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ECONOMIC

WATCH

*A Digest of Development Policy Information*

*A Project of the Overseas Development Council*

WASHINGTON ECONOMIC WATCH

*A Digest of Development Policy Information*

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Dear Reader:

Your letters in support of Washington Economic Watch have been overwhelming. We appreciate your comments and suggestions, and are very much encouraged by this positive feedback.

Like its predecessors, this issue of **Washington Economic Watch** includes pertinent information on trade, finance, development and many other issues important to the United States and developing countries. Readers can gain a glimpse of current Washington debates on the impending "Earth Summit 1992", aid to the Commonwealth of Independent States, and the future of free trade in U.S. policy, as well as updates and forecasts on the U.S. and global economic trends. Also highlighted in this issue are deforestation, debt conversion, and rural finance.

Thank you again for your encouraging letters. We hope that this issue also will prove to be an informative and useful resource for your institution.

Sincerely,

Christine Conte

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Director of Public Affairs
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# TRADE AND COMMODITIES

<u>TRADE</u>


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TRADE

BRUCE STOKES

# A TRADE DEAL THAT OFFENDS EVERYBODY

After five and a half years of the Uruguay Round of multilateral trade negotiations, there may be a flicker of light at the end of the tunnel.

Industry grousing about specific parts of the ambitious proposal by Arthur Dunkel, secretary general of the General Agreement on Tariffs and Trade (GATT), to break a deadlock in the talks masks widespread acceptance or resignation in Washington's trade circles. The view there is that something close to Dunkel's text is about the best that can be expected.

"There is something going on now, and the business community doesn't want to lose this," a House Democratic leadership aide said. "People may be surprised in the end" when an agreement is reached in Geneva despite the pessimism now so evident on Capitol Hill.

Given the many missed deadlines of the past, most Washington trade experts are reluctant to predict that the GATT talks will be over by Dunkel's mid-April deadline. And even if a final agreement is reached, there's disagreement about whether the Bush Administration will submit the pact to Congress for its approval in an election year.

U.S. negotiators privately acknowledge that most of Dunkel's GATT proposal cannot be changed in this last round of deliberations. "The Dunkel text is politically unacceptable," a House trade expert said. "But we don't have to scrap the whole thing. It's a manageable number of issues that have to be resolved."

"Everybody has their shopping list," said Harry L. Freeman, executive director of the MTN coalition, a group of American companies supporting the Uruguay Round. "But there is a gut feeling that if we get past agriculture, and we really make progress on government procurement, services and tariffs, then you come back to the Dunkel draft. Then the probabilities are that only a limited number of changes are possible in it by the major trading countries without unraveling the whole deal. Consequently, the question will be which ones do you choose to reopen, and there will be a lot of competition to get your issue on the short list for change."

So U.S. negotiators and lobbyists for major American multinational companies are focusing on the portions of the Dunkel text they think have to be revised to create enough winners among American industries to ensure congressional approval of an eventual compact.

There is universal agreement on Capitol Hill that revisions in the intellectual property text are needed to satisfy the objections of the Pharmaceutical Manufacturers Association, which wants greater Third World protection for products in its research and development pipeline, drugs that are now routinely pirated.

Similarly, most analysts think Dunkel's proposed revisions of the dumping laws—which prohibit selling products below their production costs—have to be changed. Dunkel succeeded in offending all sides of the debate in Washington, including domestic industries that want to use the dumping code against foreign competitors and American multinationals that fear other countries will increasingly file their own dumping cases against American firms.

Moreover, "the clear perception," the House trade expert said, "is that we lost on the dumping issue [in the Dunkel draft because] Japan was leading the fight on the other side. In this political climate, all you have to do is label this package as having been weakened by Japan, and it's dead." Thus, many analysts contend that the most likely outcome in the dumping area may be retention of the status quo, with only cosmetic changes.

Although U.S. and European negotiators continue to carp about being miles apart on curbing farm subsidies, many trade experts think the mainstream American farm groups could live with the Dunkel text, which calls for a 20-36 per cent cut in farm payments that distort trade. Specialty commodities—peanuts, sugar and so forth—remain opposed. But while they can capture a lot of headlines with their objections, trade experts and politicians always assumed they would be opposed, so their objections have already been largely discounted.

Ultimately, U.S. negotiators say, the GATT deal will be made or broken by how the issues not included in the Dunkel draft are resolved. Without substantial liberalization of the antiforeign bias in government procurement rules, particularly in Europe, big American capital equipment producers, such as General Electric Co., are expected to oppose the deal. Similarly, much of the manufacturing sector is waiting to see what happens on reducing existing tariffs, the one benefit many in basic industry hope to gain from these talks. And the services industry, which pushed to launch the Uruguay Round, refuses to budge on its demands for rollbacks of trade barriers.

At the same time, old-line industries—such as textiles—are lining up their heavy artillery in case a GATT fight in Congress comes this year. The textile industry recently released a study by the WEFA Group, an economics consulting firm, that asserted the Dunkel proposal would cost 745,000 textile and apparel jobs in the United States by the end of the century.

Finally, the prospect of a GATT accord has congressional Democrats worried that the Administration may attempt to set up Congress to take the heat if the agreement brokered in Geneva draws industry fire in Washington.

In this scenario, Democrats worry that the White House will publicly state that the GATT deal is not all it had hoped for, but that it is all that can be wrung out of the intransigent Europeans. Rather than judge the pact, the White House will let Congress decide if it passes muster. Democrats fear that this tactic would subject Members of Congress to even greater than normal protectionist and free-trade pressures, making for an ugly floor debate.

So the light at the end of the tunnel may be a locomotive barreling down the tracks, bringing with it a debate over trade that the United States has not witnessed since the Senate rejected proposals for an International Trade Organization after World War II. ■

# Trade talks fall on deaf ears

## The Uruguay Round is deadlocked, but is too important to fail, writes **David Dodwell**


Negotiators in Geneva are likely to miss their Easter deadline as they struggle to break the 15-month deadlock in the Uruguay Round of talks on world trade liberalisation.

Officials at the General Agreement on Tariffs and Trade (Gatt) talk of paralysis, as the political will to make compromises among central players such as the US and the European Community appears to ebb away.

Fear that the talks face imminent collapse prompted US President George Bush last week to call for "a political push from whatever source" to rescue them. He declined, however, to offer further US concessions. American officials in Geneva say "a minor miracle" is needed to achieve a breakthrough.

At the same time, farm ministers from the 24-nation Organisation for Economic Co-operation and Development (OECD) meeting in Paris on Friday called for a swift and successful end to the negotiation. They warned of "significant downside risks for the world trading system, and costs for the world economy" if the talks fail. They too offered nothing.

The risks of failure are already apparent, as recession in 1991 led to a third successive year of faltering world trade growth: the value of trade rose by a meagre 1.5 per cent to $3,500bn - the smallest gain since 1983, according to the Gatt. Without the boost to trade that a successful conclusion to the round should bring, recovery is likely to be retarded.

The collapse of the round - launched in 1986 to break down barriers to trade in services, agriculture and textiles, to boost international respect for patents and copyright and to improve mechanisms for settling trade disputes - has been looming for a long time. A summit held in Brussels in December 1990 broke up in acrimony after the EC and US failed to agree on farm trade reform. A compromise reform package known as the Final Act was drawn up by Mr Arthur Dunkel, director general of Gatt. It was tabled late in December 1991 and was intended to break the deadlock. All of the 108 countries that have signed up to the Gatt expressed reservations with elements of the package but with the exception of the EC have agreed that it is too important to be rejected.

The issue which continues to jeopardise any agreement is farm trade, in particular the EC's Common Agriculture Policy (CAP). Reform of farm trade is essential to successful completion of the round because many participants in the developed and developing world are seeking an end to protective farm subsidies in the EC and the US in exchange for freeing their domestic markets to outsiders.

Mr Dunkel proposed cutting agricultural subsidies by 20 per cent by 1999, converting farm quotas and other protective devices into tariffs and then cutting them by 36 per cent by the same date. He also sought reductions in subsidised farm exports.

The EC rejected the plans in January. Mr Dunkel has refused to reopen the Final Act for fresh negotiation. He has instructed the EC to settle differences over farm trade with other negotiators - principally the US - and bring back a compromise acceptable to all.

Such a compromise would seem to be in the interests of the EC and the US. They spend billions of dollars a year supporting the prices farmers get for their crops, paying for storage of excess production and subsidising the price of farm products being dumped on the world market. Such policies place a heavy burden on taxpayers and consumers in the west and damage agriculture in the Third World by depressing world prices for meat and cereals in particular.

Although the EC has made some concessions over the past few months, two contentious issues remain.

● EC demands to "rebalance" its protective regime by raising protection against the import of cereal substitutes in exchange for lowering protection for other farm products.

● EC demands that compensation payments to farmers (seen as the centre-piece of plans to reform the CAP) should not be regarded by the Gatt as a distortion of trade.

Today, compromise on both these issues appears possible with the EC suggesting it could drop its demands for "rebalancing" in exchange for compensation payments to farmers which do not distort trade. One EC spokesman in Geneva said that the remaining differences between the EC and the US are "more a matter of presentation than substance".

Many observers of the tortuous manoeuvrings within the Gatt find it hard to understand why the entire accord is being put at risk over the issue of CAP reform when the potential gains from an agreement are immense.

For the first time trade in commercial services - worth $680bn in 1989, the latest year for which the Gatt has figures, accounting for about 19 per cent of world trade - would fall under the Gatt umbrella. A timetable would be set for the markets of all Gatt signatories to be opened to foreign banks, securities houses and insurance companies. National monopolies in telecommunications would be dismantled, liberalisation of shipping and civil aviation would begin. Detailed country-by-country negotiations on opening these markets are currently stalled with the EC and others blaming the US for seeking to limit the scope of liberalisation. But there is a general assumption that progress on the farm subsidy issue would yield US concessions.

In addition, respect for patents and copyright - vulnerable to piracy in many developing countries - would also be built into an agreement on intellectual property rights. Trade in textiles and garments would be brought into Gatt after having defied liberalisation for 40 years. Over 10 years the labyrinth of bilaterally negotiated quotas that determine textile trade would be dismantled and replaced by tariffs.

Moreover, reinforced Gatt dispute settlement rules would be expected to check the destructive proliferation of rows over goods that are allegedly subsidised, or "dumped" in export markets. They would tackle the abuse of technical or industrial standards which are frequently used as a block to imports.

Perhaps most important of all a successful conclusion to the Uruguay Round would secure the participation of much of the developing world in multilateral trade agreements. Since 1986, more than 60 countries from the developing world and former communist bloc have adopted policies of reductions in tariffs and quotas. The prospect of reduced barriers to their exports - which depend on the completion of the Uruguay Round - have been an important incentive.

**Value of world merchandise trade 1991**

| Exports: Value ($bn) | Exports: Annual change per cent | | Imports: Value ($bn) | Imports: Annual change per cent |
|---|---|---|---|---|
| 3,530 | 1½ | World | 3,660 | 1½ |
| 555 | 5½ | North America | 625 | -2½ |
| 1,365 | -1 | EC | 1,460 | 1½ |
| 885 | 11½ | Asia | 825 | 8½ |
| 70 | 16 | China | 66 | 19½ |

Source: Gatt

Although deadlines in Gatt negotiations have often been missed, the current stalemate is creating a growing sense of urgency. Beyond April, there are not enough days in the US congressional calendar to get an agreement ratified ahead of the US presidential elections in November. Officials in Geneva, including those from the US, are already talking of what might be done to minimise "backsliding" from compromises already made in the areas of services, patents and copyright, and tariff cuts if negotiations have to be postponed until January 1993.

