its perceived lack of commitment to the drug war. This would be a serious mistake. The traffickers and Sendero would feast on Peru's weakened, and internationally isolated, political and military institutions.

But certification alone will be a hollow victory unless the United States puts its resources behind the Peruvian program — that Mr. de Soto predicts could reduce national coca production by 70 percent or more.

If Washington does not fight alongside the Peruvians now, it may be forced to fight later without them.

Wesley Smith is a Latin American policy analyst at the Heritage Foundation.

The War in the Andes: The Military Role in U.S. International Drug Policy

by Coletta Youngers
Washington Office on Latin America, Conference Paper Number 36
1990

Abstract

The Bush administration prioritized the drug issue within overall U.S. foreign policy objectives and institutionalized a fundamentally military approach to the "war on drugs." As a result of the Andean Initiative, presented to the nation on Sept. 5, 1989, the Andean region is now the primary recipient of military aid to Latin America, and the U.S. military has taken on an integral role in the implementation of U.S. international drug policy. The Pentagon's drug plan calls for the U.S. military to provide intelligence and strategic planning for the Andean nation's military forces, which would be assigned the task of actually carrying out the counternarcotics operations. However, the underlying assumption that Andean militaries will be allies in the U.S. war on drugs is dubious at best. U.S. assistance to Andean military forces will have no impact on drug production, but will exacerbate political violence, particularly in Peru and Colombia, where military forces are battling entrenched insurgencies. Assistance to those militaries will lend direct U.S. support to the two most violent counterinsurgency campaigns in the hemisphere today. It also provides ammunition to the region's insurgencies, which have effectively utilized U.S.-backed antinarcotics programs to gain the support of local populations. Finally, U.S. international drug policy strengthens the hand of the Andean militaries and reinforces attitudes that military forces are better qualified than civilian authorities in maintaining public order. Thus, the policy may undermine the very processes of democratization in the region that the U.S. government claims to be supporting.

USAID News
Agency for International Development
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Contact: Kelly J. Presta
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USAID ANNOUNCES $82 MILLION IN ECONOMIC ASSISTANCE TO HAITI

The U.S. Agency for International Development (USAID) today announced $82 million in economic assistance to support Haiti's transition to democracy.

"Haiti has just become the region's newest democracy with the inauguration of Jean-Bertrand Aristide as the first freely elected president in Haiti's 187-year history," noted Jim Michel, assistant administrator for Latin America and the Caribbean.

The FY 1991 assistance will fund a broad range of programs, including health, nutrition, business development, education, agriculture and preservation of natural resources.

A major aim of the assistance is to help Haiti, the least-developed country in the Western Hemisphere, to strengthen the democratic process and promote private sector-led growth. Special emphasis will be placed on improving public and private democratic institutions which respond to the needs of the Haitian people, with a strong role for private voluntary organizations.

The $82 million represents a significant increase over the $54 million provided in FY 1990. Funding levels for FY 1992 are expected to continue to reflect increased United States emphasis on U.S.-Haitian relations.

(more)

"The election of President Aristide represents the passing of an era for the people of Haiti," Michel said. "It means that the opportunities of freedom and democracy are at hand. We will be working closely with the new government to assist in the continued development of their country and democratic institutions."

USAID is the U.S. government agency that administers $7.2 billion in economic and humanitarian assistance in more than 80 countries worldwide.

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WASHINGTON TIMES, February 18, 1991

MICHAEL WILSON

Will aid reap bitter fruit?

As Nicaragua celebrates its first year of democratic government this month, Haiti joins the ranks of democracies in the Western Hemisphere. Predictably, the United States has just announced its decision to send $82 million in aid to ease Haiti's transition to multiparty rule and spur economic growth.

But U.S. assistance — like that to the Nicaraguan Sandinistas in 1979 — may help produce the bitter fruit of political dictatorship and economic misery that ravaged Nicaragua for more than a decade.

Newly elected President Jean-Bertrand Aristide may be just the man to establish a communist dictatorship in Haiti. A lifelong leftist, Father Aristide became a Roman Catholic priest and was later ousted from the Salesian Order of the Roman Catholic Church as a revolutionary.

Father Aristide blames the United States for Haiti's economic troubles, and his platform calls for the redistribution of wealth from rich to poor — already stirring panic among property owners and business leaders. This is a familiar tune in Latin America. Under Sandinista rule, most Nicaraguan landowners had their property seized, and those who didn't were harassed by the government.

Despite winning internationally observed elections, the Aristide government now seems to be taking the first steps toward establishing a left-wing dictatorship. For example, although Port au Prince and Havana have never had diplomatic relations, members of Fidel Castro's communist Politburo were present at Father Aristide's inauguration earlier this month.

Meanwhile, Father Aristide's party, the FNCD, is sending "young volunteers" to Cuba for political training. What does his government hope to learn from Castro's model of one party rule? The Sandinistas, it should be recalled, also were quick to ship thousands of youths to Cuba's political indoctrination camps.

Finally, FNCD leaders are creating neighborhood militia called "vigilance committees" to mobilize against Haiti's political opposition, the press and business interests. The committees, patterned after those in Cuba, seem to walk hand in hand with leftist brutality. Such groups formed the nexus of Sandinista support in Nicaragua.

Jean-Bertrand Aristide

As a result, government-sponsored street violence is growing in Haiti. Aristide supporters have lynched and burned dozens of people since the election.

This may be only the start of the violence. Father Aristide recently ordered that 165 former government officials, including interim President Ertha Pascal-Trouillot, not be allowed to leave Haiti for one month. Is a purge in the making? We don't know, but the government has called for the destruction of all remnants of the family dictatorship of Francois and Jean-Claude Duvalier.

With this as the political backdrop to Haiti, Washington should postpone releasing any financial assistance until Father Aristide proves that he will support democracy and human rights. If he is unwilling to do so, the Bush administration must make clear to him that returning to political and economic repression carries with it a price. This can be done by:

- Imposing a trade embargo on Haiti. The United States now imports about $400 million in goods from Haiti, with exports valued at approximately $480 million. A freeze on trade would help pressure the government to adopt free-market reforms.
- Encouraging Caribbean and European nations, such as Venezuela and France, to isolate Father Aristide and suspend trade and financial help to Haiti. There is precedence for such cooperation, since both Venezuela and France have helped to promote democracy in Haiti.
- And assisting pro-democratic parties in Haiti. Working through the National Endowment for Democracy, the United States could provide training and assistance to truly democratic forces, such as the National Alliance for Democracy and Progress.

The United States must not repeat the mistakes made in Nicaragua by giving another leader the breathing space he needs to crush his enemies and institutionalize political tyranny.

Michael Wilson is a Latin American policy analyst with the Heritage Foundation.

THE CHRISTIAN SCIENCE MONITOR Wednesday, January 16, 1991

Haiti: Avoid The Statist Model

By Henry F. Carey

HAITI'S president-elect, the Rev. Jean-Bertrand Aristide, might well look to Mauritius for guidance. The economy of that Indian Ocean island has boomed since it dropped socialism for capitalism.

But Aristide, a self-described socialist, looks favorably upon the impressive education and health system of his neighbor Cuba. Like Mauritius and Haiti, Cuba overinvested in sugar and can no longer afford its achievements now that the Soviet subsidies are ending. Aristide would be wise to visit both islands and compare.

During the presidential campaign, Aristide hinted he'd respect the Haitian private sector, and eschewed some of his rhetoric against the U.S. (the "devil incarnate") and foreign enterprise.

Yet, his economic platform argues for statist, protectionist, and populist initiatives. Aristide may be planning a post-Berlin Wall socialism for the most impoverished country in the hemisphere.

Aristide must contend with corrupt and inefficient state ministries and enterprises, a largely mulatto business elite that is totally uninterested in the mostly indigent, illiterate black masses, gross underemployment, and a new phenomenon of 35 percent inflation. Urban migration has spawned some horrific slums, the worst of which possibly has no rival anywhere.

Aristide certainly has an overwhelming personal mandate to exercise leadership and enjoys an absolute majority of the Senate and a *de facto* majority in the House of Deputies. [illegible] Aristide will doubtless be Haiti's first honest ruler.

Without government experience, Aristide makes his proposals sound as if they are risk- and cost-free, which they are not. He is faced with many unhappy choices about whom he will have to disappoint. Aristide will lose more than a halo.

His populist camp has contradictions between those complaining about the high cost of living and those seeking protection from much cheaper imports. If Aristide proposes price controls, there will be a scarcity of basic goods.

Aristide was supported in his campaign by an "unholy alliance" of self-styled progressives advocating national economic self-sufficiency and protected industrialists like Antoine Izmery and the Association of National Producers.

Aristide proposes war on contraband, the sign of a sick economy. Contraband is the peasant's entrepreneurial response to Haiti's monopolistic prices. The real enemies are predatory, Duvalierist trade practices like licenses, tariffs, duties, and quotas. They only serve Duvalierists that collect bribes and the military that takes fees on illegal imports that the poor need.

Aristide also wants to shut down secondary, provincial ports not beholden to the corrupt customs House. These cheap, but illegal imports have been a lifeline for many poor Haitians.

Port closings would cause a depression in many regions based on efficient foreign commerce. Gonaives, Haiti's most radical city, which probably voted at least 70 percent for Aristide, would become a ghost town. An additional irony would be that Aristide could only stop contraband by using the army.

Worst, Aristide wants to build the inefficient kleptocratic state by nationalizing more industries, creating state banks, and forcing private ones to lend. Sounds economically disastrous.

Gerard Pierre-Charles and Aristide used to criticize Minister de la Tour when he closed some of the state monopolies, which were overcharging Haiti's poor consumers, such as 30 cents a pound from the Darbonne Sugar Mill in Leogane when the world price was only 10 cents a pound. Now the world price of flour is about $12, but the Haitian Minoterie flour mill charges $20-50.

Yet Aristide's charismatic leadership might also engender the kind of public-private cooperation in which Haiti's government has never been interested. Former Social Affairs Minister Claudette Werleigh noted, "With Aristide in charge, Haitians can start working again for the public good, something they have not been allowed to do before."

What Aristide should do is get his government out of flour and sugar and into education and health. Invest in public education that will create thousands of jobs instead of ironically preserving basic parts of the Duvalierist economic system.

■ *Henry F. Carey is writing a book on elections in five countries.*

EDITORIAL RESEARCH REPORTS

DEBATE OVER PUERTO RICO'S POLITICAL STATUS

by Patrick G. Marshall

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Puerto Rico's three political parties have united in calling for a vote on the island's future relationship with the United States. At the moment, islanders are closely divided over whether to continue the current commonwealth status or to opt for statehood, with only a small minority favoring complete independence. The U.S. Congress also is divided on the issue, however, and lawmakers may not give the islanders the chance to vote — a possibility many Puerto Ricans say would be intolerable.

After more than 92 years of living under U.S. domination, Puerto Rico may at last have a chance to decide whether it wants to become an independent country, enter the Union as the 51st state, or continue its current "commonwealth" status. The decision will not be an easy one for Puerto Ricans, for each status carries with it certain advantages and disadvantages.

Under commonwealth status, Puerto Ricans are U.S. citizens, but the island has no senators or voting representatives in Congress and islanders cannot vote in presidential elections. Puerto Rico also does not receive the same level or variety of social welfare programs as the states, although the federal government does give the island some money. On the other hand, commonwealth status carries benefits, too: Puerto Ricans are not required to pay federal income taxes, and companies establishing businesses on the island are given federal tax incentives that they could not receive in a state.

If Puerto Rico were to become a state, it would gain political power in Congress, and poor Puerto Ri-

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cans would qualify for many federal welfare benefits they cannot now receive. At the same time, however, they would have to pay income taxes, and the island would lose its corporate tax incentives, which could harm the economy.

Independence, the third option, would be emotionally gratifying to most Puerto Ricans, and it would give the island more flexibility in making trade arrangements with other countries. But it would mean the end of most of the subsidies currently provided by the United States — and an end to even the limited social welfare benefits that poor Puerto Ricans now receive.

Puerto Ricans are divided over which status would be best, but they are at one in their resentment over their continuing lack of power to decide the issue for themselves. Every president since Harry S Truman has conceded the right of Puerto Ricans to do so, but in spite of public plebiscites and diplomatic pleadings, legislation that would give Puerto Ricans control over their own destinies has yet to make it through Congress.