In spite of a consensus that further delay is inevitable, no one is willing to contemplate outright failure. As Ambassador Bal Krishan Zutshi, India's long-standing Gatt representative, commented: "No one can afford to abandon what has been achieved out of the round so far. Negotiators will come back sooner or later and settle it."

Even delay carries with it grave dangers.

● Protectionist lobbies in the US in particular have been held at bay largely because of the promise that trade grievances would be dealt with more speedily in the Gatt by new trade dispute procedures. If the round is put on hold it will be hard for President Bush's administration to resist demands for unilateral action against "unfair trade".

● June 1 is a critical date on which a two-year US Farm Bill expires. With it, commitments not to match EC farm export subsidies on a tit-for-tat basis also expire. In fact, the US administration will face a formal commitment to relaunch a subsidy war with the EC on exports of farm products. Such action would almost certainly trigger retaliation.

● The multi-fibre arrangement which controls world trade in textiles and garments expires in December. With no Uruguay Round in place, awkward renegotiation of rules for trade in textiles and garments would be needed.

● Long-sought improvements in Gatt's rules for settling trade disputes would be held up. Countries frustrated with how Gatt currently deals with trade disputes - the US foremost among them - may resort to bilateral sanctions which again could trigger retaliation.

Delay would also hamper attempts to address new problems - such as reconciling free trade principles with environmental concerns, and bringing competition policy under the rubrick of the Gatt.

There is a growing feeling among critics that it is time for the world's leading industrial powers to set an example to newly liberalising countries in the Third World. They should set aside narrow domestic political considerations in favour of improving the world trading system.

An old joke about Moses might prove instructive. He was sent by the Israelites to the top of Mount Sinai to negotiate with God over the commandments. He came down exhausted after 10 days with a list of 310 commandments. The Israelites angrily sent him back to negotiate a better deal. Three more days passed before a gaunt Moses reappeared. "I have good news and bad news," he said. "The good news is I've got the list down to 10. The bad news is that adultery is still in."

For negotiators in Geneva struggling with ennui and exhaustion after six years of non-stop haggling, such a spirit of compromise could be timely.

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# Backsliding on Free Trade

By Brink Lindsey

It's starting to look as if free-trade agreements [illegible] free trade as [illegible] the [illegible] rights. This has become painfully clear in the case of the U.S.-Canada free trade agreement [illegible] Canada [illegible] ing from [illegible] kicks in the shins deliv ered by its "free trade" partner to the south: first, the Commerce Department's imposition of punitive duties on Canadian lumber, and now the Customs ruling that Canadian-assembled Hondas don't qualify for duty-free treatment. [illegible] agreement like this, who needs a trade war?

A similar mess is now brewing in the negotiations among the U.S., Canada and Mexico for a North American Free Trade Agreement, or Nafta. Specifically, the dry and technical talks over "rules of origin" (incidentally, the same issue that was involved in the Honda dispute) are being used by U.S. negotiators to impose a crude form of industrial policy on the continent. In conjunction with other U.S. maneuvering, these proposed origin rules would not only distort and inhibit regional trade and investment, but in some cases would actually raise intraregional tariff barriers above existing levels. This is the very opposite of what a free trade agreement is supposed to accomplish.

Rules of origin are a set of criteria by which to determine what country a given product is made in — not a simple question in an era of globalized production. The traditional U.S. standard for deciding origin questions has been the "new and different article of commerce" test: namely, that a product's country of origin is the last country where assembly or processing operations "substantially transformed" the inputs or components into a new product.

## Abusing Origin Rules

In the Uruguay Round of General Agreement on Tariffs and Trade negotiations, the U.S. has argued for the adoption of uniform rules that would implement, in a transparent and predictable fashion, this traditional standard. According to a 1987 U.S. proposal in the Uruguay Round, origin decisions should "give weight chiefly to commercially significant changes in products" and should be made "without consideration to secondary criteria such as trade policy considerations."

In the context of a bilateral or regional trade agreement like Nafta, the purpose of origin rules is to ensure that companies from third countries don't take unfair advantage of the liberalized trade environment. Specifically, it is feared that without proper Nafta origin rules, foreign companies would set up low-value-added "screwdriver" plants and finishing operations in Mexico for the sole purpose of gaining duty-free access to the U.S. market. The "new and different article of commerce" approach would address this concern by restricting Nafta duty-free status to those products that underwent commercially significant operations in the region.

Unfortunately, the U.S. has completely abandoned this neutral, results-blind approach — and thus its own GATT position — in the Nafta talks. Instead, it is pushing origin rules that are dictated more by special-interest influence than by any notion of commercial significance.

The most blatant example is automobiles, for which U.S. negotiators are urging a stiffening of the 50% local content imposed by the U.S.-Canada free trade agreement. Thus Nafta would take a protectionist rule (ask the Canadian workers at Honda for details) and make it even worse. In taking this position, the U.S. government is doing the bidding of the Big Three automakers, which are eager to keep Mexico all to themselves. The Big Three are currently turning out more than half a million cars a year in Mexico; the only Japanese carmaker with an assembly plant in Mexico is Nissan.

> *In industry after industry—in high-definition television, in microelectronics, in textiles — the U.S. is pushing for commercially arbitrary and trade-distorting rules of origin.*

For color televisions, the U.S. wants duty-free status to be limited to televisions with North American picture tubes. This makes no commercial sense. TV and picture tube production are generally regarded as separate and distinct industries; many of the world's TV producers don't make their own picture tubes. In fact, of the 20 companies producing color televisions in North America, only six make their own tubes here. Moreover, the picture tube constitutes only about a third of a TV's total value; under the proposed rule, a TV with 67% North American value added could still not qualify for duty-free treatment.

The purpose of this arbitrary rule? Nothing other than to divert business to U.S. picture tube makers, most notably Zenith. By the way, since nobody makes picture tubes of less than 13 inches in North America, the U.S. is proposing a different rule for small TVs. So much for even the pretense of a consistent "results-blind" rule.

Another egregious example involves laptop computers. In the effort to build a U.S. flat-panel display industry through trade policy (a project begun with the disastrous antidumping case against Japanese computer screens), the U.S. initially demanded a rule under which laptops could qualify for Nafta treatment only if they had North American screens. At [illegible] the U.S. [illegible] forced something of a retreat, the current proposal makes the flat screen one of three components, two of which must be North American, for the laptop to qualify. Even so, some U.S. laptop makers will find it difficult to meet the new standard. This isn't just industrial policy; it's sheer stupidity. As in the dumping case, the government is sacrificing an industry that is large and competitive on behalf of another that is tiny and inefficient.

Numerous similar cases could be cited. In industry after industry — in high-definition television, in microelectronics, in textiles — the U.S. government is pushing for commercially arbitrary and trade-distorting rules of origin. In so doing, it is undercutting the whole purpose of the free trade agreement: to create an integrated North American market in which trade and investment decisions are based on economic efficiency, not political influence.

It gets worse. U.S. negotiators are also demanding the elimination of the Mexican *maquiladora* program. Maquiladoras are assembly plants that are allowed under Mexican law to import components duty-free, provided that the finished goods are then exported. These plants, the vast majority of which are U.S.-owned, last year accounted for about [illegible] of Mexico's manufactured goods exports to the U.S.

## Double Whammy

If the ability to bring in imported components duty-free is eliminated, existing maquiladoras that don't meet the strict Nafta origin requirements will get hit with a double whammy. Not only will they continue to pay U.S. duties on their exports, but they will now also have to pay Mexican duties on their imported components. In these situations, Nafta would have the perverse effect of raising tariff barriers for Mexican exports to the U.S. above existing levels.

And in a crowning outrage, the U.S. is trying to make sure that the double whammy stays as bad as possible. It is actually pressuring Mexico to pledge not to reduce its external tariff rates in the future, lest Mexico, in spite of everything, should become too favorable a spot for foreign investment.

Friends of free trade should take a long, hard look at these ugly details of the Nafta talks. Together with the current souring of U.S.-Canada trade relations and the endless wheelspinning of the Uruguay Round, they call into serious question the wisdom of pursuing free trade through negotiations with other countries. Maybe all the intellectual firepower and political capital expended to keep these flawed talks afloat would have been better spent on a more direct approach: convincing the American people and their representatives in Congress that open markets are good for us no matter what other countries may do.

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*Mr. Lindsey is director of regulatory studies at the Cato Institute in Washington, D.C.*

## EDITORIAL/OPINION

# 'New World Order' for Trade

By CLAUDE BARFIELD

Without fanfare or even much discussion, the "new world order" proclaimed by President Bush is about to acquire its first organizational component — the Multilateral Trade Organization, or MTO. If the Uruguay Round of world trade talks are successfully completed during the next several months, the new MTO will assume extraordinary authority over the international trading system.

The sudden appearance of a major new international trade body abounds with ironies, both historical and current.

Forty-five years ago, post-World War II leaders, with U.S. diplomats in the vanguard, laid plans for the creation of a multilateral International Trade Organization. The goal was to deter the trade wars that deepened the 1930s depression. Ultimately, Congress torpedoed the idea, partly because of fears relating to U.S. sovereignty and partly in reaction to an overall disenchantment with wartime ideals and policies.

Thus, the General Agreement on Tariffs and Trade, which has provided the basis for all subsequent multilateral trade negotiations, grew from an ad hoc interim agreement, without full international legal stature, without a real organizational structure and without effective dispute settlement mechanisms. Though amazingly successful considering its rocky beginning, GATT has always been a stepchild among international economic and political organizations.

That circumstance is about to change, and the means by which this has come about are surprising. The bold proposal for a Multilateral Trade Organization was sprung upon the GATT nations at the last moment as part of a take-it-or-leave-it package for the entire Uruguay Round. It was not a part of the negotiating agenda. Indeed, in the past several years, leading trade experts have argued that extended negotiations would be required to create a new international trade organization.

The circumstances behind the birth of the proposed MTO — its sudden appearance at the very end of a negotiation and the lack of time for detailed discussion — may greatly complicate the Bush administration's drive for acceptance of a total Uruguay Round trade package. Congress can argue with justification that it gave no mandate for the creation of an MTO. And congressional opponents of the substantive portions of a Uruguay Round package, combined with private sector opponents, undoubtedly will try to exploit fears about the implications for the United States of a wholly new trade organization and regime.

Upon examination, however, the case for an MTO is quite strong. Indeed, not only is it in the U.S. national interest, but it also is an indispensable foundation for the achievement of America's substantive goals in the Uruguay Round. Chief among U.S. demands from the negotiations are inclusion of new areas — patents, trademarks and copyrights, and services and investment — in the multilateral trading system, dispute settlement sanctions that have teeth and operate with dispatch, and elimination of "free rider" elements that allow nations to opt out of trade obligations. While not perfect, the results of the negotiations go a long way toward fulfilling these goals.

Because GATT has traditionally dealt only with issues related to goods, a new umbrella organization — the MTO — is necessary to incorporate into the multilateral regime rules for services and intellectual property. As a part of the new MTO, separate councils are provided for these two areas, thus awarding them equal status with manufacturing goods.

Of even more importance for the United States, however, is that cross-retaliation among the three areas is allowed — that is, violations of services rules can provoke retaliation against manufactured products, and vice versa. Thus, it will be possible to hit nations that break the rules in their most vulnerable and vital sectors.

Further, the entire dispute settlement system is much more efficient. Recommendations by dispute panels will stand unless unanimously overturned by MTO members. Moreover, the entire complaint process will take no more than 15 months.

Finally, while not totally eliminated, the problem of "free riders" will be greatly reduced. While less developed countries have some leeway, nations that sign up for the new MTO must agree to abide by all existing GATT rules, including earlier codes that originally were not mandatory.

For the United States, the issue of greatest controversy could well be the impact of the new trade rules on Section 301, the provision in U.S. trade law that provides for unilateral retaliation against alleged unfair trade practices of other nations.

The MTO rules do not disallow such action, but they do require that a nation first exhaust all multilateral dispute settlement procedures before acting on its own. This is likely to cause a negative reaction in Congress, but the United States cannot have it both ways.

For years, U.S. officials have defended Section 301 by arguing that GATT sanctions are weak and GATT rules do not cover key sectors. With the new MTO, neither of these arguments is valid. The United States will have to give way or demonstrate by its obduracy that the arguments were advanced merely to mask a determination to muscle smaller nations into submission, whatever the justice of its cause.

Hopefully, statesmanship and a true vision of national economic interest will prevail. For whatever the extraordinary circumstances surrounding its birth, the MTO is the indispensable organizational linchpin to the achievement of U.S. trade goals in the Uruguay Round.

*Claude Barfield is director of trade policy studies for the American Enterprise Institute in Washington.*

"Why couldn't you have been a nuclear scientist? Doreen's husband has harnessed the power of the sun."

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THE WALL STREET JOURNAL THURSDAY, APRIL 9, 1992

# Where the New Markets Are

## Board of Contributors

*There is evidence of a deep structural shift — economic growth can no longer be based on consumer demand*

By Peter F. Drucker

For 40 years, since the end of the reconstruction after World War II, the [illegible] an unprecedented expansion of the world economy has been propelled by consumer demand, [illegible] in the developed countries' great shopping sprees of the 1980s. But there is mounting evidence of a deep structural shift — economic growth and expansion can no longer be based on consumer demand.

One exception: Ever since the first TV set appeared on the market, each new consumer electronics product has immediately set off a buying explosion, especially in Japan. Yet when several technically very exciting consumer electronic products were introduced in the Japanese market last year, they produced little more than a yawn.

More important, the new markets are not consumer goods markets. Nor are they traditional producer goods markets, that is, markets for machinery and factories. In fact there is probably worldwide overcapacity in manufacturing plants, most acute in Japan and in Western Europe.

Rather, three of the new markets are for various kinds of infrastructure — that is, for facilities that serve both producers and consumers. And the fourth new market is for things that are neither "products" nor "services" in any traditional meaning of those terms.

### Most Accessible Markets

The most immediately accessible of the new markets cluster around communication and information. The biggest demand [illegible] in the world is for telephone service in Third World countries, including the former Soviet bloc. There is no greater impediment to economic development than poor telephone service, and no greater spur than good telephone service. A telephone system is highly capital-intensive. But technologies that replace the "wiring" of traditional telephones with the "beaming" of cellular phones are radically reducing the capital investment needed. And once a telephone service is installed it begins to pay for itself fairly soon, especially if well maintained.

In the developed world, the information and communications markets may be even larger. Both the office and school of tomorrow will be built around information and communication. We already know that the factory of tomorrow will be organized around information rather than automation, as we thought only 10 years ago. The technology is already in use; it needs only to be properly packaged.

The second of the new markets — call it the "environmental market" — may end up being even bigger. It has three separate components, all rapidly developing.

1. The market for equipment to purify water, air and [illegible]. In the U.S. purification of water, and of other [illegible], is proceeding apace. Water use in U.S. manufacturing is already down by one-third since 1977 and will be cut by as much again by the year 2000.

Air pollution in U.S. manufacturing has been cut drastically. Japan may be even further ahead, whereas Europe is still way behind. But manufacturing is not the world's biggest polluter. When it comes to water pollution, for instance, municipal sewage is the worst offender. There the task has not been tackled in any country, though the technologies are available.

2. The agro-biology market for replacing chemical herbicides and pesticides with non-polluting, mainly biological, products. The first of these have just appeared on the market. By the year 2000, industry experts believe that practically all herbicides and pesticides used in commercial farming in developed countries will be biological rather than chemical.

3. The biggest component of the environmental market — the energy market — will not become a major factor until after the year 2000. There is a growing need to cut down on high-polluting energy sources, e.g. gasoline in automotive engines or coal-burning power plants. The first technologies to do so — solar fuel cells and non-polluting coal-burning furnaces — are no longer "sci-fi"; within 10 years they will be affordable.

The third new market is not really "new" at all. It is the growing need in developed and developing countries alike to repair, replenish and upgrade physical infrastructure, especially transportation systems: roads, railroads, bridges, harbors and airports.

Little of the world's infrastructure is less than 30 years old, and in undeveloped countries infrastructure has been neglected since 1929 or even World War I. Even the few Japanese superhighways date back to the '60s; the U.S. road system, once the wonder of the world, is older. No European rail system carries more than one-tenth of its country's freight; all lose money. And while Japan's railroads carry enormous numbers of passengers, they are unable to serve the economy by carrying the country's freight.

By contrast, America's railroads are in reasonable shape — at least they carry almost two-fifths of the country's freight and earn money doing so. But even in the U.S., overloaded and under-maintained transportation systems cannot support much more activity. Ocean shipping — that part of transportation that in the developed countries of the non-Communist world has been left to private enterprise — is in good shape by and large. But otherwise the world's transportation system may require 10 years or more of boom-time investment, comparable perhaps to the railroad boom of the mid-19th century.

And then there is the fourth of the new markets, the one created by demography. It is the market for the "investment products" to finance survival into old age.

Life insurance, which should of course have been called "death insurance," was a major investment product of the 19th century. It protected the family against economic catastrophe caused by the breadwinner's early death. The new growth industry in all developed countries is "survival insurance" — the fund created by the income that wage earners put aside to provide for their retirement years. As everyone knows, pension funds have become the only "true" capitalists in the American economy. They are rapidly becoming the true capitalists in the other developed countries as well — and for the same reason: the growing number of people who live well beyond retirement age. This development creates a demand for investment vehicles that goes way beyond anything seen earlier.

There is thus ample potential for economic growth, perhaps even for another 40 years of it. The demand is there, so are the technologies and capital resources. But this potential does not fit traditional assumptions and proposals by America's Democrats and Britain's Labor Party that increased government expenditure will stimulate [illegible]. In fact, [illegible] little more than bigger [illegible]. What is needed is not increased government spending but long-term investment and the jobs it creates.

The measures America's Republicans and Britain's Tories propose to encourage such investment are equally unlikely to do the trick. They assume that the investors are the "rich," when actually today's investors are barely "affluent." The typical individual contribution to a pension fund is well below $10,000 a year, and the typical mutual fund purchase — the preferred investment vehicle for individual savers — runs around [illegible].

What is needed is something totally different: the privatization of infrastructure. The needs of communication, the environment and transportation should be entrusted to investor-owned, profit-seeking enterprises operating in competitive markets. There is a precedent for this: the concept of the "public utility" invented in the U.S. in the second half of the 19th century. This enabled American railroads, power companies and telephone companies to remain private and to stay competitive, while such services everywhere else in the world were taken over by government.

### Privatization Is Key

We can already see some progress in the privatization of infrastructure markets. Germany long ago cleaned up its most polluted river, the Ruhr, by making it profitable for businesses not to pollute. And in California's Central Valley the water allotments of individual farmers have become tradable commodities, giving users incentives to conserve and to profit.

Privatization is the one way to make sure the needs for infrastructure will be fulfilled. No government in the world today is solvent enough to do so on its own, either through taxation or through borrowing. Yet the capital is there, and in abundance, and so are the opportunities for profitable investment.

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*Mr. Drucker is a professor of social sciences at the Claremont Graduate School in California.*

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OPINION

*The biggest trade opportunities for the United States aren't with Japan, but with the newly opening economies of Latin America*

# Look Southward, US

By Richard Feinberg and Peter Hakim

THE market-opening objectives that were sought in vain by President Bush on his recent foray to Japan should be pursued closer to home – in Mexico and the rest of Latin America – where they are far more easily attainable. Mexico is ready to sign a North American Free Trade Agreement (NAFTA) with the United States and Canada, providing for reciprocal reductions in import and investment barriers, and most Latin American countries are eager to follow suit.

Americans, even those who should know better, tend to spurn Mexico and Latin America as a collection of poor countries without much economic importance for the US. They think Japan is where the commercial action is – where the high-profit markets are to be found.

Americans need to get the facts right. The US actually sells more to Latin America each year than it does to Japan – and more than one-half of those sales are destined for Mexico.

Living on less than one-tenth the income, the average Mexican spends nearly as much per year on US products as the average Japanese (about $300 versus $400). Not only is Mexico already a booming market for US goods and services – prominently including Detroit's automobiles – but the potential for expansion is also enormous, probably greater than that of Japan.

In the first place, Mexico – along with most other Latin American countries – is just beginning to recover its economic dynamism after a prolonged slump that forced imports, wages, and public spending to contract sharply.

Following a painful economic restructuring, Mexico has established a sound strategy for sustained growth that will require stepped-up purchases from abroad – most of which will come from the US. For each dollar that Mexico spends on imports, almost 70 cents goes to the US; the comparable figure for Japan is less than 25 cents. Stimulated by a free-trade agreement, an open and growing market in Mexico would mainly benefit US exporters. Not so in Japan, where European and Asian traders would score the most gains from reduced protection.

Just as US sales to Japan mean more jobs for American workers, so do sales to Mexico. Reciprocal market access with Mexico – precisely what we demanded of Japan – is what NAFTA is all about, and it will create employment at home.

Substantial economic changes inevitably cause disruptions, however, and some American workers will lose their jobs. The US government should stand ready to assist these workers generously through, for example, retraining, resettlement allowances, and the like. Rather than opposing free

THE GLOBAL ECONOMY

trade with Mexico, labor unions in the US should fight for these kinds of benefits.

Economic advantage is a powerful reason for Washington to pursue a free-trade pact with Mexico. But it is not the only reason. For the first time this century the US and Mexico – facing each other across a 2,000-mile-long border – have the opportunity to become genuinely good neighbors.

Never have the prospects been better for the two countries to engage in effective cooperation on such shared problems as drugs, migration, and the management of scarce water resources.

In addition, Mexico has become increasingly attentive to US concerns about human rights, democratic practice, labor conditions, and environmental contamination.

This is the right time for the US and Mexico to try to reach mutually acceptable agreements on these issues, although not necessarily as part of a free-trade accord. Indeed, none of them can be resolved once and for all; what is crucial is to assure that they remain prominent on the bilateral agenda.