Legislators came close last year. The House passed a bill that would have provided funds for a referendum in Puerto Rico on the island's status and would have required Congress to take some action on the results of the referendum. In the Senate, however, a referendum bill was allowed to die in the commotion surrounding Congress' last-minute wrangling over a federal budget.

New bills were introduced in both houses early this year, and their respective sponsors have pledged to try to iron out the not inconsiderable differences between the two pieces of legislation so that an effective vote on Puerto Rico's status can finally be taken. Though many in Congress expect an uphill battle, an unexpected victory took place when the three Puerto Rican political parties issued a unified call for a referendum in November 1989. This agreement between Puerto Rican parties, says a staff member of a congressional committee that deals with the issue, has elevated the idea of a status referendum from a pipe dream to a potential reality. "That's always been tougher than the United States getting together on a process," says the staff member, who asked not to be identified.

The divisions within Puerto Rico over the island's relationship with the United States are clearly reflected in the political landscape. In fact, the three political parties are themselves largely defined by their respective positions on the status question. In recent years, the governorship has passed back and forth between the Popular Democratic Party, which currently occupies the governor's house and which favors commonwealth status, and the New Progressive Party, which favors statehood. The party that favors independence — appropriately named the Puerto Rican Independence Party — has been unable to gather more than about 5 percent of the vote in island elections.

But even though Puerto Ricans elected a pro-commonwealth governor — Rafael Hernández Colón — in 1988, that does not mean they would favor commonwealth status in a referendum today. Opinion polls in January 1989 showed Puerto Ricans favoring commonwealth status by 52 percent to 41 percent, but a more recent poll in 1990 showed islanders favoring statehood 48 percent to 42 percent.[1]

Commonweath vs. Statehood

This table compares estimates of what the federal government would pay Puerto Rico (in billions of dollars) for certain entitlement programs under its current commonwealth status or under statehood. The increased costs under statehood are broken down by program.

Programs	1992	1993	1994	1995
Outlays under commonwealth	**1.8**	**1.9**	**2.0**	**2.1**
Outlays under statehood	**3.5**	**3.7**	**4.6**	**5.1**
Increases under statehood				
Food stamps	0.7	0.7	0.7	0.7
Medicaid	0.9	1.0	1.1	1.2
Medicare	0.1	0.1	0.1	0.1
Supplemental Security Income	0	0	0.6	0.9
Aid to Families with Dependent Children	- †	- †	0.1	0.1
Foster Care	- †	- †	- †	- †
Total increase	1.7	1.8	2.6	3.0

† *Less than $50 million*

Source: Congressional Budget Office, Potential Economic Impacts of Changes in Puerto Rico's Status Under S. 712, *April 1990*

On the surface, the most significant issues in the status debate seem to be economic. "Voters anywhere tend to vote their pocketbooks, and we're being shortchanged terribly in economic and social benefits," says Roland I. Perusse, a professor of U.S.-Puerto Rican relations at the Inter-American University of Puerto Rico.

Indeed, though Puerto Rico receives generous tax benefits and more than $6 billion a year from the U.S. government, the standard of living on the island, along with federal funds directed to the island, lags well behind states on the mainland. Federal expenditures in Puerto Rico amounted to only $1,893 per person in 1988, which put Puerto Rico at the bottom of the list. Of the 50 states, the lowest in terms of per capita expenditures was Michigan, which received an average of $2,543 per person in 1988.[2] Social welfare programs such as Aid to Families with Dependent Children (AFDC), food stamps and Medicare, are available in Puerto Rico, but expenditures are arbitrarily capped at levels far below those on the mainland.

"It's legal, geographical discrimination," complains Perusse, an advocate of statehood. And such disparity is all the harder to take, he says, when Puerto Ricans are expected to fight in America's wars. "There's a terrible feeling in Puerto Rico right now, especially in light of the Persian Gulf where we're expected to fight as equals with U.S. citizens, that we don't get equal benefits."

The reduced aid is certainly not a result of there being less need in Puerto Rico. While the island's standard of living is generally much higher than that found in nearby Caribbean countries, Puerto Ricans are

Major Dates in Puerto Rican History

1493 Columbus lands in Puerto Rico, an island inhabited by about 100,000 Indians.

1508 Ponce de León arrives with Spanish settlers and becomes the island's first governor.

1897 Spain grants autonomy to Puerto Rico.

1898 On July 25, U.S. troops land in Puerto Rico. At the conclusion of the brief Spanish-American War, Spain cedes Puerto Rico to the United States. Puerto Rico becomes a U.S. colony.

1917 President Woodrow Wilson signs the Jones Act, which grants U.S. citizenship to Puerto Ricans and sets up a bicameral legislature for the island.

1947 Congress passes the Elective Governor Act, and Luis Muñoz Marín becomes the island's first elected governor.

1948 Operation Bootstrap, a combination of federal and Puerto Rican tax incentives for industries setting up in Puerto Rico, is initiated.

1952 With the adoption of a new constitution by Puerto Rico, and its ratification by the U.S. Congress, the island becomes a commonwealth of the United States.

1953 The United Nations, taking note of Puerto Rico's popular vote in favor of becoming a U.S. commonwealth, removes the island from its list of non-self-governing territories.

1978 The U.N. Decolonization Committee calls for the transfer of all political power to Puerto Rico.

far worse off than residents in the 50 U.S. states. According to a recent Congressional Research Service study, the incidence of poverty was six times greater in Puerto Rico in 1979, the most recent year for which figures were available, than in the United States as a whole.[3] Although more recent figures are not available, there does not seem to have been significant improvement over the past decade.

It is the promise of getting the additional benefits that would come with statehood, many analysts say, that has given new popularity to the idea of joining the Union. "If you're aged, blind and disabled in Puerto Rico, you get about one-eleventh what you'd get under Supplemental Security Income," says a congressional staff aide. "You could be a dedicated *independendista*, and if you knew your income was going to go up elevenfold, there'd be a lot of incentive to vote for statehood."

But the issue of Puerto Rico's future goes much deeper than just a question of economic benefits. "It's not simply a fill-your-belly situation like a lot of people would paint it," says Perusse. Rather, he says, "it's civil rights that's probably the basic consideration right now."

Supporters of independence, who argue that Puerto Ricans are first of all Puerto Ricans and Latin Americans — with their own cultural and national identity — and only secondarily Americans, couldn't agree more. Manuel Rodríguez, electoral commissioner of the Puerto Rican Independence Party, warns that any attempt to absorb Puerto Rico into the United States through statehood would "create a problem for the United States by having a national minority — not an ethnic minority, but a national minority — with a thriving culture, language, literature and art that is distinctly different."

Indeed, it is these cultural and political issues that propel most Puerto Ricans' opinions about the island's ultimate status. "Probably 90 percent of Puerto Ricans will vote for one of those statuses" based on non-economic considerations, says a staff member of a Senate committee with jurisdiction over Puerto Rican issues. But ironically, because those who favor statehood and those who favor commonwealth are so close in numbers, it is the economic issues that will provide the swing vote and decide the issue. "Welfare payments are probably the single largest factor in making people switch their votes," the Senate staff member says. "We're really only talking about a 10 percent swing vote, and a fair percentage of those are poor people, and they'll vote for whatever gives them the most money."

Whether they have a chance to vote, however, depends on what happens in Congress, and the Popular Democratic Party has insisted that Congress reach some sort of consensus by Feb. 19. If no agreement is reached by that date, the party says it will withdraw its support. Even if consensus is reached by Feb. 19, many of those involved in the debate say final legislation would have to be enacted by early July for there to be enough time to prepare for a referendum next fall. If legislation is enacted any later, the referendum would probably be delayed until 1993 so that it wouldn't interfere with Puerto Rico's 1992 gubernatorial election.

From colony to commonwealth

Ever since control over Puerto Rico was transferred to the United States at the end of the Spanish-American War in 1898, the island's relationship with the mainland has been an ambiguous one. Ruled as a colony after the war, Puerto Rico achieved a distinction unusual for colonies when, in 1917, the island's residents were given U.S. citizenship. Then in 1952 Puerto Rico, with the agreement of the U.S. Congress, adopted its own constitution. The colony thus be-

came a commonwealth, an "autonomous body politic" in permanent union with the United States. In practical terms, the new agreement meant that the island had self-government for purely local matters, but all policies relating to defense and trade were set by the federal government in Washington.

As a commonwealth, Puerto Rico was "connected to" but not "part of" the United States. Citizens on the island could vote in presidential primaries, but not the final event. They could receive Medicare, food stamps and Social Security retirement benefits, but not at the same levels as mainlanders. Yet, if a Puerto Rican were to move to the mainland — and, as citizens, they have the right to do so — they could receive full welfare benefits and even vote for senators and presidents.

This political "limbo" has been matched by the development of a similar economic limbo. Historically, the primary economic feature of Puerto Rico's relationship with the mainland has been the island's transformation from a poor but largely self-sustaining economy into one somewhat richer but heavily dependent on the United States.

When the first U.S. governor arrived on the island in 1900, Puerto Rico's economy was almost exclusively agricultural. The country was, however, far from a pastoral paradise. Only 10 percent of the island consists of fertile flatlands that are well-suited to agriculture. An additional 25 percent of the island consists of uplands that are marginally arable. Thus, even before the turn of the century the island was not able to supply all of its own food directly, but had to rely on the export of specialty crops, mostly to Europe. Sugar, tobacco and coffee were the cash crops most suitable to the island's soil, and the best land was devoted to their cultivation. Production of domestic food crops — primarily by peasant landholders — took place on the marginal uplands.

The early period of the American occupation was relatively benign, with significant improvements in health care, sanitation and education. Apart from improvements in roads and other public infrastructure, however, the federal government did not get actively involved in restructuring the Puerto Rican economy. Nevertheless, increased access to the huge, and geographically close, American markets encouraged structural changes in the economy. A boom in exports of tobacco, coffee and, especially, sugar led to immense profits for the small elite that owned the rich agricultural land. Export crops came to predominate the island's economy, and as the sugar, tobacco and coffee farms grew in size and power, peasants were increasingly forced off their small farms.

The year 1947 marked a major turning point for Puerto Rico. That was the year that Operation Bootstrap — a program of industrial development based on tax incentives and tariff rebates — was inaugurated. Rewritten in 1976 as Section 936 of the Internal Revenue Code, the federal tax incentives introduced in the late 1940s featured rebates to mainland U.S. companies establishing facilities in Puerto Rico roughly in the amount of the taxes on earnings produced on the island.* At the same time, Puerto Rico itself also introduced nearly complete exemptions on local taxes for corporations moving to the island.

The incentives, combined with the low wages prevalent on the island, produced dramatic results. By 1952, about 70 new plants a year were opening in Puerto Rico. From being the site of only 82 industrial plants in 1952, Puerto Rico became the home for more than 1,000 such plants by 1970. "Rapid economic growth in the 1950s and 1960s became the hallmark of Operation Bootstrap," writes economist James L. Dietz. Between 1950 and 1960 Puerto Rico's gross national product (GNP), the total value of its annual output of goods and services, more than doubled, with the rate of annual growth averaging 8.3 percent. "From 1960 to 1970," Dietz writes, "GNP growth was even more spectacular, at an average rate of 10.8 percent per year, thus nearly tripling over the decade."[4]

At least at first, it was labor-intensive industries that were most attracted to the island. In 1949, for example, production of textiles and clothing accounted for 13.7 percent of all manufacturing companies. In 1954, the figure was 19.5 percent and by 1967 it was 19.9 percent. These manufacturers "were attracted to Puerto Rico not just by tax exemption," Dietz notes, "but also by the possibility of being able to pay wages substantially below mainland rates and by the absence of such risks as political instability that are often associated with foreign operations."[5]

Shaky economy, divided society

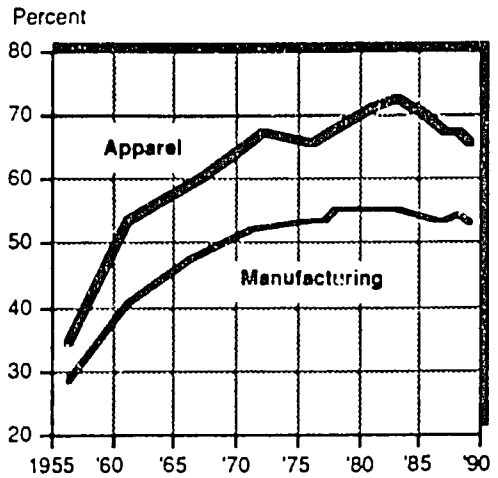
Just behind Puerto Rico's observable economic success, however, there were some serious problems. While Operation Bootstrap accomplished a shift from an agriculture-dominated economy to a diversified one, it was an unbalanced development. To begin with, the fruits of Puerto Rico's boom were not evenly distributed. Even as a small middle class was developing, huge ghettos sprang up in the capital city of San Juan. Thousands of Puerto Ricans, unable to find enough work on the island, began emigrating to the mainland in search of opportunity. Perhaps the most distressing trend to government planners was that companies that came to Puerto Rico were not stimulating the kind of broad-based development that was hoped for.