The conclusion of a NAFTA agreement with Mexico and Canada would point the way toward free trade throughout the Americas. Whatever the economic and political gains of open trade arrangements with Mexico, these could be doubled by extending the arrangements to the entire hemisphere.

There are good symbolic and practical reasons for Washington to sign a free-trade pact with Mexico first. But the US should not be hesitant to start negotiating with other Latin American countries – like Chile and Venezuela – that are striving to meet US conditions for free trade. It would be understood that any early agreements would be subject to modification to insure their compatibility with NAFTA.

Ideally, the NAFTA agreement would be signed by this spring and quickly ratified by Congress – in defiance of the rising protectionist pressures in the US.

That timetable should then allow free-trade accords to be concluded with other Latin American countries and endorsed by Congress in early 1993 – prior to the termination of the special "fast track" procedure for approving international trade agreements. That, in turn, could create the necessary momentum for sustained movement toward free trade throughout the Western Hemisphere.

In the end, however, a good agreement with Mexico – one that can be supported by a healthy majority in the US Congress and is viewed positively by the American and Mexican people – is more important than any quick accord. And once a good agreement with Mexico is in place, others will follow.

Eventually, US trade routes to São Paulo and Santiago, to Caracas and Cartegena, and to Bogota and Buenos Aires may become busier than those to Tokyo.

■ *Richard Feinberg is executive vice president of the Overseas Development Council. Peter Hakim is staff director of the Inter-American Dialogue.*

WORLD BANK NEWS

Feb. 20, 1992

# Karaosmanoglu: Lifting Trade Barriers Is at Heart Of Decade's Development Challenge

*The following are excerpts of a speech delivered by World Bank Managing Director Attila Karaosmanoglu on February 13 at a meeting in Colombia sponsored by the United Nations Conference on Trade and Development.*

During the first half of the 1980s, developing countries' rates of economic growth and trade expansion had decelerated sharply, with the notable exception of China and India. Incomes and investment were falling. Heavily indebted countries were cutting back imports severely.

There were many reasons for this unsatisfactory performance. The global economic environment was far from favorable for most developing countries. They faced high trade barriers for many of their exports. Terms of trade were deteriorating, especially for Latin America and sub-Saharan Africa, and commodity trade was sluggish. Real interest rates were high, official development assistance for low-income countries was stagnant, and access for middle-income countries to capital markets was shrinking.

The main reason, however, for the unsatisfactory performance of many developing countries was their domestic economic

See UNCTAD, page 4

# Trade-Talks' Failure Could Degenerate Into "Greater Discord"

UNCTAD, *from page 1*

policy. Too many developing countries have been made vulnerable to external shocks by poorly designed and executed policies which they have been slow to reform.

How has the international community responded to this crisis over the past four years? Perhaps the most ambitious response has been in the area of trade. The Uruguay Round is trying to grapple with a wide range of issues, and developing countries are participating to a much greater extent than in the past. We at the World Bank share the disappointment at the failure so far to reach agreement. Failure at this critical juncture to make significant progress could postpone by many years much needed benefits. It could also degenerate into greater discord and further restrictions, which at worst could stifle growth in industrial and developing countries alike.

In the area of debt, there has been a number of initiatives to deal with the crisis. We welcome the resulting real progress in reducing debt owed to commercial and official lenders.

In the area of financial flows, official development assistance from bilateral sources has stagnated as a share of gross national product, while official development assistance from multilateral sources has increased moderately.

Despite the impressive collective effort...to promote development and reduce poverty, the challenge of the 1990s remains formidable.

Yet, if one reflects on the pace and complexity of the breathtaking and historic political and economic changes we have witnessed in the four years since the last U.N. Conference on Trade and Development, one cannot but be struck by the opportunities facing mankind in the 1990s:

• The end of the Cold War could release vast resources in the developed and developing worlds to be switched from wasteful military expenditures to investment and development;

• The growing consensus on development strategies encourages governments in developing countries to concentrate on things they should be doing, such as investing in people and maintaining a "market-friendly" climate, while freeing the private sector in these economies to realize its full potential;

Attila Karaosmanoglu

**The challenge of the 1990s remains formidable.**

• Many countries are returning to the fold of an increasingly integrated world economy;

• We live in an increasingly interdependent and shrinking world. Since solutions to development problems are interwoven, we must advance on a broad front;

• And the sheer magnitude of the challenges we face demands a common response.

We have it in our power to make the 1990s a decade of sustained development. We can [rise to the occasion] if we all summon the political will and recognize our shared responsibility.

Devel-ping countries must recognize that the quality of domestic policies and institutions chiefly determines their economic health. Macroeconomic equilibrium must be maintained or re-established. Microeconomic efficiency is also vital. Social policies are also an important prerequisite for development.

Industrial countries can help by:

• Re-establishing the conditions for sustained noninflationary growth in the OECD economies;

• Ensuring better macroeconomic balances and higher savings rates, which help to reduce long-term real interest rates, and thus lighten the debt service burden and raise the import capacity of developing countries;

• Improving developing country access to developed country markets, especially...by successfully concluding the Uruguay Round in a way which significantly lowers trade barriers globally;

• Assisting developing countries in managing commodity price risk using private market instruments;

• Increasing official development assistance for countries pursuing sound development strategies;

• Further relieving the debt and debt service burdens of the severely indebted countries.

International institutions will be at the heart of this shared responsibility. They must create a framework within which non-inflationary growth, trade and development can flourish. They must provide policy advice on, and technical assistance for, reforms countries undertake. They must be catalysts for mobilizing funds for development and debt reduction and in coordinating donors' and recipients' progress towards shared goals.

The World Bank stands ready to contribute fully to this exciting endeavor. The Bank's headroom--at some $60 billion--is sufficient to respond quickly to strong programs and projects in middle-income countries while meeting the needs of potential new members from the Commonwealth of Independent States and the Baltic states. Concessional resources, however, remain scarce. Discussions on a tenth replenishment of the [lending base of the Bank's concessionary lending affiliate,] the International Development Association are underway. I cannot overemphasize the importance of an adequate replenishment if we are to respond satisfactorily to the growing needs of our poorest members while also meeting the requirements of many new claimants in all regions. ☐

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THE WASHINGTON POST January 17,1992

*Jessica Mathews*

# A Retreat on Trade?

## *It could mean hunger for hundreds of millions of people.*

After five years, the world trade talks are teetering on the brink of failure. Massive agricultural subsidies provided by developed countries are the decisive issue. The United States rightly wants to remove or at least lower them. Europe and Japan do not.

If the talks break down over this impasse and the accumulated irritations of the years of negotiation, one likely consequence for the developing world will be harsh: more hunger for tens, and eventually, hundreds of millions of people.

Those of us lucky enough to live in one of the world's few rich countries have seen decades of explosive growth in agricultural productivity, yielding unprecedented variety and abundance from less land, sometimes even with less environmental damage. We are awash in surpluses we pay to store. It is hard from this vantage point to appreciate how precarious the global food outlook is.

While the proportion of malnourished people in the world is declining, their numbers are growing. There are more hungry people now than there ever have been. An appalling 40,000 of them die from hunger and hunger-related causes daily.

There is, moreover, accumulating evidence that the agricultural resource base is stressed as never before. Few opportunities remain to bring new land into production or to add to the area under irrigation. Worse, land now used for agriculture is being lost from overuse and environmental mismanagement.

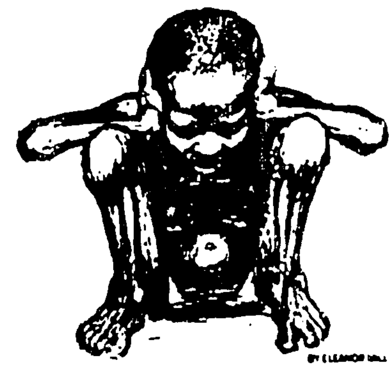
Preliminary results of the first global assessment of soil conditions were released a few months ago. They make grim reading. Since World War II, 11 percent of the earth's vegetated surface—an area about the size of India and China—has been degraded. About one-tenth of this area is permanently destroyed. On about one-quarter, the soil's biological functions are "largely destroyed" but could be expensively reclaimed. On the rest, agricultural productivity is merely "greatly reduced."

The study confirms what earlier anecdotal evidence had suggested. The great increases in agricultural production of the '50s, '60s and '70s were achieved through expanding cropland and irrigated acreage, better crop strains and heavier use of pesticides and fertilizer. These additions masked an underlying loss of productivity from erosion, waterlogging, salinization and loss of green cover and of soil nutrients, without which production would have been much greater. The world has, in effect, been running up the down escalator.

For 35 years, world grain production grew by 3 percent annually, handily outpacing population growth. But since 1984, grain production has grown by only one percent per year, far slower than the number of mouths. Total food production has fallen behind population growth in 70 nations, including most of Africa, the Philippines, Bangladesh and Mexico. Latin America has made a tremendous effort just to stay even.

The trend since 1984 need not be permanent. Deteriorating soil conditions have been reversed before. "Our lands were originally very good, but use and abuse have made them quite otherwise," complained George Washington in 1768. They were to become worse still, and then to improve mightily in the years after the Dust Bowl. One needn't be a blue sky optimist to be confident that the stream of powerful new technologies—especially from biotechnology—will continue to flow.

It would be almost criminally foolish, however, to ignore the severity of the environmental constraints or be confident that they can be overcome. Population will grow by 40 percent in 20 years, adding another India each decade. Per capita availability of cropland and irrigated land will drop. Pressure on the land will continue. Most of the proven sources of increased productivity—research, construction of rural roads and food storage facilities and land reclamation—cost money that many developing countries simply do not have.



With so little elasticity in the system, the last thing the world can afford is economic policies that depress production or exacerbate environmental harm. The subsidies over which the General Agreement on Tariffs and Trade talks are hamstrung are prime offenders.

They encourage farmers in the developed countries to overproduce at unnecessary environmental cost. Governments then dump the surpluses on the international market, forcing down prices. This in turn reduces production by farmers in developing countries whose crops are taxed, not subsidized, by their governments. To partially make up for low prices, these governments heavily subsidize irrigation, pesticides and fertilizer, causing their overuse and consequent water pollution, health problems and land degradation.

If the president's disastrous Asian trip had not been about politics, politics, politics, Japan's closed agricultural market and immense farm subsidies would have belonged at the top of the agenda. The attempt to negotiate precise targets for Japanese imports of U.S. products compounded the damage of this missed opportunity by throwing Mr. Bush's long commitment to free trade into question.

The United States is still pushing in the GATT talks for an agreement that would wean the world from subsidies that create more food where it isn't needed and less where it is desperately needed. The question now is whether "whatever it takes to get reelected" includes a retreat on trade. The president should stick with his instincts on this one, and those who care about poverty, hunger and the global environment should stick with him.

*The writer, vice president of World Resources Institute, writes this column independently for The Post.*

## EDITORIAL/OPINION

# Making Trade Reforms Stick

By VINOD THOMAS & JOHN NASH

Barriers to trade with the developing world are far fewer today than at any time in recent history.

This conclusion may be surprising amid all the talk of increasing protectionism, regionalism and trade wars. But consider the following: Over the past decade numerous Third World countries, such as Chile, Ghana, Korea, Mexico, Morocco, and Thailand, have been steadily opening their trade regimes.

Others, such as Argentina, China, India, Pakistan, Peru, and Vietnam are embarking on the same path. Eastern European countries have in recent years been dramatically opening up their economies, and the republics of the former Soviet Union are poised to follow the same course. If sustained and deepened, these changes will mean tremendous opportunities for expanding world trade, growth and welfare.

The developing world contains some of the fastest growing economies in the world. While the industrial countries doubled average incomes in the past three decades, many of the developing economies of East Asia quintupled their standards of living.

Having noted these favorable developments for global trade, it must be emphasized that trade liberalization has been far from uniform. Nor is its future certain.

Chile and Mexico, for example, have carried out the most far-reaching liberalization in recent history. On the other hand China and India, which together are home to two-fifths of the world's people, still have perhaps the most protectionist trade regimes in the world.

In these and other cases, encouraging and sustaining progress is predicated on three factors.

First, macroeconomic instability is a major threat to maintaining and furthering trade reform. Countries facing large fiscal deficits find it difficult to reduce tariffs upon which government revenues depend.

High inflation obscures relative price changes from trade reforms, thereby limiting the effect of the price changes on improving efficiency. And the needed efforts to bring down high inflation often cause the exchange rate to appreciate in real terms, whereas successful trade liberalization usually requires its depreciation.

All this does not mean that trade reforms cannot be designed to alleviate fiscal deficits and inflation. Many trade reforms are revenue-generating — such as those that get rid of prohibitions, rely on tariffs instead of quantitative restrictions, eliminate exemptions and raise tariff rates on some imported inputs.

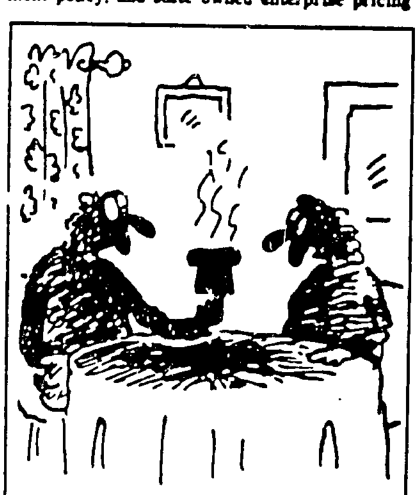
For countries that carried out these kinds of reforms, import tax revenue actually rose following trade liberalization. Import liberalization can also dampen inflation and inflationary expectations by lowering import prices.

Second, domestic regulations that strangle a country's entrepreneurs also limit the effectiveness of trade reforms. The failure to address complementary policies is one of the greatest threats to sustaining trade liberalization.

A prime example of such complementary action is reducing direct regulation of market entry and exit. Another example is getting rid of the central allocation mechanism in socialist economies.

Such measures also include reforms of most labor market regulations that make it costly or impossible to lay off employees. Such regulations not only force some firms into bankruptcy, but also make expanding firms reluctant to hire permanent workers.

Transport regulations, public sector investment policy, and state owned enterprise pricing policies are among the myriad other areas where complementary reforms help.



'Let's use the toaster for now and we'll try nuclear fusion again tomorrow'

Third, growing protection in industrial countries is a stumbling block to further reform in developing countries. Europe, Japan and the United States expanded the coverage of non-tariff barriers while admonishing developing countries to do the opposite. The volume of industrial country imports covered by non-tariff barriers increased by some 20% between 1981 and 1987, and these now affect around a fifth of all their imports.

The industrial-country non-tariff barriers include the Common Agricultural Policy mechanisms in Europe and numerous direct import restrictions on agricultural products in Japan and the United States, "voluntary" export restraints (undertaken voluntarily by exporters with about the same degree of enthusiasm shown by a robbery victim relinquishing his wallet), the Multi-Fibre Arrangement (a species of voluntary export restraint that operates as a global central planning mechanism for textile and garment production), and, recently, "anti-dumping" actions.

Together, these non-tariff barriers cost developing countries (and consumers in industrial countries) billions of dollars annually. According to conservative estimates, they reduce the levels of developing country exports by 10% and GNP by 3%.

Developing countries have been arguing, with some justification, that unless industrial-country barriers to trade are rolled back, further reforms on their part will go to waste.

Worldwide exporters are finding increasing access to rapidly expanding markets in the developing world. For this prospect to be fully realized, developing countries' reforms need to be deepened and maintained. Industrial countries can encourage this by quickly bringing down their own trade barriers.

The GATT negotiations . . . which are off the back burner and cooking once again . . . provide a vehicle for global liberalization. In bilateral negotiations and multilateral fora such as the General Agreement on Tariffs and Trade, the World Bank and the International Monetary Fund, these countries have preached the benefits of liberalized trade policy to the developing countries. Now it is time for them to take these lessons to heart.

*Vinod Thomas is chief economist of the East Asia/Pacific region of the World Bank. John Nash is co-director of the United Nations Development Program/World Bank Trade Expansion Program*

WALL STREET JOURNAL, February 28, 1992

# Why the Third World Is Embracing Free Trade

## Speaking of Business

By Lindley H. Clark Jr

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# IMF Study Examines Impact of Resurgence In Regional Trade Arrangements

While regional trading arrangements are hardly a new phenomenon, they are a newly resurgent one, and the current focus on regionalism "may be qualitatively different from past efforts and may carry greater risks of becoming a substitute for, rather than a complement to, multilateralism," cautions a recently published IMF study. Among the differences, notes *Regional Trade Arrangements*, No. 93 in the IMF's Occasional Paper series, are the United States' interest in regionalism and regional arrangements that include industrial and developing countries.

> ***Regionalism may carry greater risks of becoming a substitute for, rather than a complement to, multilateralism.***

The study examines the instruments of integration and the effectiveness of existing arrangements in both industrial and developing countries and assesses the impact that growing regionalism in trade arrangements could have on the multilateral trade system, particularly the ongoing negotiations of the Uruguay Round. It was written by Augusto de la Torre and Margaret R. Kelly of the Trade and Payments Division of the IMF's Exchange and Trade Relations Department, with the assistance of Bernhard Fritz-Krockow and Miranda Xafa.

### Industrial Countries

In global terms, it would be difficult to overestimate the potential significance of industrial country arrangements. The major regional groups in Europe (the European Community (EC) and the European Free Trade Association (EFTA)) and North America (Canada, Mexico, and the United States) together account for about 65 percent of world imports and nearly 50 percent of developing country exports. ANZCERTA, the Australia New Zealand Closer Economic Relations Trade Agreement, is currently the only Pacific Rim arrangement. Japan does not participate in a regional arrangement—the only industrial country not to do so. The Association of South East Asian Nations (ASEAN), while it does not function as a regional trade arrangement, has become an "effective interlocutor for cooperation in economic matters and foreign affairs with OECD [Organization for Economic Cooperation and Development] countries."

The study assesses the effectiveness of regional arrangements by measuring the degree to which they have kept to their implementation timetables and the extent to which they have increased intraregional trade. Implementation has generally not been a problem within industrial country arrangements. The EC, for example, has consistently implemented agreements on, or even ahead of, schedule. There is general agreement that regional arrangements among industrial countries have not so far hindered multilateral liberalization, because these countries have reduced barriers against nonmembers before, or in conjunction with, regional liberalization. The authors caution, however, that not all sectors have become more open to nonmembers; many sector-specific bilateral restraints involving agriculture, textiles, apparel, automobiles, and other sectors remain at the national level, often taking the form of "voluntary" restraint arrangements.

Regional arrangements in industrial countries initially contributed to an increase in intraregional trade according to the study, but recent evidence is less conclusive. In the EC and EFTA, for example, intraregional trade increased markedly in their first ten to fifteen years but has leveled off or decreased in recent years.

The study cites several reasons why industrial country arrangements tend to increase intraregional trade and face fewer implementation problems than their developing country counterparts. First, trade liberalization is principally carried out in differentiated manufactures. This can be achieved "without major shifts in factor proportions and entails relatively lower transitional adjustment costs, particularly in terms of labor dislocation." Second, industrial countries are in a better position to absorb structural adjustment costs within the context of steady growth. Third, the industrial countries have postponed structural adjustment in sensitive sectors.

Given the growing importance of regional trade arrangements, the study examines whether the preferential treatment accorded to participating members will intensify discrimination against nonparticipating members. It concludes that three factors



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will influence the extent of future discrimination.

• The course of the negotiations of the General Agreement on Tariffs and Trade (GATT). With industrial country discrimination concentrated in such areas as agriculture and textiles, which are subject to multilateral negotiations, a successful conclusion to the Uruguay Round could, the authors suggest, help ensure that regional arrangements "serve as building—rather than stumbling—blocks to global trade liberalization."

• The openness of the external trade regime. Given an open trade regime, nonmember countries could benefit from increased demand for imports, lower-cost exports from the regional groups, and expanded access through a regional market that was largely unhampered by administrative, technical and regulatory barriers.

• The continued globalization of investment and production. "Foreign firms that have internationalized their operations and are already located within the geographic boundaries of the regional group," the paper suggests, "may gain from discrimination."

The paper warns that if either the EC or North America were to adopt a "fortress" trade policy stance, it could have "large negative effects on world GDP, on most countries, and on all regions, including the region that increases protection."

### Developing Countries

For many developing countries in Latin America and sub-Saharan Africa, regional trade arrangements have been a key element in their policy agendas over the past three decades. The study examines the impact of the Latin American Free Trade Association (LAFTA), the Central American Common Market (CACM), the Andean Pact, and the Caribbean Common Market (CARICOM) in Latin America; the Economic Community of West African States (ECOWAS), the Preferential Trade Area (PTA), the Economic Community of Central African States (CEEAC), and the Southern African Development Coordination Conference (SADCC) in sub-Saharan Africa; and the Gulf Cooperation Council (GCC) in the Middle East. The study notes, however, that political interest in these arrangements has not always been translated into effective implementation of economic goals, and the overall impact of these arrangements has been limited.

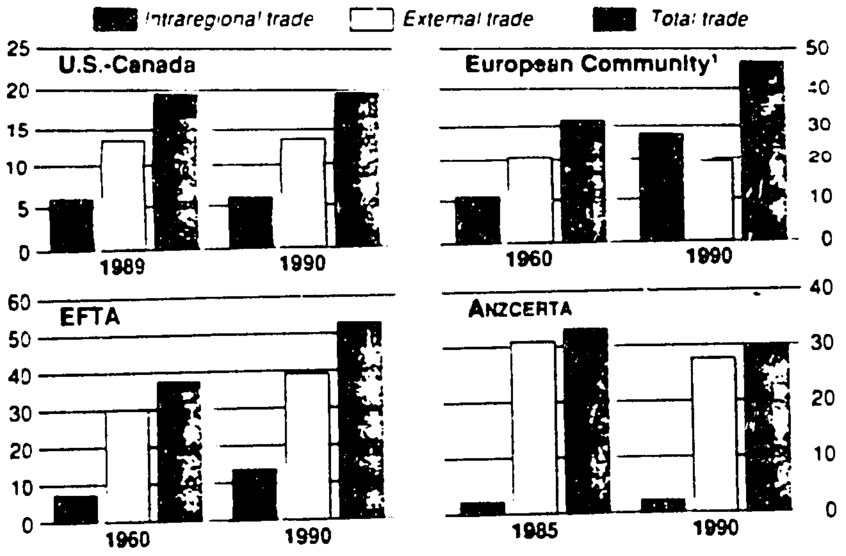
The same two criteria—whether these arrangements raised intraregional trade and whether these groups were able to keep to the implementation timetables they had set for themselves—are used to gauge the effectiveness of regional trade arrangements in developing countries. Generally, the study finds regional arrangements among developing countries have not produced large or sustained increases in intraregional trade. (They have been more successful, it notes, in other areas of economic cooperation, including agricultural research and development, and coordination of investment incentives.)