Planners had hoped that Operation Bootstrap

*Section 936 of the Internal Revenue Code provides to qualifying companies a tax credit equal to the federal income taxes they would otherwise owe on income from their activities in Puerto Rico. To qualify, a company must be incorporated in the United States and must earn at least 80 percent of its income from activities in U.S. territory, including Puerto Rico.

Lower Wages Helped Attract Industries

The graph below shows the hourly wages of manufacturing and apparel workers in Puerto Rico as a percentage of the wages of U.S. workers in those industries. Puerto Rican wages, while still significantly below wages on the mainland, rose dramatically in the 1960s and 1970s, but have leveled off in recent years. In the case of apparel workers, wages (as a percentage of wages on the mainland) have begun to decline.



Sources 1990 Statistical Abstract of the United States. *Office of the Resident Commissioner of Puerto Rico, Bureau of Labor Statistics*

companies would stimulate the creation of new spinoff businesses created to supply raw materials and semi-finished goods, and to distribute the output of the manufacturing companies. "What actually happened was quite different," Dietz writes. "The firms that located on the island were integrated into sourcing and distribution networks with other firms in the United States or other countries. They made no attempt to forge linkages within the island economy, nor were they motivated to do so by the government or its incentive package." [6]

To make matters worse, even the partial success of Operation Bootstrap — as measured in employment gains and the number of companies attracted to the island — has waned in recent years. The reason is that there have been significant reductions both in the tax and tariff advantages of doing business in Puerto Rico and in the wage advantage of using Puerto Rican workers.

In 1951, the effective tax on corporate profits on the mainland was 54.2 percent. Since facilities of qualifying companies paid virtually no taxes on earnings in Puerto Rico, those companies enjoyed a tax advantage of 54.2 percent. But federal corporate tax rates fell significantly in the early 1980s. In 1981 alone, the Economic Recovery Tax Act at one stroke reduced the rate to below 30 percent. At the same time, Puerto Rico was itself increasing the amount it taxed companies on earnings leaving Puerto Rico. In 1976, a 10 percent withholding tax on such earnings was imposed. In 1978, a 4.5 percent tax on earnings was imposed, a rate that was to rise every five years until a total of 20.25 percent was imposed after 20 years. By 1982, according to Puerto Rican economist Bertram P. Finn, the tax advantage for a corporation locating in Puerto Rico had eroded to only 20.42 percent.[7]

At the same time, Puerto Rican wages, while still significantly below prevalent wages on the mainland, have risen dramatically. The average manufacturing wage in Puerto Rico climbed from below 30 percent of U.S. wages in the early 1950s to about 55 percent in the late '80s. (*See graph*) This has, of course, further reduced the advantages to mainland companies of doing business in Puerto Rico.

Another blow to Puerto Rico's economy was the reduction of U.S. tariffs. Negotiations during the 1960s reduced U.S. tariffs across the board, and further reductions were made specifically for Caribbean countries under the Caribbean Basin Initiative of the early '80s, a U.S. program aimed at aiding the development of economies in the Caribbean.* Lower tariffs for Puerto Rico's Caribbean competitors meant that the island's privilege of exporting goods to the United States on a tariff-free basis was less important

The most noticeable result of these combined trends was a sharp reduction in economic growth rates. Where GNP growth exceeded 10 percent per year in the 1960s, in the late '70s and early '80s the economy grew at an annual rate of only 1.86 percent.[8] Since then, the growth rate has picked up slightly; it has grown at 3.6 percent since 1985.[9]

Economic Climate

Puerto Rico experienced strong economic growth in the 1950s and 1960s as a result of Operation Bootstrap, a combination of federal and Puerto Rican tax incentives begun in 1948. In the past two decades, however, the island's economy has grown more slowly and unemployment rates have risen.

Decade	Average annual growth rate of real GNP per capita	Average annual unemployment rate
1940s	4.0	N/A
1950s	4.7	14.3
1960s	5.5	11.5
1970s	1.6	15.5
1980s†	1.5	19.5

† *Data for the 1980s does not include 1990.*

Source Congressional Budget Office, Potential Economic Impacts of Changes in Puerto Rico's Status Under S. 712, *April 1990.*

But the island's economy has changed structurally as well. Where the combination of tax incentives and low wages previously favored labor-intensive industry, beginning in the late 1970s it was capital-intensive industries — most notably, pharmaceuticals and electronics — that were attracted to Puerto Rico. "These capital-intensive endeavors required low levels of employment and did very little to solve chronic unemployment," writes Luis Neves Falcon, a Puerto Rican sociologist. "Ironically, many of the highly skilled positions opened by the new transnational subsidiaries could not be filled from local manpower and the employees had to be imported." [10] What's more, many of the labor-intensive industries that had come to Puerto Rico in earlier years began to flee. According to a recent report by the Congressional Budget Office (CBO), apparel and shoe manufacturers have been leaving the island in recent years for countries with lower wage rates.[11]

Today, after more than 90 years of association with the United States, Puerto Rico remains essentially a

*For background, see "Caribbean Basin Revisited," *E.R.R.*, Feb. 1, 1985 (Vol. I, No. 5).

Third World country, underdeveloped economically and with more than 60 percent of its people living under the U.S. federal poverty line. By comparison, in the United States as a whole, less than 10 percent of the population lives below the poverty line.[12]

"Unemployment hasn't been below 14 percent in over 15 years," complains Manuel Rodríguez, electoral commissioner of the Puerto Rican Independence Party. Even more telling, says Rodríguez, is the labor participation rate — the percentage of people who could be working who actually have jobs. According to the CBO, the U.S. rate in 1987 was 65.6 percent. In Puerto Rico the rate was only 44 percent.[13] "With those figures you can figure that unemployment is really closer to 25 or 30 percent," Rodríguez says.

One result of these trends is a very heavy reliance on federal welfare programs. For example, about 43 percent of the population receives some form of federal nutritional aid, compared with about 8 percent on the mainland.[14]

Congress is deadlocked over procedures

Some analysts blame Puerto Rico's ambiguous political status for many of the island's economic problems. The relationship between Puerto Rico and the mainland has created an economy of dependency that has ill-served the island, argues Eric Negrón, an attorney and a tax adviser to the Puerto Rican Independence Party. "The main problem is that it's a structure almost exclusively reliant on just one single U.S. piece of legislation, Section 936 of the Internal Revenue Code," says Negrón. That reliance, he says, has resulted in an economy that is based on a handful of capital-intensive industries that actually employ few Puerto Ricans. At the same time, other U.S. laws tie the island's hands in dealing with other countries. "Japan, Canada, Germany have been interested in entering into tax agreements with Puerto Rico," says Negrón, "but have been prevented by the United States."

While each of the Puerto Rican parties has its own particular diagnosis for Puerto Rico's economic ills — and its own prescription for getting the patient back on its feet — it is the island's political relationship with the United States that is the focus of each party's analysis. And though each party bases its position on Puerto Rico's political status on cultural factors as well as economic factors, it is the economic issues that most clearly differentiate the parties.

And, as might be expected, support for each status option tends to be divided along socioeconomic class lines, though the fracture lines are far from rigid. Business people and members of the middle class are, analysts say, more likely than not to favor continuing commonwealth status. The poor and members of the lower-middle class, attracted by the inevitable increase in social welfare benefits, are more likely to favor statehood. As for independence, while it is an emotionally attractive option to many, political support is largely confined to the universities.

If Puerto Ricans are divided on the status issue, so is Congress.

Many analysts thought that Congress might be finally on the verge of putting the island's status to a vote last year. But the House and Senate were not able to reach agreement on legislation before the 101st Congress finally adjourned in October.

At least on the surface, the disagreement in Congress is not over what status is best for Puerto Ricans, but how best to put the matter to a vote. The House passed legislation in 1990 — HR 4765 — that would have appropriated $13.5 million to conduct a status referendum in Puerto Rico. The House bill, sponsored by Democrat Ron de Lugo, the non-voting delegate from the Virgin Islands, offered voters four options: statehood, independence, a new commonwealth arrangement or no change. If any of the choices received a majority vote in the referendum, HR 4765 committed Congress to considering legislation implementing that status on an expedited basis.

Though the full House passed HR 4765 on a voice vote last October, and though the bill had the support of all three Puerto Rican parties, it was not good enough for Sen. J. Bennett Johnston, D-La., chairman of the Senate Committee on Energy and Natural Resources and a longtime champion of Puerto Rican status legislation. "What the House bill does is to provide for a referendum in Puerto Rico whereby the people of Puerto Rico would be able to make a choice between statehood, enhanced commonwealth, and independence. But that choice would be under a one-word definition or, in the case of, I think they call it improved commonwealth, a two-word definition," Johnston told his colleagues on Oct. 10, the day the House legislation passed.[15] Without specific definitions of the statuses — what benefits and obligations would go with each — the voters would not know what they were voting for, Johnston argued.

Johnston's own bill — S 712 — provided just such definitions. In its more than 3,500 lines of text, S 712 attempted to specify in detail the consequences of each status. In the event of statehood, for example, not only were the welfare benefits and tax obligations laid out, but the bill specified how U.S. military lands on the island would be handled, how electoral laws would apply to the election of Puerto Rico's new senators and congressmen, and even which courts would handle disputes arising from the electoral process.

The legislation also went beyond simply explaining in detail what would happen if Puerto Ricans voted for a given status. Johnston's bill included provisions that made it "self-executing." If a majority of Puerto Ricans voted for, say, statehood, no further vote would be required in Congress. Puerto Rico would become a state

under the conditions contained in S 712.

"The senator believes that unless you give the definitions first, you may get the wrong vote," explains a Senate committee staff member. "The way the process works down there is that each of the three parties makes wild claims about what statehood and commonwealth are. You could very likely have a vote for either statehood or commonwealth which would come back to Congress and Congress would just say it's ridiculous. In other words, the outcome of the vote would be different if Congress told people upfront what Congress was willing to implement in terms of statehood or commonwealth."

Indeed, even with the definitions of statehood spelled out in such detail in Johnston's bill, Senate staff members say that many misunderstandings remain. "Statehooders have the impression that they would still have some identity internationally even as a state, that they'd be able to be at the Olympics as their own team," says the committee staff member. "That's just not so. Also there's the impression that they'd still be able to set their quotas and tariffs on coffee. Obviously a state can't do that."

Though his Popular Democratic Party gave its support to the House bill, Gov. Rafael Hernández Colón agreed with much of Johnston's approach. "Congress has to express itself as to what each formula entails, and what transition schemes and measures are realistic and acceptable," Hernández said in a speech at Harvard University in April. "The people need to know what they are voting for, in order to make an intelligent choice. They need to know what to reasonably expect from each status option in terms of taxes, fiscal arrangements, trade, citizenship, language, social programs, Olympic representation, defense, transitional measures, and a wealth of related issues. For too long, myths and misconceptions have dominated the debate on political status in Puerto Rico, and it is about time that the people are told the truth, clearly and without reservations." [18]

Citing a referendum in 1967 in which Puerto Ricans voted for enhancing their commonwealth status only to have Congress take no action at all,* Hernández also endorsed the self-executing nature of S 712. "We cannot repeat the sad episode of the 1967 referendum, where the vote was overwhelmingly in favor of enhancing commonwealth status — more than 60 percent — yet Congress did not act."