Regional integration schemes failed to increase intraregional trade in part because the structural characteristics of developing countries limited the scope for potential gains and in part because so little of the intended integration was actually implemented, the study finds. Implementation delays were often grounded in a basic incompatibility between the inward-looking development strategies being pursued in national economic policies and the requirements of regional liberalization.

Strong vested interests in import-

**Trade Developments in Industrial Country Arrangements**

(percent of regional GDP)




¹ The figures for 1960 are for the original six members, with a GDP of $190 billion. Figures for 1990 are for the EC 12 with a GDP of $6 trillion.

Data: World Bank, *World Development Report*, 1991 and IMF, *Direction of Trade Statistics*.



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competing industries and a weakened external environment also thwarted efforts to liberalize intraregional trade. At the operational level, the study indicates, "timetables lacked automaticity, included 'positive' lists rather than across-the-board liberalization of tariff and nontariff barriers, and entailed restrictive rules of origin. This made it easier for members to backtrack in the face of balance of payments difficulties or not to implement reforms owing to the lack of supporting policies."

Few developing country regional groups removed barriers across the board. Mechanisms set up to allocate new industries among member countries on a nonmarket and negotiated basis were frequently crippled by massive administrative problems and the sharp conflicts of interest that became the basis for decisions in the absence of market criteria and clear comparative advantage.

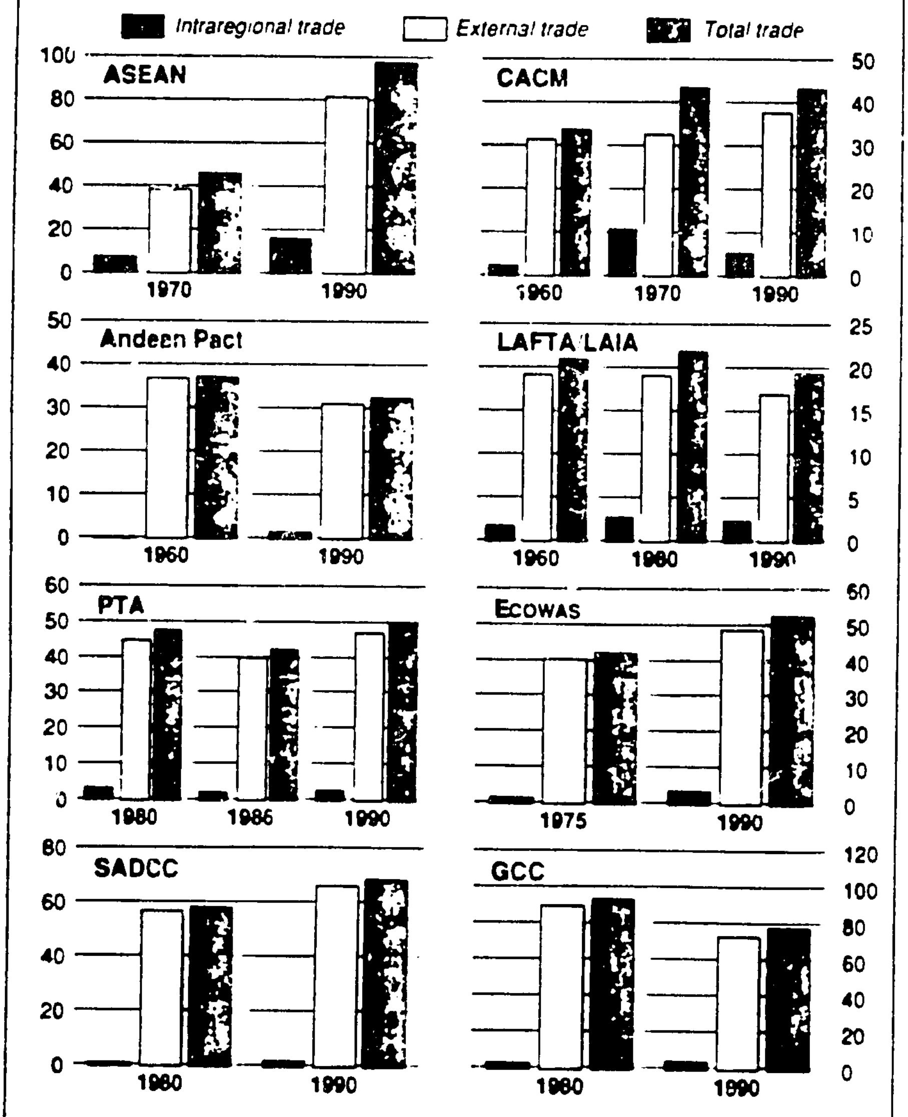
Inappropriate macroeconomic policies also contributed to the poor implementation record. "Against a background of external and internal imbalances—often reflecting expansionary fiscal and monetary policies—country authorities unwilling to allow a substantial devaluation of their overvalued currencies also tended to resist meaningful reductions in trade barriers," the authors note. They cite the experience of the Central American Common Market in the early 1980s as an instance in which a successfully implemented regional arrangement with a relatively high level of intraregional trade was not supported by national policies and was ultimately undermined.

Political and institutional factors also impeded implementation. Many developing country arrangements, although modeled after the EC, "were unable to endow their integration agreements with the institutional effectiveness needed to achieve their often ambitious objectives." These difficulties were further exacerbated, in some instances, by conflicting political philosophies among members, political instability within member countries, and border conflicts.

The study notes that important distributional questions often went unaddressed. These questions reflected not only potentially uneven distribution of the short-term costs of economic dislocation and lost revenue but also concern that the dynamics of integration might, over time, favor the more developed of the member countries.

Even if implementation of regional arrangements had been successful, the authors conclude, structural constraints would have limited the po-

**Trade Developments in Developing Country Regional Arrangements**
(percent of regional GDP)



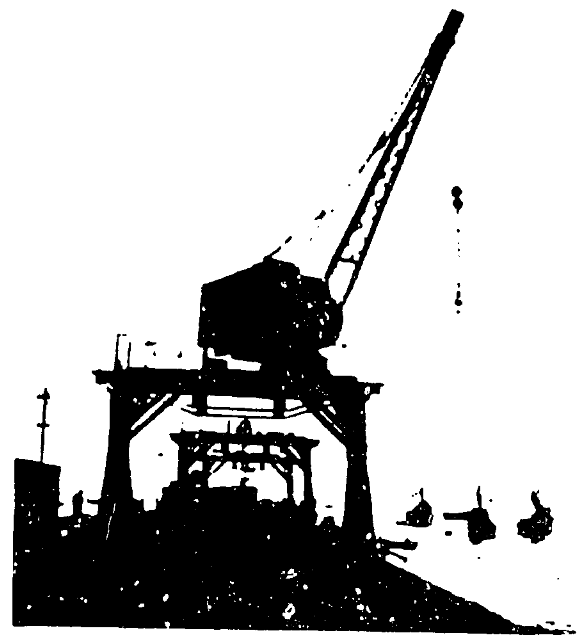

Data: World Bank, *World Development Report 1991*, and IMF, *Direction of Trade Statistics* tential gains. Their similar factor endowments, small markets, and low per capita incomes allowed them little scope for trade based on economies of scale and product differentiation. Likewise, the capacity to reallocate and rationalize productive resources was seriously constrained, given underdeveloped capital markets, barriers to entry, different tax and regulatory environments, and restrictions on intraregional factor mobility.

A survey of the literature suggests that developing countries would be better off "exploiting gains from trade based on differences in resource endowment and productive structure—seizing comparative advantages dynamically at every point in time as they build their human, capital, and technological stocks," the study maintains. This strategy is best pursued in the context of unilateral and multilateral liberalization. In this connection, the abandonment of import-substitution policies in developing countries in favor of outward-oriented policies is a positive development.

### Implications for Multilateral System

The growing interest among industrial and developing countries in regional trade arrangements has coincided with a period of mounting frustration over the pace and productivity of multilateral negotiations. The study notes that "the GATT's inability to curb rising protectionist pressures since the end of the Tokyo Round has created frustration with the slowness of the GATT process and raised concerns about its effectiveness and its ability to adapt to the emerging trade issues of the 1990s." Also cited is the growing concern over lax implementation of GATT Article XXIV; nondiscrimination, once the cornerstone of GATT, has been undermined, the study finds, by exceptions and ambiguities.

In this setting the authors find, regionalism has been advocated as an alternative to multilateralism, and the regional initiatives pursued by major industrial countries "have created the perception that preferential trading arrangements are here to stay." The United States appears to have shifted from a singular emphasis on nondiscrimination to a multiple approach encompassing unilateralism, regionalism, and multilateralism. Indeed, all the major countries, the authors suggest, "may be giving greater priority to regionalism in their trade policy agendas at the expense of multilateralism."



*Regional arrangements are likely to remain a feature of the international trading system.*

The authors acknowledge, however, that regional arrangements are likely to remain a feature of the international trading system and emphasize the importance of maintaining an outward orientation (to minimize trade diversion and ensure that developing countries are part of the globalization of investment and production) and of providing across-the-board intraregional liberalization with automatic timetables.

The risks of regionalism are several, the study warns, including "the possible diversion of scarce skills from multilateral to regional negotiations, the increased potential for friction among regional groups, and possible adverse effects on countries excluded from such arrangements." Despite efforts to liberalize areas not currently covered by the GATT, there is little evidence that regional arrangements will be able to tackle the areas most in need of substantive reform—such as agriculture, textiles, and apparel. The Uruguay Round may offer the best, and perhaps the only, means to reach an agreement in these areas, the study concludes.

Copies of Occasional Paper No. 93, *Regional Trade Arrangements*, are available at a cost of US$15.00 (US$12.00 for full-time university faculty and students) from Publication Services, Box S-346, International Monetary Fund, Washington, D.C. 20431, U.S.A.

## SDR Rates

| Week Beginning | Rate of SDR Interest and Charges (percent) |
|---|---|
| April 6 | 6.72 |
| April 13 | 6.45 |

The rate of SDR interest and charges is calculated weekly by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rates, call (202) 623-7171.

Data: IMF Treasurer's Department

JOURNAL OF COMMERCE, January 3, 1992

# No Future in a Fortress Asia

By YOSHIHIDE ISHIYAMA

Tokyo must break its eerie silence on emerging plans for an East Asia Common Market. It should say "yes" to a loose, open framework for regional cooperation and "no" to a protectionist "Fortress East Asia."

The idea of a regional economic group has gained momentum since Malaysian Prime Minister Mahathir bin Mohamad proposed it in late 1990. In January, the Association of Southeast Asian Nations is expected to begin work on the consortium, tentatively named the East Asian Economic Caucus.