In negotiations between the House and Senate last year, however, House members objected strongly to S 712's detailed definitions and its self-executing character. According to staff members, House leaders had two main problems with the detailed definitions in Johnston's bill. First, they felt it would be nearly impossible to get agreement on the definitions. Secondly, even if the legislature agreed on the definitions, they would be definitions that were created without the pressure of lobbyists, other than the Puerto Rican parties, and wouldn't likely stand up once those pressures came to bear.

"When you add the collective weight of all the companies — which now would rather see no bill or would rather see commonwealth prevail — if the decision is statehood and the companies know that it's going to be statehood, they might grandfather in for themselves all kinds of special deals, as every tax bill has, for companies that lose preferences," notes one House committee staff member. "Right now the Senate Finance Committee can make a very simple judgment about how Section 936 ought to be treated under statehood or independence. But that's in a situation where the committee is being told by the commonwealthers who control the government to shaft statehood, and where the companies are doing nothing to preserve their interest."

An additional problem with the definitions, some observers say, is that spelling out the consequences of each status tends to give undue weight to the short-term economic consequences of the choice. "It puts forward some goodies for the plebiscite," Del. de Lugo says of the Senate bill's treatment of the benefits that would go with statehood. As a result, voters would "not be looking at the overall long-term issue of what they're going to have to live with."

The only fair way to develop a political status, particularly with an area where the issue is as complicated as Puerto Rico, de Lugo says, "is where there's some process of bilateral negotiation between the people affected and the Congress." And that's something at least the House isn't willing to go through, he says, until the Puerto Rican people have decided which status they want to negotiate.

This year, de Lugo has stood his ground by reintroducing the very same bill the House passed last year. Sen. Johnston, on Jan. 23, introduced a revised version of his legislation — S 244. The major difference between S 244 and S 712 is that the new bill — though it contains the same lengthy, detailed explanations of each status option — is not self-executing. If S 244 were adopted, after Puerto Ricans selected a status, Congress would have to ratify the choice, and would have an opportunity to make changes in the implementing legislation. "The difference between the House and Senate bills has narrowed considerably," says a Senate staff member. "Structurally they're the same. The difference is in the length of definitions."

Key House members apparently disagree. "We argue that it's still self-executing," says a House staff analyst. "His bill is really a combination of three prospective implementing bills to the people of Puerto Rico. If you offer that in any seriousness to the people of Puerto Rico, then it's still self-executing, even if you don't say it's self-executing. Presumably, if

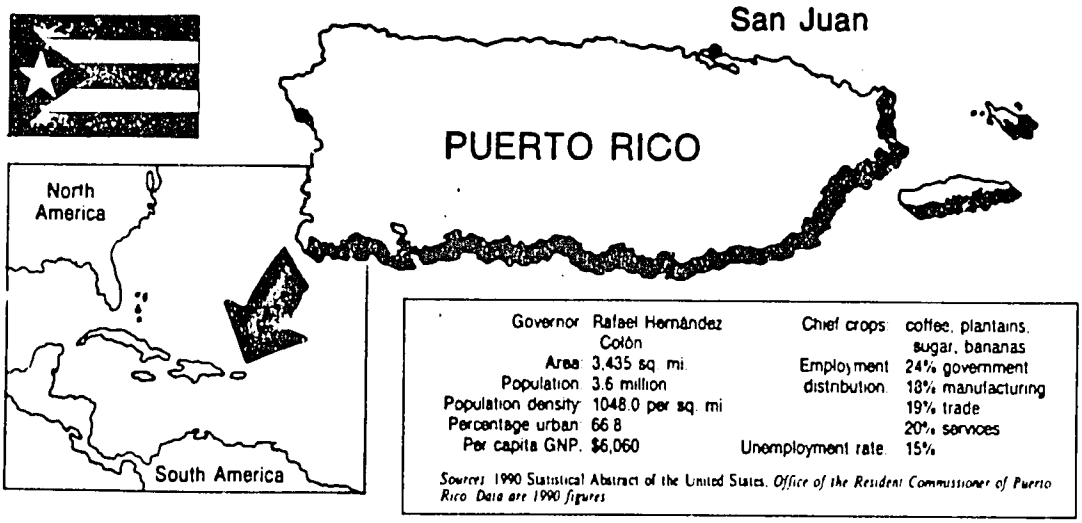
*One explanation for Congress' failure to respond to the referendum in Puerto Rico is that the Independence Party boycotted the vote, and the pro-statehood New Progressive Party also urged non-participation.

you're offering it to them with all these details, you've decided that it all makes sense." De Lugo agrees. "Detailed definitions are in fact binding on the Congress, and Congress is not ready to be bound at this time," he says.

Some legislators and staff members have argued — off the record — that there's more to the dispute between the House and Senate than simply a matter of procedure. Supporters of Johnston's bill have intimated that many House members — and possibly many senators — are against Puerto Rico becoming a state, though they'd rather not go on record saying so. Hence, there's a reluctance to make the legislation self-executing, and thereby putting the choice in Puerto Rico's hands.

Johnston says he would rather force the issue sooner rather than later. "If there's going to be a disappointment, it's a whole lot better to have it in advance of the vote," he says. "The worst thing we can do is to string these people along, have a congressionally mandated choice and then not deliver on their choice." But de Lugo contends that it's too early to force the issue. "I want to see the people of Puerto Rico given the opportunity to have this plebiscite," he says. Once the people have spoken, then Congress will respond. "And let's see how decisively they speak," de Lugo adds. "That goes into the equation, too, as to how Congress will respond."

Puerto Rico



Governor	Rafael Hernández Colón	Chief crops	coffee, plantains, sugar, bananas
Area	3,435 sq. mi.	Employment distribution	24% government
Population	3.6 million		18% manufacturing
Population density	1048.0 per sq. mi		19% trade
Percentage urban	66.8		20% services
Per capita GNP	$6,060	Unemployment rate	15%

Sources: 1990 Statistical Abstract of the United States. *Office of the Resident Commissioner of Puerto Rico. Data are 1990 figures.*

Statehood, commonwealth or independence?

Sen. Johnston's bills, with their detailed and lengthy definitions of each status, clearly demonstrate one thing: While some of the implications of the various status options for Puerto Rico are clear, a great many are not. In the process of writing S 712, many of the subtle but potentially explosive issues were brought to light.

Whether decisions on those issues are made before a status is selected, as Sen. Johnston would have it, or after, as Del. de Lugo would have it, the decisions will have to be faced. Even a clear choice by the Puerto Rican people in favor of continuing the current commonwealth status will probably not save legislators from having to deal with many of the intractable tradeoffs between sovereignty and dependency that represents the uncomfortable status quo for Puerto Ricans.

Statehood. If a vote were held today, the likely winner would be statehood. That is also the result that would entail the most dramatic and complex changes in the U.S.-Puerto Rican relationship.

Politically, statehood would mean a stronger political presence in Congress for Puerto Rico. Instead of merely having one non-voting representative (called the "resident commissioner") in the House, the island would send two senators and six or seven representatives to Congress. Political analysts seem to be in agreement that virtually all of those sent to Congress from Puerto Rico would be Democrats, which may explain what one Senate committee staff member describes as the "skittishness" of Senate Republicans toward the idea of Puerto Rican statehood.

Economically, one of the most dramatic effects of statehood would be huge increases in the amounts of social benefits islanders would receive. Currently, many of the welfare benefits Puerto Ricans receive are capped at levels significantly below those received by the states. Medicaid payments, for example, are only about one-tenth what they would be if Puerto Rico were a state. And islanders cannot participate in some programs — such as Supplemental Security Income (SSI) — at all.

While stressing that cost projections of entitlement programs like food stamps and unemployment involve a lot of guesswork — since they are so dependent on future economic conditions and on decisions by the Puerto Rican government — the Congressional Budget Office estimated in April 1990 that if Puerto Rico became a state, U.S. payments to the island would

increase by $1.7 billion in 1992, and as much as $3 billion in 1995.[17] The big-ticket items in the estimate were Supplemental Security Income ($900 million in 1995), Medicaid ($900 million over current payments in 1995) and food stamps ($700 million above current payments).

The benefit increases, as spelled out in detail last year in S 712, were so attractive that many critics, particularly advocates of commonwealth status, charged that Johnston's bill was "front-loaded" in favor of statehood. "This offer," said Gov. Rafael Hernández Colón in a speech last April, "has already had an impact on the Puerto Rican electorate. For the first time in history, statehood has come out ahead in the polls in Puerto Rico, having gained 15 points since the . . . bill was reported out." Commonwealthers argued that the same improvements in welfare benefits should be provided under the commonwealth option in order to "level the playing field."

Instead, in an attempt to keep both the statehood and commonwealth options "revenue neutral" — that is, incurring no net cost to the federal Treasury — Sen. Johnston in his new bill has reduced the benefits available to Puerto Ricans under statehood. Specifically, the legislation calls for SSI payments to Puerto Rico to be phased in gradually to a maximum of only about 75 percent of what islanders would otherwise qualify for by the time Puerto Rico actually became a state, five years after the referendum. Similarly, food-stamp benefits to Puerto Ricans would be capped at levels well below those available on the mainland.

Some observers, however, have described these measures as nothing more than a ruse to placate advocates of commonwealth and to maintain the illusion that statehood would not be a drain on the federal Treasury. To begin with, it's not at all clear that, once Puerto Rico became a state, islanders could be limited to lower benefits than citizens of other states — particularly in light of Article IV of the Constitution, which holds that "the citizens of each state shall be entitled to all privileges and immunities of citizens in the several states." Even a Senate analyst concedes that such discrimination is "probably unconstitutional," and would not stand up to a court challenge.

Another major change that would come with statehood is the repeal of the special tax benefits to U.S. corporations setting up businesses in Puerto Rico under Section 936 of the Internal Revenue Code. According to the Treasury Department, in 1989, tax benefits received by Section 936 companies amounted to about $1.9 billion.[18]

The effect of losing Section 936 on Puerto Rico is uncertain. Commonwealth advocates, citing the 160,000 employed directly by Section 936 companies, along with an additional estimated 150,000 jobs dependent on those companies, claim that removal of federal tax exemption would be disastrous. "About three-fourths of all manufacturing employment in Puerto Rico is in 936 companies," Jaime B. Fuster, Puerto Rico's non-voting representative to Congress, told the Senate Finance Committee in 1989. "Moreover, 936 deposits in Puerto Rican banks have allowed the financial sector to grow and thrive to unprecedented levels. Together manufacturing and banking and the indirect service jobs they create account for close to a third of the island's labor force. . . . The elimination of federal tax exemption will inevitably result in a sharp decline of the existing manufacturing and financial structure with the loss of thousands of jobs and the removal of hundreds of millions of dollars from the productive sector of the island's economy."

Statehood advocates, on the other hand, claim that commonwealthers' estimates are grossly inflated. "The industries that take advantage of 936 now aren't labor intensive. They're all mechanized," says political scientist Roland Perusse. "You'll pick up story after story by responsible reporters that talk about the 936 program being the economic cornerstone of Puerto Rico. It *was*, in the 1950s and '60s, no question it was." In the 1980s, however, this assertion "wasn't justified any more. And it's even less justified now in the 1990s."

The truth probably lies somewhere in between. The Congressional Budget Office has put the effects of losing Section 936 at about 1 or 2 percentage points of annual economic growth in Puerto Rico. "Increased federal transfers (less new taxes) would initially stimulate the economy," reads the CBO report. "Later, however, statehood could lead to slower economic growth than would be expected under commonwealth status because statehood could reduce the growth of investment, output and employment in the manufacturing sector."[19]

In claiming overall revenue neutrality for the statehood option, however, Johnston's new bill relies on the full $2 billion of new taxes from Section 936 companies to balance the increase in expenditures on entitlement programs. The crucial assumption is that repeal of Section 936 would not affect Puerto Rico's economy. Under the circumstances, most experts think that is unlikely.

At the same time as Puerto Rico would lose Section 936, individual Puerto Ricans would lose their exemption from federal income taxes. Though loss of the exemption could have a notable impact on Puerto Ricans' standard of living, and could add to those seeking federal entitlement benefits, given the low per capita incomes on the island, experts do not expect income taxes to add noticeably to federal revenue.

In the long run, statehooders argue that the tradeoffs of statehood would work in favor of Puerto Ricans by attracting more businesses and tourism. "Statehood will immediately make the island a more attractive place for investment," writes Hector Ricardo Ramos Díaz, a former secretary of consumer affairs in Puerto Rico. "In the business world potential profit is seen as a direct function of risk. The political security and stability offered by statehood will reduce the perceived risk of investing in Puerto

Rico. Statehood will reduce the current demand of corporations for a larger return on investments in Puerto Rico than on the mainland."[20]

Commonwealth advocates paint a dramatically different picture. "Puerto Rico would be the first state to come into the Union as a dependent of the federal Treasury," Gov. Hernández argued last year. "After our transition to statehood, our economy almost certainly would decline. The federal government would have to spend $2 billion to $3 billion annually in excess of revenue generated in federal taxes paid by Puerto Ricans to provide the safety net necessary to make up for a devastated economy."[21]

Commonwealth. If Puerto Ricans choose the commonwealth option, very little would change. In fact, it is possible that nothing at all would change, though both the House and Senate bills have proposed the inclusion of an "enhanced" commonwealth status among the options.

The House bill does not actually specify what a new commonwealth relationship would entail. The Senate bill goes into great detail as to what enhancing the commonwealth relationship would involve. The major features that would change would be the increase in nutritional aid for the poor to match that which the island would enjoy under statehood. The new commonwealth would also receive increased grants for the aged, blind and disabled, to a level equal to what would be available to the island under statehood with SSI. In both cases, the benefits would increase significantly over their current levels, but would still not match the levels of benefits received by the states.

The only other significant change of commonwealth status under Johnston's bill would be the creation of an "office of liaison" to the Senate. Unlike the island's non-voting representative to the House, however, the liaison to the Senate would not be allowed to serve and vote on committees.

As a commonwealth, Puerto Rico would still not receive the same level of benefits in other entitlement programs, such as AFDC and Medicaid, as it would as a state. On the other hand, commonwealth advocates argue that for the foreseeable future the island would retain the benefits of Section 936 tax exemptions. But there's no guarantee as to how long such exemptions would be kept in place. As statehood advocates point out, Section 936 benefits are totally at the discretion of Congress. And the Treasury Department has several times in recent years suggested scrapping the program as too costly.

Commonwealth advocates have also argued for a host of other changes, including Puerto Rican control over negotiating air routes, shipping rates, and other trade arrangements with foreign countries. In fact, Gov. Hernández has even argued that legislation "should make clear that the sovereignty of the commonwealth government would be unequivocal."[22] It is considered unlikely that Congress would grant many if any of these changes, and certainly not "unequivocal sovereignty." "The commonwealth people are *independendistas* in their hearts," says one congressional analyst. "But they can't have their cake and eat it too. Commonwealth status does not carry the same sovereignty as independence."

Independence. Virtually everyone, including most of those who favor independence, agree that this

Puerto Rican Extremists

The great majority of Puerto Ricans who favor independence have pursued that goal peacefully through the political process. But over the years extremists have resorted to terrorist acts.

The most dramatic incident occurred in 1950, when two Puerto Rican nationalists attempted to assassinate President Harry S Truman at Blair House in Washington, where the president was living while the White House underwent repairs. Truman was not harmed, but a Secret Service agent and one of the would-be assassins were killed in a gun battle during the attempt. The other assailant was captured.

Then in 1954, shortly after Puerto Rico became a commonwealth, four militant nationalists sprayed the floor of the House of Representatives with gunfire, wounding five members of Congress.

Over the next 25 years, terrorist activities were limited, with only an occasional pipe-bombing or sniping at U.S. military facilities on the island. In 1979, however, a series of incidents began that demonstrated greater organization on the part of extremists. The two most dangerous groups were the *Macheteros*, which operated primarily in Puerto Rico, and the Armed Forces for National Liberation (FALN), which operated mostly on the mainland.

The *Macheteros* claimed credit for a 1979 ambush on a U.S. Navy bus in Puerto Rico that left two sailors dead and eight wounded. In January 1981, the group followed up with an attack on Muñoz Marín Air Base in San Juan, destroying nine National Guard fighter planes. In November 1981, the *Macheteros* blew up two electric power stations on the island.

In September 1983, in an effort to get funds for future operations, members of the *Macheteros* pulled off a $7 million robbery of a Wells Fargo armored car in Hartford, Conn. One of the most recent actions by the *Macheteros* was a bazooka attack on a U.S. District Court building in San Juan in August 1985. Shortly after that attack, the FBI arrested a dozen *Macheteros*, effectively neutralizing the group at least for the time being.

In 1984, the FBI described the FALN as the most dangerous terrorist group in the United States. Though the FALN did not undertake the sort of high-profile actions executed by the *Macheteros*, the group was responsible for more than 150 attacks between 1973 and 1987, which involved six deaths and more than $3.5 million in property damage.†

There have been no significant terrorist actions related to Puerto Rico in the past few years.

† *Roland I. Perusse*, The United States and Puerto Rico: Decolonization Options and Prospects *(1987), p. 30*

option doesn't have much chance of winning a plebiscite in the near future. The main appeal of independence to Puerto Ricans is emotional, not economic. And though many Puerto Ricans yearn for the dignity that would come with independence, the "stomach issues" for the time being dictate against such a choice.

Analysts are generally agreed that, over the short-term at least, independence would mean a serious dislocation for Puerto Rico's economy. The island would lose most of the federal entitlement benefits it has received, with the exception only of pension and Social Security benefits. And it is almost certain that Congress would also revoke the Section 936 tax exemptions.

What's more, the CBO notes that as an independent country, Puerto Rico would face interest rates on funds borrowed abroad "at least two percentage points higher than those it would pay under other status options." Some analysts, the report adds, "are concerned that, like other developing countries in Latin America and elsewhere, the island might suffer from a shortage of external capital."[23] Also, while those Puerto Ricans currently holding U.S. citizenship would likely be allowed to retain it, those born in Puerto Rico after independence would not be U.S. citizens. Accordingly, the "escape valve" of migration to the mainland United States would be abruptly shut off.

It is likely, however, that if and when Puerto Ricans opt for independence, the United States would provide some transition assistance. The Senate bill, in fact, provides for payment to an independent Puerto Rico of block grants equal in value to the social benefits currently provided, including Medicare, for a period of 10 years. Also, tax benefits, including Section 936, would not be ended abruptly, but would be phased out over a five-year period. Even if the United States were to decide to provide all the transition benefits listed in the Senate bill, however, the Congressional Budget Office projects that by 1995 the U.S. Treasury would be better off by about $1.6 billion than it would if Puerto Rico retained its current status.[24]

Despite the loss of U.S. funds, however, the Puerto Rican Independence Party argues that independence is the only long-term answer for Puerto Rico, economically as well as politically. "The relationship between Puerto Rico and the United States has created an inordinate amount of economic dependency," says Manuel Rodríguez, electoral commissioner of the Independence Party. "It's an economic dependency that, while it does help in some ways to at least raise the level of the standard of living, it doesn't solve the problem structurally. You might have someone who lives on food stamps for $800 a month, or someone living on food stamps for $1,500 a month. But they're still living on food stamps."

The key change that needs to be made in the Puerto Rican economy, says Eric Negrón, tax adviser to the Independence Party, is to diversify it. "Under independence, our aim is to diversify our sources of capital and our export markets," he says. "About 30 percent of our imports are from European countries. We have very few products going to those markets. That's partly due to the fact that we don't have the favorable access we could get if we were considered a developing nation in terms of not only market access to those otherwise sheltered markets, but also in terms of permitting companies from those areas to come into Puerto Rico without having to face taxes both here and at home." Until Puerto Rico is independent, he adds, the island cannot negotiate such arrangements with foreign countries.

Those who favor independence don't see the loss of Section 936 benefits as an insurmountable hurdle. The kinds of companies that have been attracted to Puerto Rico by Section 936 in recent years have been the kind "that do not engage in the research and development stages of production here," Negrón says. "Here they just do their assembly portions, which yields a lot of nominal value added. They strive to operate here without incurring expenses. They don't have incentive to employ many people, or to engage in labor-intensive activities whatsoever. So we have a system that is not conducive to very high employment." Unfortunately, high-employment industries are just what Puerto Rico needs.

Negrón believes that as an independent country Puerto Rico could continue to attract foreign investment, and it would at the same time be better able to direct what sorts of industries it brought to the island. CBO analysts agree that such a scenario is at least feasible. "As an independent nation, Puerto Rico might offset, wholly or in part, the loss of tax incentives for direct investment by U.S. corporations and, in addition, may be better able to attract direct investment from third countries than the island has in the past," the CBO report notes.[25]

Most analysts agree, however, that even if Puerto Rico were eventually to prosper under independence, there would likely be a lengthy period of painful adjustment to go through first.

From Cold War to Cold Shoulder? The US in Central America

BY PETER HAKIM

In the past ten years, the United States has provided the nations of Central America over $10 billion in economic and military assistance, excluding covert aid and the costs associated with the US invasion of Panama. With a population of approximately 25 million, the region emerged in the 1980s as the third largest per capita recipient of US aid in the world. Indeed, per capita aid to Central America was nearly 20 times greater than that allocated to the rest of Latin America and the Caribbean.

This massive aid transfer—four times larger in real terms than that of the 1970s—was prompted by the perceived security threat from an increased Soviet and Cuban presence in Central America and concern about the spread of communist rule in the region. US largesse followed the intensification of the guerrilla challenge in El Salvador and the rise to power of the Marxist Sandinista leadership in Nicaragua; it was accompanied by support for the Contra insurgency to overthrow the Sandinista government.

No one in Washington today considers US security to be at risk in Central America. Sandinista rule in Nicaragua ended in April 1990, when the US-backed government of Violetta Chamorro took office following its unexpected electoral victory. The Faribundo Marti National Liberation Front (FMLN) guerrillas in El Salvador, although retaining the capacity to wage a damaging war, have little chance of defeating the Salvadoran army. Any negotiated settlement of the conflict is almost certain to leave the US-supported government of Alfredo Cristiani in place. With the end of the Cold War, neither the Soviet Union nor Cuba currently presents any credible challenge to US interests in Central America, nor are they likely to do so in the future.

The achievement of these US strategic objectives, however, has not produced significant progress toward stable democratic rule in Central America, nor has it led to a revival of the region's economies—two other declared goals of the United States. Clearly, the nations of Central America have taken some important steps toward democracy. In 1980, only one country in the region, Costa Rica, was governed by an elected civilian president; today all five countries as well as Panama are democracies for the first time ever. The practice of democracy is, however, precarious in each nation—again excepting Costa Rica—and still truncated in most.

In Guatemala and El Salvador, not all political views are represented at the polls, nor has democracy extended far beyond periodic elections. Human rights abuses remain endemic, political participation and public expression are still restricted, and military forces define the extent of civilian authority. In Nicaragua and Honduras, armies also escape full civilian control and exert major influence on government policy.

Throughout the region, democratic institutions remain fragile and under siege: legislatures and judicial systems lack the autonomy, stature and competence to carry out their functions; political parties are weak and unrepresentative; and citizens have little voice in government policy. Social and political stability are jeopardized by sharp class disparities, and in some places by bitter ethnic divisions.

Economically, Central America was devastated in the 1980s. Despite large-scale US aid, overall per capita income in the region has plummeted by 17 percent in the past ten years—nearly twice the drop suffered by Latin America as a whole. Every nation of Central America has lost ground.

In Costa Rica, income fell by 5 percent; in Honduras, Guatemala, El Salvador and Panama, by 14 to 18 percent; and in Nicaragua, ravaged by war, natural disasters, a US economic embargo and disastrous economic policy, by more than 40 percent. Unemployment and underemployment soared to record levels throughout the region, while poverty, malnutrition and inequality worsened.