Japan cannot afford to remain non-committal on this important issue. Continued fence-straddling will cast further doubt on Tokyo's ability to assume a responsible role in the emerging world order, and will give our Asian neighbors cause to question our sincerity.

Accelerated trade and investment has strengthened interdependence among the countries of East and Southeast Asia. Today, a grouping to promote regional cooperation makes good business sense. But vast cultural and economic differences remain, and any thought of eliminating tariffs and import quotas and turning the area into a free-trade zone would be premature.

The EAEC concept seems to have been inspired as much by external concerns as by internal imperatives. Western Europe is preparing for market integration in 1992, and Mexico is negotiating a free-trade pact with the United States. Mahathir and others are concerned that these agreements may lead to blocs that would stifle growth in Asia's export-led economies.

That the EAEC was conceived in reaction to European and North American developments is evident from the tentative guest list. Japan is prominent among the invitees, while the United States and Canada are conspicuously absent, whether Australia and New Zealand will be included remains unclear.

The Bush administration recoils at the notion of an exclusive Asian trading club, fearing that it would undermine U.S. influence and give Japan undisputed dominance of the region. Washington is throwing its weight behind the fledgling Asia-Pacific Economic Cooperation forum, which thus far includes Australia, Canada, New Zealand and the United States, as well as Japan and 10 other East Asian countries.

Japan's neighbors are also ambivalent about strengthening Tokyo's hand in the area. The idea of a new Greater East Asia Coprosperity Sphere doesn't sit well with former victims of Japanese aggression.

Tokyo cannot afford to ignore apprehensions on either side of the Pacific. At this point the only practical option is to steer a middle course.

By this I mean committing ourselves to an East Asian economic consortium that is open to countries in other parts of the world. The aim should be to strengthen intraregional ties and reduce dependence on foreign markets without shutting out Western business and investment.

It sounds tricky — and it will be. But here at last is an appropriate proving ground for Japanese global leadership.

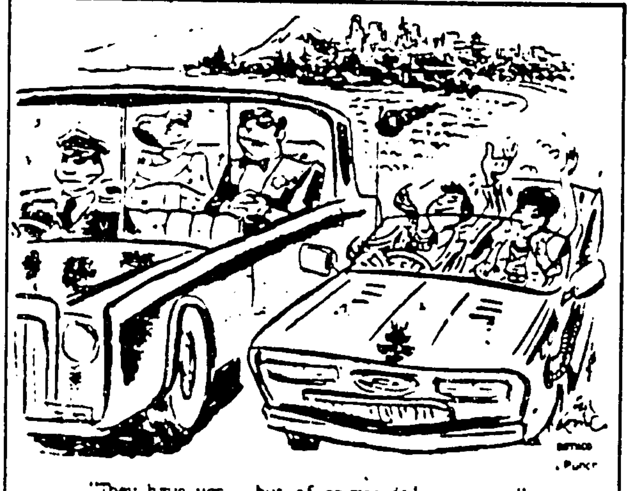
The way to begin is by redirecting the group's basic orientation. Rather than an economic bloc designed to compete with Europe and North America, it should be envisioned as a forum for promoting greater regional cooperation.

Some likely items on the agenda would be expanding air routes and communication links, developing free ports and special economic zones, signing bilateral investment agreements, creating productivity research centers and establishing an organ for settling regional disputes. Both U.S. and Soviet participation should be encouraged.

Another aim should be to promote cultural relations and exchanges of students, researchers and trainees. Progress in these fields lags far behind moves toward economic interdependence.

There is no reason why groups of two or three countries shouldn't form "miniblocs" as an outgrowth of such interaction. But clearly the time is not ripe for an East Asian Common Market.

Here is a unique opportunity for Japan to help build a new world order. Let's not allow rigidity or unseemly ambition to get in the way.



"They have yen - but of course it's new yen."

*Yoshihide Ishiyama is director of economic research for IBM Japan. This article, translated by the Asia Foundation, is reprinted from the Japanese newspaper Yomiuri Shimbun.*

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# The Environment and Free Trade With Mexico

## President Bush, Fact Sheets

**President Bush**
**February 25, 1992**

*Remarks at US-Mexico Environmental Border Plan Meeting, Los Angeles, February 25, 1992 (introductory remarks deleted).*

We're here today because today marks another step to a better future for all of the people of the United States and Mexico. Ambassador Carla Hills' [US Trade Representative] new report—and I have it here; it will be available—shows that higher standards of living for both our nations will help people keep the air and water cleaner on both sides of the border. The engine for higher living standards is the North American Free Trade Agreement. That agreement will link the United States, Canada, and Mexico in one of the world's largest open markets, with 360 million people and more than $6 trillion in output.

EPA [Environmental Protection Agency] Administrator Bill Reilly and his counterpart from Mexico today have issued a comprehensive new plan—and I have it here—for cleaning up pollution along the US-Mexico border. They've worked hard on this, and—thanks to our trade representatives, to our environmental officials, and to their partners in private industry, many of whom are here today—we now have a better understanding of the environmental problems along our border. We have a joint plan of action to correct these problems, and we've made the financial commitment to get this job done.

I've said many times before: Environmental destruction knows no borders. That is why, today, we're reaching hands across the border to improve our environment on both sides and improve our economies as well.

My fiscal 1993 budget—FY 1993—requests almost a quarter of a billion dollars for the border environment. This includes $125 million for wastewater treatment projects in three major border communities—including San Diego-Tijuana and the Imperial Valley-Mexicali—and we're seeking $75 million for improved drinking water and sewage improvements in low-income housing areas on the US side of the border.

We're also expanding our successful air quality monitoring programs to the San Diego-Tijuana and Imperial Valley-Mexicali areas. We're deepening the involvement of California universities in our overall research and training efforts. Our new plan will include San Diego State University and the think tank for studying environmental problems along the border, and it will help UCLA [University of California, Los Angeles] and the state of California improve training for Baja, California's health and environment inspectors.

My good friend—and I use that term advisedly—President Carlos Salinas is announcing the Mexican participation in this joint effort today. When I meet him tomorrow in San Antonio, I'll tell him that the free trade agreement can be a bright green light for both our countries. We need that agreement sooner, not later. We need the new jobs that open trade will create. We need the environmental benefits of higher living standards for both our nations.

Mexico has reduced its tariffs dramatically over the past 4 years, allowing us to more than double our exports to a level of $33 billion. But even after so much progress, their trade barriers are still 150% higher than ours. There's much more we can, and must, do.

Remember: The reward for each billion dollars of manufactured exports—each billion—averages nearly 20,000 new jobs in the United States of America. For every billion dollars in agricultural exports, the figure is 27,000 new jobs. More open Mexican markets will mean tremendous opportunities for Californians. Mexico needs machinery and equipment of all kinds. Mexico is a net importer of food; California industry and California agriculture are better positioned than anyone to fill those needs. I am delighted that our outstanding Governor [of California, Pete Wilson] is pushing so hard for this fair trade agreement. Already, California is reaping rewards from Mexico's partial trade liberalization. From 1987 to 1989, California's exports to Mexico increased by 107%. That's 39% higher than California's increased exports to the rest of the world.

Four weeks ago, in my State of the Union message, I spoke of urgent actions that we must take to get our economy moving. I spoke, too, of the long-range vision that we need to stay strong far into the future.

Our best interests for both the near and long term require vigorous trade relations with the rest of the world. We must not hide behind protectionist walls. We must let open commerce flourish—in commodities, in manufactured goods, in services, and in ideas.

Let me be very clear, as I will assure President Salinas tomorrow. I want to wrap up a sound new North American Free Trade Agreement. I believe economic growth and a clean environment go hand in hand. I want to move forward with new opportunities and a better quality of life for everyone from the Yukon to the Yucatan. We're here to celebrate these two important areas of agreement.

I might just say, in conclusion, one of the joys I have is working with the President of Mexico. It gives me a great sense of personal pride. I'm sure I speak for Ambassador Hills and for Administrator Reilly [in saying] that relations with the United States and Mexico have never, ever been better. We're going to make them even stronger, and the way to do that is to get a successful conclusion of this very, very important free trade agreement.

Thank you all for what you're doing. Thanks for your interest in the border. ■



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## Fact Sheet: Review of US-Mexico Environmental Issues February 25, 1992

*Fact sheet released by the White House, Office of the Press Secretary, Washington, DC, February 25, 1992.*

In a letter to the congressional leadership dated May 1, 1991, the President called for extending the fast track procedures to permit negotiation of a North American Free Trade Agreement (NAFTA) with Mexico and Canada. Responding to concerns about the environmental effects of free trade, the President indicated that the Administration would conduct a thorough and detailed review of US-Mexico environmental issues.

This review was coordinated by the Office of the US Trade Representative with the assistance of other federal agencies, including the Environmental Protection Agency (EPA), the Council on Environmental Quality, and the Departments of State, Agriculture, and the Interior. As part of the review, hearings were held in six cities, and public comments were sought.

### Key Conclusions

In Los Angeles today, after briefing President Bush on their findings, US Trade Representative Carla A. Hills and EPA Administrator William Reilly announced the results of the Administration's review. The review produced the following conclusions:

- The United States and Mexico have a strong record of bilateral cooperation on the environment.
- Completing and implementing NAFTA will enhance cross-border environmental cooperation and provide Mexico with resources and revenues to fund environmental protection and infrastructure development initiatives.
- It is reasonable to expect that a NAFTA would encourage industry to shift away from the *maquiladora* sector—that is, assembly plants benefiting from Mexican Government incentives for firms that export most or all of their production. This would reduce environmental stress on the US-Mexico border. Conversely, without NAFTA, Mexico's industrial resources will continue to flow into the *maquiladoras*, leading to further, uncontrolled development along the border and increased pollution.
- NAFTA will not turn Mexico into a pollution haven for firms seeking to escape US environmental standards.
- Consistent with the President's May 1 letter, the NAFTA negotiators should take steps to ensure that NAFTA is consistent with strong environmental protection policies and does not weaken US environmental, food safety, and pesticide laws and regulations.

### An Intensified Cooperative Relationship for Environmental Protection

The United States and Mexico have worked together for many years on environmental problems, particularly those affecting the US-Mexico border region. As momentum has built behind NAFTA, such cooperation has expanded and intensified.

The United States and Mexico have entered into formal, bilateral agreements covering the border environment, boundary and water issues, the conservation of natural resources, and Mexico City air pollution. In addition, both the United States and Mexico are parties to the Montreal Protocol on Ozone Depleting Substances, the Convention on International Trade in Endangered Species, and the Basel Convention on Transboundary Movement of Hazardous Wastes and Their Disposal. Finally, bilateral cooperation has benefited from extensive technical and scientific exchanges covering a broad range of environmental standards and enforcement issues.

By fostering economic growth and expanded bilateral trade, a NAFTA will enhance cooperation on economic and environmental issues and provide Mexico with resources and tax revenues to fund environmental and infrastructure development initiatives.

### Environmental Effects of NAFTA on the US-Mexico Border

The US-Mexico border region is under environmental stress, in part due to Mexico's *maquiladora* sector. The situation is similar to that of an expanding urban area unable to keep pace with essential infrastructure and environmental enforcement.