Nowhere will the task of economic reconstruction be easy or rapid. Every country faces daunting obstacles to recovery. Billions of dollars will be needed to repair the physical damage caused by war in Nicaragua, El Salvador and Guatemala, and by the invasion of Panama. Fighting and destruction continue in El Salvador and Guatemala. As long as strife persists in Central America, it will be difficult for any country in the region to fully return to normal business activity and attract significant foreign and domestic investment.

Armies throughout Central America remain bloated, diverting enormous sums from economically productive activities. Given each country's concern about military balance, the downscaling of military expenditures will require region-wide agreements, which will be possible only when peace is established throughout Central America. Even Costa Rica, which dismantled its armed forces some 40 years ago, felt impelled to expand its national police force in the 1980s.

The countries of Central America have yet to begin to confront the costs involved in resettling and reintegrating the 2.5 million people who have been displaced from their homes. This is some 10 percent of the region's population, equivalent to about 25 million people for a country the size of the United States. Even if Central America did not face these terrible legacies of war, its economic outlook would remain bleak. With the exceptions of Nicaragua and Costa Rica, Central

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American debt burdens are not large by Latin American standards, but they are a significant drain on the region's desperately short supply of foreign exchange and will continue to undermine confidence in the region's economic future.

While Costa Rica has obtained substantial relief from the United States under the Brady Plan for debt reduction, all of the other countries are in arrears to their commercial creditors, and several to international lending agencies, thereby cutting off new loans from these agencies. Because their debt obligations to the United States are so large, the Central American countries are potentially the main beneficiaries of the reductions in US bilateral debts proposed last June by President Bush in the Enterprise for the Americas Initiative. But gains for the region over the next several years are likely to be modest since most countries are now paying only a fraction of their interest obligations.

Central America's prospects for expanding foreign trade—which ultimately must be the main source of capital for debt repayment and for imports which are vital for production—are very uncertain. The region's export performance in the 1980s was dismal, although some improvement has occurred in the past few years. Only Costa Rica and Panama have managed any sizable export expansion in the past ten years; Guatemala, Nicaragua and El Salvador have all suffered dramatic declines, ranging from 17 to 47 percent.

The prices of Central America's traditional exports remain low in world markets, and the region has so far had only mixed success in promoting new export products. At the same time, every one of the countries is an importer of petroleum; every dollar increase in the world price of oil adds some $35 million a year to the region's import bill.

High rates of population growth and accelerating environmental deterioration are two other constraints on Central America's economic prospects. Fertility rates in the region have declined in the past 25 years, but they remain among the highest in Latin America—some 50 percent above the regional average, and almost triple those of the advanced industrialized countries. Population pressures coupled with wasteful economic exploitation are depleting Central America's natural resources; the region's forests, for example, are rapidly being uprooted, and soil erosion is widespread in rural areas. Few effective programs are in place to prevent the continuing destruction of these resources.

Finally, mass poverty and sharp inequalities of wealth and income stand in the way of Central America's economic recovery. Nearly half of the region's population is impoverished, lacking the resources to satisfy even the most basic necessities. As health and education standards decline, so does the productivity of Central America's work force. The ever-widening gap between the region's rich and poor is a persistent source of political and social friction and makes it difficult to design and implement consistent economic policies.

Most Central American countries have little hope of recovering soon from the devastating economic traumas of the past decade. The prospects even for gradual improvement depend on four conditions being met.

First, civil strife in El Salvador and Guatemala must come to an end. Although these two countries are suffering the most, economic progress in the entire region is frustrated by the climate of violence and political turmoil, the continuing flow of refugees and displaced persons and the costs of maintaining oversized armies. Neither conflict is likely to be resolved by force of arms. What hopes there are for peace rest with current UN-mediated negotiations. Even though no breakthroughs have yet been produced, the fact that the negotiations are continuing is an encouraging sign.

Second, the governments of Central America must pursue needed programs of economic reform. To varying degrees they are attempting to do so. They are seeking to curtail budget

Peter Hakim

deficits and to control inflation, trying to expand efforts by maintaining competitive exchange rates, lifting trade restrictions, allowing a greater role for markets in setting prices and encouraging private enterprise. If successful, these efforts at reform would lead to a more efficient use of the region's scarce economic resources and would help generate new savings and investment. These necessary changes, however, are difficult to implement and sustain. They face extensive political resistance almost everywhere. Additionally, capital shortfalls remain a roadblock, and the technical capacity for managing economic policy is in short supply in almost every country.

Third, the governments of the region must continue their efforts to strengthen regional economic cooperation. Central America's once vigorous common market became moribund in

the 1970s, and intra-regional trade has been limited ever since. The governments are now moving to rebuild that market; if they are successful, trade and regional economic competitiveness should increase. Yet trade among these poor, deficit-ridden countries cannot be a substitute for the expansion of exports outside the region.

Fourth, in the future Central America will need substantial international economic assistance to revive its economies. During the 1980s the United States was overwhelmingly the largest supplier of aid to Central America. Aside from the Soviet Union, which provided considerable military and economic assistance to Nicaragua, support from sources such as Japan, Europe and international financial institutions has been extremely limited.

US assistance to Central America began to expand significantly in the early 1980s as US relations with Nicaragua deteriorated and the insurgency in El Salvador intensified. The amounts grew steadily, reaching $800 million in 1984 (nearly four times the yearly average, in real terms, from 1975 to

Export crops of tobacco in Nicaragua.

1979). US support then jumped to $1.6 billion in 1985, following the report of the National Bipartisan Commission on Central America—the so-called Kissinger Commission—which called for an urgent and massive response to the crisis in Central America. Since then, US support has been about $1 billion a year, excluding a special supplemental allocation of $720 million for Panama and Nicaragua in 1990, following the ouster of Noriega and the electoral defeat of the Sandinistas.

There is no way to determine precisely the levels of international support that Central America will require to restore long-term growth to its economies. Calculations of the financing gap that such support must fill depend on a variety of assumptions about the region's ability to increase domestic savings and investment, its capacity to attract foreign investment and the return of flight capital, its trade prospects (estimates of which, in turn, depend on projections of world prices for Central America's exports and imports) and many other factors.

In a well-documented 1989 study, a private blue-ribbon panel—the International Commission for Central American Recovery and Development (the Sanford Commission)—concluded that the five countries of Central America, excluding Panama, required $2 billion a year in external capital inflow for a five-year period in addition to significant debt relief. Some five years earlier, the Kissinger Commission had reached a remarkably similar figure.

Whatever the precise amount, there is no doubt that Central America will need substantial international assistance. The US government clearly recognizes this and has recently taken the lead in organizing a multilateral coalition of potential donors—the Partnership for Democracy and Development—to encourage them to expand and coordinate their assistance. This initiative, however, is at best likely to produce only modest amounts of new support for Central America, given the other economic demands on the major industrial countries resulting from events in the Persian Gulf and Eastern Europe and the continuing distress of many other less-developed nations in Africa and Asia. Support from the international financial agencies may expand somewhat, but the new resources they are expected to make available to Central America are limited.

Realistically, the United States will remain the major source of external assistance for the region. Yet, facing its own budget constraints, the costs of the Gulf War and economic recession at home, the US government will be tempted to substantially pare down its aid to Central America. Indeed, indications are that Washington has already made this decision; the only question may be by how much.

Now that Central America is no longer enmeshed in the East-West conflict, the United States clearly has no vital stake in the region. It is Central America, not the United States, that will suffer the consequences of reduced support.

A significant decline in American aid below the current level of approximately $1 billion per year—even under the most optimistic assumptions about peace and economic restructuring—will leave most countries of the region in a precarious economic state. They simply will not have the resources they require to recover, re-establish growth and meet the most basic needs of their citizens. Given the past decade's legacy of violence, destruction and economic deterioration, even that amount may be insufficient. Ironically, Central America faces a reduction in outside aid just at the time when its countries are reforming their economies and thereby improving their capacity to make effective use of such aid. In the past, US assistance, because it was hostage to security concerns, was often misdirected; instead of encouraging policy reform, it gave countries the financial means to avoid hard economic decisions.

It is not only the region's economies that are at risk. Democratic politics can hardly be expected to prosper under the conditions of prolonged economic hardship—when millions are without jobs, adequate shelter, nutrition or hope.

Opponents of US policy in Central America have argued that the United States never really cared about the region or its people, and that Washington's declared commitment to the goals of democracy and development was empty rhetoric to justify and gain support for an anti-communist crusade there. On this score at least, the United States still has the opportunity to prove its critics wrong by sustaining its investment in the region long enough to achieve economic reconstruction.•

SALVADOR AID FIGHT

BY MAYA WEBER

Peace talks between the El Salvadoran government and leftist guerrillas are inching forward, but the warring parties continue to hedge their negotiating positions. So in Washington, the question of which side has done more hedging is driving the debate about military aid to the Central American nation.

Flush from success in the Persian Gulf war, President Bush has kept ahead of opponents in Congress, following his Jan. 15 announcement that he would release $42.5 million in military aid. Congress last fall had halved an $85 million El Salvador military aid package for fiscal 1991, giving the President power to release the rest only if El Salvador made progress on human rights and if the threat from the Farabundo Marti National Liberation Front (FMLN) continued.

March 15 is the deadline by which Bush said he will reinstate the funds if there is no cease-fire in El Salvador. In its explanation of the policy, the State Department cited stepped-up FMLN attacks on civilians and purchases of surface-to-air missiles from Nicaragua and accused the rebels of stalling on the talks.

Although Bush's Democratic critics have been stifled tactically by the dominance of the Gulf war, they have continued to protest that Bush has ignored the Salvadoran government's delaying the investigation of the murder of six Jesuit priests and two others in November 1989.

"No one is thinking about El Salvador. If we talk about it we are viewed as insensitive to the President," lamented Rep. Joe Moakley, D-Mass., chairman of the Rules Committee. He has been heading a team investigating the Jesuit case.

Another factor keeping Democrats quiet is the fear of being "tarred with the association" with the guerrillas, especially in the wake of the January killing of two U.S. Army soldiers after their helicopter was shot down, said Peter Hakim of Inter-American Dialogue, a group of 90 leaders from the Americas.

Still, a few battle plans are in the works. Moakley, along with Sen. Christopher J. Dodd, D-Conn., a longtime Central America policy critic, and Sen. Patrick J. Leahy, D-Vt., chairman of the Appropriations Subcommittee on Foreign Operations, is preparing a letter appealing to Bush to reverse his decision. Sen. Brock Adams, D-Wash., and Rep. James A. McDermott, D-Wash., are proposing legislation to ban El Salvador aid in 1992-93.

Opponents of aid argue that release of the funds undermines their goal of pushing both sides in the 10-year-old war toward peace talks. "With the negotiations going along well, this is exactly the wrong message to send," Moakley said. "There will be joy and jubilation in the military."

In the opposing camp, Rep. Duncan L. Hunter, R-Calif., has asked Congress to designate the FMLN as a terrorist organization and expel its delegates and staff from the United States.

The acerbity of the debate has mellowed, congressional aides say, as Members have become disgusted by new violence and human rights violations by both sides in the war. The urgency of the issue has also eased since the 1989 electoral defeat of neighboring Nicaragua's leftist Sandinistas. "Support for Central America was driven by Cold War considerations," Hakim said. "The rationale for aid has wound down."

U.N.-mediated talks under way in Mexico City are beginning to resurrect some long-buried optimism. "The process has cultivated its own momentum," said William C. Goodfellow, a director of the Center for International Policy, a liberal group in Washington.

Still, a solution is unlikely until well beyond the March 15 deadline, Goodfellow and others say. Both the Salvadoran government and military seem to think that they can gain militarily, observers said, and that a delay is to their advantage. ■

EL SALVADOR

Bush Holds Off on Military Aid That Congress Had Resisted

Eager to avoid another bruising battle with Democrats over El Salvador, the Bush administration has delayed releasing military assistance that Congress had blocked.

In the fiscal 1991 foreign aid bill (PL 101-513), Congress voted to withhold half of the administration's $85 million military aid request for El Salvador. But in January, the White House announced that President Bush would release the aid on the grounds that the country's leftist guerrillas had violated conditions of the bill.

In a report to Congress Jan. 15, the administration said the funds would not "need to be" released if the rebels of the Farabundo Martí National Liberation Front (FMLN) agreed with the government on a cease-fire by March 15. The action came in the wake of the FMLN's murder of two U.S. servicemen after their helicopter was shot down. *(Weekly Report, pp. 189)*

Although no truce was reached, the administration said it would nonetheless delay releasing the aid. Assistant Secretary of State Bernard W. Aronson told the House Appropriations Subcommittee on Foreign Operations on March 13 that other factors would be weighed "in deciding how quickly we obligate those funds."

Aronson indicated that the administration would assess the military situation in the country as well as the government's investigation of the brutal 1989 murders of six Jesuit priests at a San Salvador university. Allegations that the military had covered up its role in the slayings played an important role in the congressional vote to cut military aid.

The administration retained its option to provide the assistance later this year. Aronson and Assistant Secretary of Defense Henry S. Rowen insisted that the United States had no intention of abandoning its ally.

But several administration officials said they have been encouraged by recent favorable trends in El Salvador, including elections held on March 10, and hope to use the blocked assistance as leverage in pressuring both sides to seek a settlement of the civil war.

By Carroll J. Doherty

The officials acknowledged that strong congressional opposition to releasing the aid was a significant factor in their decision. In early March, 150 members of Congress — including Senate Majority Leader George J. Mitchell, D-Maine, and pro-defense Rep. John P. Murtha, D-Pa. — wrote to Bush, urging him to continue withholding the assistance.

Mindful of last year's messy fight, the administration has made conciliatory moves as Congress nears consideration of its fiscal 1992 foreign aid request, which includes $86.4 million more in military assistance for El Salvador.

Bush nearly vetoed the fiscal 1991 foreign aid bill because of the El Salvador aid reduction, even though the measure also included an administration-backed provision forgiving Egypt's military debt.

Rep. Matthew F. McHugh, D-N.Y., a member of the Foreign Operations Subcommittee, said he is cautiously optimistic that both sides in the war realize that a military solution is impossible. That realization, said McHugh, could give impetus to negotiations.

Each side has sent mixed signals.

El Salvador's military command announced new steps to solve the Jesuit case. Salvadoran Defense Minister René Emilio Ponce recently wrote the country's justice minister, René Hernández Valiente, requesting that the investigation include 12 officers who had not been implicated.

The letter, however, referred to the two housekeepers murdered with the priests as "collaborators."

At the same time, opponents were accusing the government of President Alfredo Cristiani of vote fraud in the balloting on March 10.

Before the election for mayors and the national assembly, the FMLN agreed to support the democratic process, and hard-line commander Joaquin Villalobos portrayed the rebels as more "social democrat" than "Marxist." Yet the rebels have continued to pursue their military campaign, recently launching an attack on an upscale San Salvador neighborhood.

"Rhetoric on both sides has to be taken with a grain of salt," McHugh said.

Inter-American Development Bank, 1990

LATIN AMERICAN SOVEREIGN DEBT MANAGEMENT

Legal and Regulatory Aspects

Edited by

Ralph Reisner

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FOREWORD

Little remains today of the original agreements under which the Latin American debt was originally contracted. In every case the terms of the debt, whether originally public or private, have been significantly modified as to both maturity and interest. In a few instances, the original principal has been reduced by agreement of the parties. While economists may disagree as to whether these modifications of financial terms have been sufficient from a developmental perspective, they nonetheless represent a striking achievement since they are the product of negotiated agreements between the parties, rather than the result of governmentally imposed solutions. It is also noteworthy that creditors have, by and large, avoided resorting to judicial remedies to enforce their contractual rights, thereby underscoring their commitment to a negotiated solution.

The attainment of what amounts to a negotiated multistaged adjustment of the debt crisis has not been easy. For one thing, the underlying financial issues dividing the parties were of gargantuan proportions. What was frequently at stake was nothing less than the economic viability of entire countries and some of the largest financial institu in the world. An additional complication was the sheer numbers of participants that of necessity were involved in each of the negotiations. For example, more than 500 banks participated, either directly or indirectly, in the various negotiated agreements with Mexico. Complexity was also introduced by differences in the home country regulatory and tax environments under which the creditor banks operate. These differences had to be taken into account and accommodated in the structuring of the various agreements.

It is clear, in any event, that law and lawyers have played an essential part in a process which up to now has, at the very least, avoided major financial upheavals and at best, has led to an orderly adjustment of one of the most serious financial crises of modern times. It was in recognition of the important

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role of the legal dimensions of the adjustment process that the Inter-American Development Bank has sponsored a series of three seminars to deal with these issues. These colloquia, designed to provide a detached and objective evaluation of the legal components of the debt adjustment process, involved the participation and contribution of many. They included among others: many of the key officials involved in the negotiations themselves; their legal representatives; members of the international banking community; and numerous experts from both within and outside the Bank.

This book is a direct outgrowth of these programs and represents, in most instances, an elaboration of papers presented at the two most recent conferences. It hopefully will provide to a wider audience some important analytical perspectives on some of the crucial issues that have, in recent years, confronted the international financial community.

The adjustment measures taken to deal with the debt crisis may be divided into basically three overlapping phases. The first phase concentrated on the restructuring of debt. Initially, this involved a restructuring of only those maturities coming due in the reasonably near future. Beginning in about 1985 these programs were characterized by the use of multiyear restructuring agreements, some extending as long as twenty years. Aside from the changes in terms that resulted from these restructurings, this phase was significant in that it signaled the willingness of the parties to continue dealing with each other in conventional contract and remedies law terms. At the same time, these initiatives led to the development of a format or structure for the conduct of the negotiations between the debtor and their several hundred creditors. In many ways, devising such a decision-making structure was a new problem that the international banking, regulatory, and legal communities addressed reasonably well considering very few precedents were available in the early years of the crisis. In effect, a remarkably uniform approach was adopted in virtually all of the countries involved in this crisis, notwithstanding the variations on the theme that met the special characteristics of the countries concerned.

The legal dimensions of the restructuring phase are treated in Chapters I and II of this book. The contribution by Mr. Buchheit in Chapter I provides a comprehensive overview and analysis of the alternative techniques that have been employed for the longer term restructuring of sovereign debt. The second section of Chapter I by Messrs. Buchheit and Reisner focuses on the rights and duties of the creditors *inter se* as variables in the debt restructuring process. Finally, the section in Chapter II by Messrs. Stumpf and Debevoise addresses a closely related issue—the providing of new money which has been an integral part of most restructuring programs.

A second phase which began in about 1986 was characterized by initiatives designed to reduce the debt by the use of debt-to-equity conversions. Under these programs, portions of a country's stock of external debt is redeemed in its local currency equivalent with a view to having these funds utilized to fund equity investments in the debtor country. From the perspective of the *debtor* country, such debt-to-equity programs serve to reduce its external indebtedness. From the standpoint of the banks, these programs can serve either to reduce immediately a bank's credit exposure in a particular debtor country or

to create an equity interest which can be marketed at some time in the future to individual investors. These initiatives, which have already achieved some measures of success in the case of Chile, Mexico, and Brazil, required extensive modification of the regulatory framework both in the U.S. and the participating debtor countries. Implementation of these programs has also required complex modifications in the terms contained in the documentation negotiated in earlier reschedulings.

A less successful initiative during this phase was the securitization of existing LDC loan debt. Under these arrangements the commercial bank debt is dissembled into different credit forms which, in turn, permit the sale of interests in the original debt obligations to investors in a broader secondary market. While securitization initiatives have, to date, not gained broad acceptance within the international financial community, this mechanism may have promise in the future particularly if means can be found to provide some form of credit enhancement for the dissembled debt.

Chapter III of this book treats the subject of debt-to-equity conversion. An overview of the topic is provided by Mr. Buchheit's article "The Capitalization of Sovereign Debt." A comprehensive analysis of the mechanics of debt-to-equity exchanges is provided by Messrs. Chamberlin, Weltchek, and Gruson. The Brazilian and Mexican debt-to-equity conversion programs are the focus of the contributions of Messrs. Eracher and Mendes and Mr. Foncerrada. The regulatory structure controlling the participation of U.S. banks in the securitization of debt and debt-to-equity exchange programs is presented with great clarity in the article by Ms. Ricki Rhodarmer Tigert. Finally, the accounting and tax considerations which have, to some extent, driven the various transactions in this phase are treated in a section authored by Messrs. Baumann and Harvey.

A third phase, which began in 1988, has also been characterized by initiatives designed to achieve a reduction of the debt. However, unlike the mechanisms undertaken in the second phase, these initiatives involve a reduction of the countries' overall stock of debt by the purchase of the debt at a discount by the debtor countries themselves. The first initiative in this direction was undertaken by Mexico under what has come to be known as the Mexican Floating Rate Bond program of January 18, 1988. Under this program, which met with mixed success, Mexico undertook to purchase from the banks a portion of its own debt with a view to achieving a reduction in its future debt service obligations. The use of the buy back mechanism gained new momemtum with the announcement by the Secretary of the Treasury, Nicholas Brady, on March 10, 1989, that the United States Government was prepared to support debt reduction programs for those countries committed to pursuing an economic adjustment program. The financial assistance necessary to facilitate these debt reduction transactions were to be provided by international financial institutions such as the International Monetary Fund and the World Bank and, possibly, bilateral government creditors. The significance of what has come to be known as the Brady Initiative is underscored by the fact that, after one year, debt reduction programs are either in place, or nearing completion for Mexico, Costa Rica, the Philippines, and Venezuela.

An overview of these programs is provided by the article "Overview of Debt Reduction Techniques" authored by Mr. Buchheit, which appears in Chapter III. The regulatory issues raised by these debt reduction programs are treated in the article immediately following by Mr. James Hurlock.

The debt crisis has spawned extraordinarily little litigation. In part, this is undoubtedly due to the general realization of all concerned that is was not to anyone's advantage to trigger endless and fruitless litigation over the external debt of the countries concerned. Also, various loan documentation provisions such as the sharing clauses served to reinforce the perception that those initiating litigation against the debtor stood to gain very little. Nevertheless, the legal framework governing remedies and dispute resolution, in general, has been an important backdrop to the process as it has developed over the past eight years. Chapter IV of this book addresses this subject. The first section, by Mr. Buchheit explores the dimensions of the doctrines of Act of State and Comity. A general overview of the other significant dispute resolution questions which have, either directly or indirectly, affected the action of both debtors and creditors are treated in a comprehensive study by Mr. Weisz, Ms. Schwarzkopf, and Ms. Panitch which forms the concluding part of Chapter IV.

Ralph Reisner

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WOMEN

Poor, female and working in Latin America

Major efforts bring meager rewards

by Elssy Bonilla

On the face of it, the women of Latin America and the Caribbean have the same problems as do women the world over: unequal pay, burdensome housework, cultural and legal discrimination, lack of opportunities. But there is also something unique about the plight of women in the region, and it is one of the major ironies of the "lost decade."

Latin America's women responded to the economic crisis of the 1980s by joining the work force in unprecedentedly large numbers. Over nine million took on remunerative work in the past decade. The region's 40 million working women now make up a full quarter of the region's work force. Their numbers will swell to 53 million by the year 2000.

These women took on the additional burden of work for pay to help keep their families financially afloat. On a national level, their actions helped to cushion the effects of the economic crisis.

What have women received in return? Very little, it appears. In fact, the 1980s brought the region's women a disproportionate amount of suffering and hardship, and gave them scant reward for their efforts.

Under better circumstances, an influx of new workers would have produced significant economic gains, both at the family and the national levels. But in the past decade, the potential benefits were essentially neutralized by extensive cutbacks in services and salaries. Hardest hit have been the growing numbers of poor women who are heads of household, sole family breadwinners who must also take care of the home, rear the children, and care for the elderly.

The problems facing Latin America's women stem from the realities of life in developing countries and from their traditional gender-determined roles in Latin American society. Through custom and practice, women have primary responsibility for child rearing and household duties. Their other activities are generally viewed as complementary, regardless of their importance.

Women responded to the economic crisis by joining the work force in unprecedented numbers.

These women, therefore, are considered to be economically inactive. This is a major misconception, and it must be changed.

In the cities, Latin America's female work force is concentrated in the urban informal sector—the street vendors, backroom manufacturers and service providers.

The recent surge in women's participation in the informal sector can be attributed in part to economic pressures. One of the strategies that families adopt in hard economic times is to send their women and other family members to the workplace. The Economic Commission for Latin America and the Caribbean (ECLAC) has dubbed this phenomenon the "added worker" effect. The informal sector is often their only option, since they cannot find work in the formal sector.

In the informal sector, women work mainly in marketing, personal services and the production of food and clothing. They typically operate one-person businesses, with few capital assets and little access to credit or technology. Many activities are simply an extension of their own housework—for example, the production of clothing and processed food. As a result, these activities are characterized by low productivity, which translates into low income and little or no capital accumulation.

In rural areas, the most significant development has been the increasing amount of work being done by women on small farms. Female farm workers are steadily replacing male workers, who are turning to other occupations. Partial estimates show that nearly 50 percent of family income in the region's small-farm subsector comes from activities carried out by women. Furthermore, an estimated 20-35 percent of rural households have succeeded in re-

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maining above the poverty level by dint of income earned by female family members.

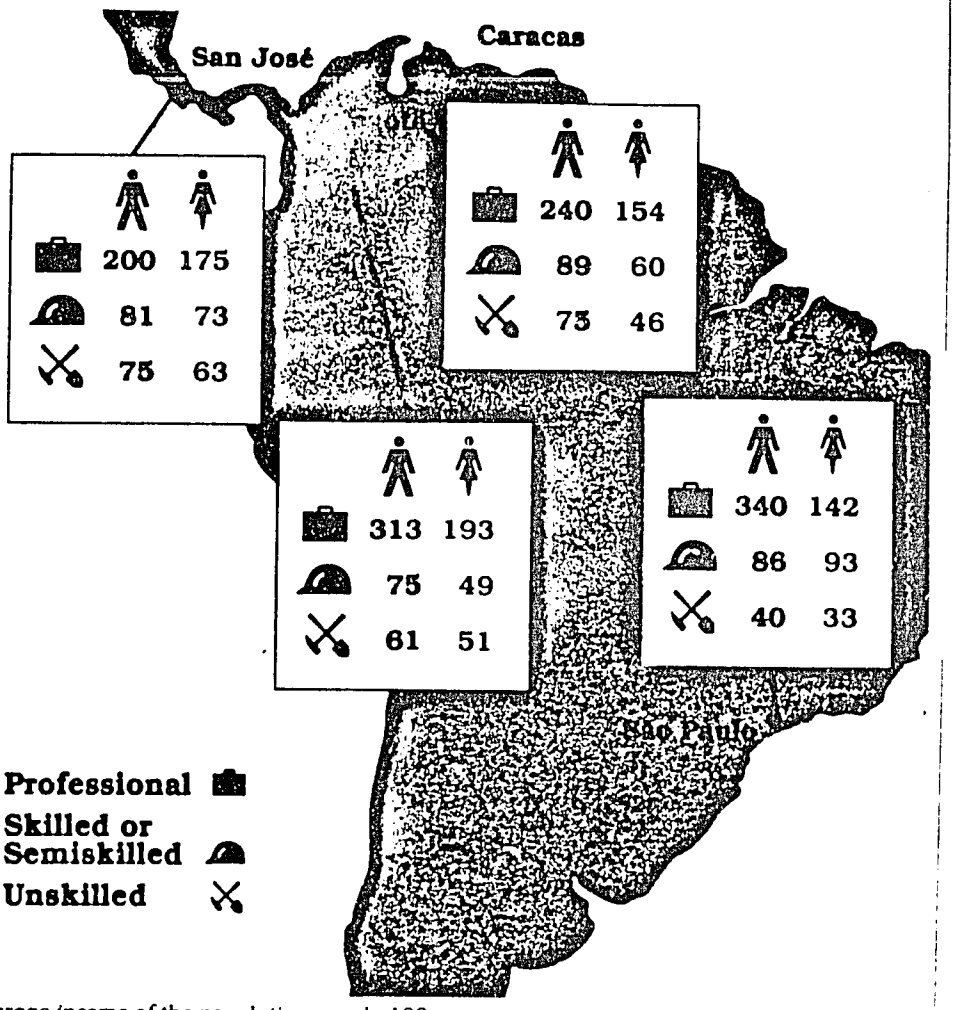
It should be noted that official statistics of women's participation in agricultural work does not cover nonhousehold work of persons classified as economically inactive. If this work were included, it would raise the official 29 percent figure of female participation up to 47 percent.

Growing female participation in the work force has not improved women's status within society. On the contrary, many more women now find themselves in positions of subordination derived from old social divisions and inequalities. For example, informal sector income is generally below the minimum wage level and, as in the formal sector, women earn less than do men performing similar work. Women's tremendous participation in the informal sector is due largely to the fact that they cannot find work in the formal sector, at least in part because of their household and family obligations. In the services sector, women are primarily domestic workers, and as a result often lack protection by labor laws, especially in regard to maternity leave, social security and retirement benefits.

One of the major problems confronting the growing numbers of rural women workers is limited land ownership. In nearly all of the countries of the region, women must confront legal restrictions to inherit land. If they do own any land, it is usually only a small plot. Furthermore, poor rural women are denied capital, credit, technical assistance or training because they are not officially categorized as "productive." For women, farm work is often seen as a natural extension of rural household work, and it often goes unrecorded statistically and unremarked upon even by the female workers themselves.

The cost of being female

The wage difference between men and women is striking, as shown in figures from four Latin American cities. The gap holds for the best-paid professions as well as for the lowest-paid jobs.



Average income of the population equals 100.
Source: ECLAC, Social Development Division, special tables of the 1985 Household Surveys.

Both rural and urban women face the problem of gender-based salary discrimination. Country-level studies carried out by ECLAC have shown that men receive higher salaries on the average than do women. Female workers in São Paulo in 1985 were paid only 58 percent of what males of comparable educational background received; the figure in Caracas was 60.8 percent, in Bogotá 66.3 percent, in San José 79.9 percent, and in Panama City 83.5 percent. This discrepancy held even in the best-paid professions.

Declines in real salaries and severe cutbacks in social spending resulting from the region's economic crisis have hit working women particularly hard. The 1980s have been considered the lost decade of Latin America and the Caribbean because of the depth and duration of the economic crisis. According to ECLAC, at year-end 1989 the average per capita GDP of the region was 8 percent less than in 1980 and equivalent to the 1977 figure. In 1980, 33 percent of the population already lived below the absolute poverty line: these people did not have enough income to guarantee for themselves a minimum standard daily level of nutrition. By 1985 this figure had risen to 39 percent of the region's households.

ECLAC has found that the crisis has made it particularly hard for women to find remunerated work,

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keep their jobs, and manage both their outside job and their household responsibilities. ECLAC furthermore concludes that women's participation in the work force has been anticyclical in terms of the economic condition of the country: female participation in the formal and informal work force has increased as average household income has declined. Although such female participation continues to increase, it is now increasing at a slower rate. According to ECLAC, female unemployment between 1982 and 1985 nearly quintupled in Bogotá, doubled in Caracas, increased slightly in São Paulo, and decreased in Panama City and San José. Among the younger women, the rates reached 30 percent in Bogotá, Panama City, and Mexico City; the relatively high educational levels of these younger women has not translated into better employment opportunities or higher incomes.

In the words of a UNICEF study, low-income working women constitute an "invisible adjustment" to the economic crisis. The worsening times are being compensated for by the "social fund" they have provided in the form of household and remunerated work activities. For example, in order not to lower household consumption any more than absolutely necessary, women during an economic crisis tend to purchase less refined but cheaper household goods that require further processing at home. As such, the household work load increases during bad economic times.

The crisis of the 1980s has most severely affected households headed by females—a category that, according to various studies, has increased significantly in recent times. An ECLAC study shows that in all five cities surveyed, the income index was lower for households headed by females. Using 100 as the average income per household in each city, incomes of male vs. female heads of household in 1985 were as follows: Bogotá, 140 and 95; Caracas, 140 and 81; Panama City, 123 and 95; San José, 127 and 84; and São Paulo, 141 and 80.

The crisis also has significantly compromised the education and development of children from low-income households. According to one study, children from female-headed households in Chile have higher mortality rates than do children from male-headed households. The difference is explained by the lower standard of living typically observed in female-headed households.

When women take an outside job, they continue to bear the housework burden—alone.

Low productivity characterizes not only women's paying jobs, but housework as well. At home, women have to contend with generally bad conditions, few resources, deficient or absent public services, and limited or nonexistent social security and health, educational, and child and elder care services.

When women take an outside job, they find that they must continue to bear the housework burden—alone. According to 1984 studies carried out in Latin America by the International Labor Organization (ILO), women in the work force put in two full shifts—one at home and one on the job. Although some more fortunate women may contract outside help for some of their tougher household tasks, this help has not significantly lightened women's household work load. As the economic crisis has forced women to work more hours outside the home, male family members have not increased their participation in household chores. According to an ILO study, women spend almost 70 hours per week doing housework, including significant parts of their weekends and holidays. In contrast, other family members only spend an average of five and a quarter hours weekly at household tasks.

Attempts to help women through special development projects thus far have had only a marginal impact and have not been integrated into national economic policies. Most such projects have adopted a somewhat traditional social-welfare stance, in which women are defined as beneficiaries rather than agents of development. This misperception leads to macroeconomic strategies that do not incorporate the productive role of women into the planning process.

Although a government may set economic policies with no intention of discriminating against females, this supposed policy neutrality is at best relative. The

Countries must raise the productivity of women —a full one-fourth of the work force— to improve the efficiency of their total resources.

economy is defined primarily in terms of marketable goods and services. Such a definition totally excludes household work, child care, and much of the work necessary to maintain and develop the economy's basic human resources. Because these jobs are performed largely by women, their exclusion from macroeconomic analyses and policies amounts to a very real example of discrimination.

At the same time, governments and especially private organizations have made a real effort to assist women through special programs. Several countries have formulated far-reaching policies or programs designed to benefit low-income rural and urban women through an array of integrated rural development programs and small-business projects. Colombia and Mexico, for example, have made steps in this direction (1983-84), and Costa Rica and Honduras (1978-89) have addressed women and family issues in their development plans. The scope of these efforts has been limited so far, but the production-oriented projects—and in particular the small-business projects—have shown women to be serious and perspicacious businesspersons who generally make good use of the credit, technical assistance, and other resources made available to them.

The responsibility for improving the situation of the region's working women falls to individuals and the private sector as well as to government. Recommendations on needed courses of action include the following:

▶ *Increase job productivity.* Gains will come from providing women with greater access to land, capital, credit, technology and training. It is not enough just to design special projects for small groups of women, no matter how efficient some of these projects may be. Such a fragmented approach will only improve the living conditions of a minuscule portion of the total population that needs attention.

▶ *Ease household chores.* Since women are responsible for household work and family care, and given the low productivity of this work, women's household activities often take time and energy away from their paying jobs. Women need more access to improved household technology and better household products. But most importantly, other family members—particularly men—should assume their share of housework and family care.

Productivity will increase when women have greater access to land, capital, credit, technology and training.

▶ *Provide training.* Any increase in women's educational levels and income gives a substantial boost to the educational level of children and their standard of living. It has been widely documented that women, unlike men, invest nearly all of their income in their households. Therefore, poverty alleviation programs that are directed toward women generally show the best overall results.

▶ *Focus on the poor.* Economic adjustment policies must address the most pressing needs of the most vulnerable population groups—low-income women and children. Expenditures should focus on programs most vital to poor families: basic health and education, and services for preschoolers and the elderly.

▶ *Assist rural women.* Rural sector policies must guarantee women access to credit, technology, land, production inputs, marketing for their products, and training. Private organizations and government agencies should carry out programs with generalized objectives that serve large numbers of the target population.

▶ *Improve statistics.* The countries of the region must generate national and regional statistics by gender, sector and product line. Research should show how to avoid worsening the living conditions of working women when carrying out governmental reforms.

▶ *Raise consciousness.* Seminars should be held to give high-level government decision makers information on practical measures for integrating programs relevant to women into their regular institutional agenda.

Improving the productivity and incomes of a full one-fourth of the region's work force is not merely just. It is also imperative as a way for countries to boost the efficiency of the region's total resources—whether human or material, male or female.

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