The review found that, without NAFTA, the border area will likely continue its rapid economic development. With NAFTA, border growth may actually slow, as industry shifts into Mexico's interior.

**Air Quality.** Without NAFTA, the review found that emissions could increase between 40% and 225% over 10 years. With a NAFTA and increased governmental cooperation, emissions growth could range from 20% to 85% over 10 years.

**Water Quality.** Growth in the border area will present the greatest obstacle to achieving and maintaining clean water. Increased demand for water may also lead to enhanced water treatment in order to make wastewater available for other uses.

**Hazardous and Municipal Waste.** Mexican law currently requires returning to the United States hazardous wastes generated at *maquiladora* industries from US raw materials. The current compliance rate is estimated at 31%. Both governments are committed to improving compliance and assuring proper handling of hazardous wastes.

### NAFTA Will Not Create a Pollution Haven in Mexico

Some have expressed concern that NAFTA might turn Mexico into a pollution haven for US firms seeking to take advantage of lower environmental requirements or weaker enforcement. The review concludes that NAFTA will not cause Mexico to become a pollution haven.

- Pollution abatement represents a small share of total costs for most industries. Thus, 86% of industries have abatement costs of 2% or less. Compliance costs tend to play a minimal role in decisions on plant location.
- Most US industries with high pollution abatement costs already have low tariffs, so that decisions on locating production would not change under NAFTA.
- The 11 US industries that have both high pollution abatement costs and high tariffs also tend to be capital-intensive. Consequently, the high cost of closing a US plant and building a new plant in Mexico is likely to overwhelm any compliance cost savings.



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• Such schemes would involve a highly questionable assumption as to future compliance costs, given that Mexico's regulatory requirements are similar to those in the United States, and new investment projects are subjected to special environmental reviews by the Mexican Government.

### Recommendations for Improving the Environment

The review produced a detailed list of policy and program options for US-Mexico environmental cooperation that are proceeding in parallel with the NAFTA talks.

The review also contains a detailed set of recommendations for NAFTA negotiators to reinforce the positive environmental benefits of NAFTA and mitigate potential adverse effects. These include:

• NAFTA should aim to expand trade and investment in environmental services and environmental and energy technology to encourage the availability of state-of-the-art expertise and technology.

• NAFTA should seek to reduce Mexico's incentives for export-only *maquiladora* plants, which tend to be concentrated along the US-Mexico border.

• NAFTA should maintain US rights to prohibit entry of goods that do not meet US health, safety, food and drug, and environmental regulations, so long as such regulations are based on sound science and do not discriminate against imports or constitute a "disguised" trade barrier.

• NAFTA should maintain the right, consistent with other international obligations, to limit trade in items or products controlled by international environmental treaties to which the United States is a party.

• NAFTA should contain dispute resolution mechanisms that are sensitive to environmental and health programs and considerations.

## Fact Sheet: Environmental Plan February 25, 1992

*Fact sheet released by the White House, Office of the Press Secretary, Washington, DC, February 25, 1992.*

During their meeting on November 27, 1990, President Bush and President Salinas directed their respective environmental authorities to develop a comprehensive environmental plan to address air, soil, water, and hazardous wastes in the border area. The United States and Mexico have reached agreement on the first stage of the plan, covering the period 1992 through 1994. The plan represents a firm commitment by both governments to protect the environment along the 2,000-mile US-Mexico border, while sustaining economic development.

### The 1983 Agreement

The new plan builds on the 1983 US-Mexico Border Environmental Agreement, which for the first time defined the main objectives of border environmental cooperation and established a mechanism for action. The primary binational mechanism will continue to be working groups led by officials of the US Environmental Protection Agency (EPA) and its Mexican counterpart, SEDUE. These working groups address concerns relating to water, hazardous wastes, air, contingency planning, enforcement, and pollution prevention. Another key mechanism is the International Boundary and Water Commission, which since the mid-1940s has fostered cooperation on issues related to water resources and water sanitation.

### Preparation of the Plan

The plan was prepared with participation by national, state, and local governments; businesses; labor groups; academic institutions; and environmental organizations. The public and private sectors participated in 17 hearings in both countries and submitted written comments. This pattern of open participation will continue during the implementation process, as well as in preparing for the next stage of the plan.

### Scope of the Plan

The Border Environmental Plan represents a commitment by the United States and Mexico to a substantially increased effort to speed environmental improvements along the border. The main objectives of the plan, which will require at least a decade to implement, are to protect the environment in the border area through:

• Strengthened enforcement of existing laws;

• Increased cooperative planning, training, and education; and

• Improved understanding of the border environment.

The plan describes in detail the joint environmental initiatives to be undertaken by the United States and Mexico in the border area between 1992 and 1994. The following is an illustrative list of actions included in the plan.

• Border Advisory Committees will be created in Mexico and the United States to provide advice to EPA and SEDUE on key environmental border issues. Membership will include leaders from environmental, business, government, academic, civic, and other organizations with expertise on border area issues.

• Air pollution monitoring programs will be established for the San Diego-Tijuana and Imperial Valley-Mexicali areas. Already, such monitoring is occurring in the El Paso-Ciudad Juarez area.

• Mexico will substantially increase the number of Mexican border environmental inspectors.

• Enforcement authorities will develop a computerized database on the transboundary movement of hazardous wastes.

• A wastewater treatment initiative will clean up the New River, which runs north through Mexicali, Mexico, into California. The New River is one of the most polluted rivers in the world.

• Drinking water and wastewater treatment systems will be constructed in the US *colonias* [border town neighborhoods].



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• Voluntary compliance programs will be established for US industry operating along the Mexican border. The main objectives are waste reduction, waste recycling, and other forms of pollution prevention.

• To improve air quality, a $120-million investment program is being launched to improve roads, bridges, and traffic along the Mexican border.

• Government officials will develop procedures for the prompt return of illegal hazardous waste exports to the country of origin.

• An inventory of legal and illegal waste disposal sites will be developed. Future needs for legal disposal will also be projected and developed.

## Financing

Funding for specific actions in the first stage of the plan (1992-94) will come from a variety of sources, including the Mexican and US Governments, state and local governments, and the private sector.

The total financing planned by the US Government for environmental protection along the border is $143 million in FY 1992 and will increase by 69%, to $241 million, in FY 1993. This includes $75 million for US border area *colonias* and over $80 million for wastewater treatment projects along the border (in San Diego-Tijuana, Imperial Valley-Mexicali, Nogales-Nogales, and Laredo-Nuevo Laredo). Other programs receiving funding include enforcement, transboundary air pollution monitoring and mitigation, environmental health, and emergency planning and response.

The Mexican Government has allocated $460 million during the 1992-94 phase of the plan. In 1992, Mexico committed $147 million for an array of environmental infrastructure projects in the border region, including wastewater treatment, solid waste management, transportation infrastructure, and dedicated land areas for low-income housing. SEDUE's resources are expected to be supplemented by a $50 million loan from the World Bank.

## Relationship to NAFTA

Mexico, the United States, and Canada are now negotiating a North American Free Trade Agreement (NAFTA) intended to reduce tariff and non-tariff barriers to trade among the three countries, thereby creating an open trading market of over 360 million people. The United States and Mexico are committed to reducing or avoiding potential adverse environmental impacts of the NAFTA. The Border Environmental Plan is a central vehicle for fulfilling that commitment. However, the plan itself will be mplemented on the agreed schedule and is not dependent on NAFTA or its pace of implementation. ■



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# TRADE AND THE ENVIRONMENT

Interaction between international trade and the environment is as old as trade itself. Awareness that the interaction has implications in public policy terms is more recent. Nevertheless, it dates back at least to the trade provisions in the 1933 convention on fauna and flora.[1] In the late 1960s, environmental problems caused by the discharge of waste and other pollutants into the natural environment emerged seriously; and so did concerns over the implications for international competitiveness.

Over the past two decades, producers in countries with stricter environmental standards have worried increasingly about the impact of those standards on their competitiveness in world markets. At the same time, governments and firms in other countries have expressed concern about new barriers being erected against imports produced under less strict standards.

Most recently, there has been growing public concern with issues related to the pollution of the global commons (for example, ozone depletion and climate change), as well as with species diversity and the treatment of animals. This has raised important questions about the use of trade policies to influence environmental measures in other countries.

The objective of this chapter is to provide an initial analysis of these and other interactions between trade and the environment, especially as they affect the multilateral trading system.[2] **Part 1** provides, for easy reference, an overview of the main issues and a summary of the principal conclusions. **Part 2** explains, on the basis of existing experience and judgement, which environmentally-motivated trade policy actions are permitted by GATT rules, and which are not. This is done with the understanding that the authority to interpret the rules of the General Agreement ultimately rests with GATT's contracting parties, that is, with its member countries. **Part 3** examines issues which arise when environmental effects are wholly domestic. Issues which arise when there are transborder physical spillovers into another country or into the global commons are covered in **Part 4**. The focus shifts in **Part 5** to the risk that environmental concerns and policies could lead, wittingly or unwittingly, to inappropriate or even counter-productive restrictions on international trade.

1 The full title of the convention, which is still in force, is the Convention Relative to the Preservation of Fauna and Flora in their Natural State. See Appendix I for a summary of multilateral environmental treaties containing trade provisions.

2 There is no generally agreed definition of "environment". The moderately broad definition used in this report - which includes the full range of pollution-related problems, plus soil erosion and loss of fertility, deforestation, product safety (food, hazardous wastes), endangered species and the treatment of animals - reflects the range of environmental issues that have been raised in discussions of the linkages between trade and the environment. The inclusion of a particular environmental issue in the analysis reflects not a judgement about the actual or potential seriousness of the problem, but rather only that it is being widely debated and therefore that there is an interest in exploring its possible implications for trade and the trading system.



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# 1. OVERVIEW AND SUMMARY

The main issues and principal conclusions can be grouped under five headings: the contribution of trade to a better environment, the need for multilateral cooperation, the role of trade policies, the political economy challenge, and risks and opportunities for the trading system.

## The contribution of trade to a better environment

Views differ regarding the impact of international trade on the quality of the natural environment. For some, expanding trade is a source of increased wealth and diffusion of technology, both of which enhance societies' ability to protect and up-grade their environments. Others argue that unrestricted trade can be harmful to the environment, especially when a country's environmental policies are weak or non-existent.

While the latter view does draw attention to certain trade-related environmental risks, there is no reason to assume that growth of per capita income necessarily, or even on average, damages the environment. To begin with, the increases in per capita income - which are boosted by increased market access and expanding trade - provide more resources to contain environmental damage, helping to finance pollution control and remedial clean-up. A country with a stagnant economy, by contrast, will be under greater pressure to stint on improving the environment.

Furthermore, if the average citizen is convinced of the need to devote more material and human resources to achieve a better environment as his or her income rises, the growth of per capita income ultimately will lead to increased expenditure on the environment. The available evidence suggests that this is indeed happening.

The opportunity for countries to trade in world markets for goods and technology facilitates the implementation of needed environment-improving processes at home. These processes often first appear in countries at the frontier of environmental regulation, and products embodying them must be exported if other countries are to catch up. Similarly, trade can help consumers make environmentally beneficial choices - for instance, imports of low-sulphur coal can encourage them to abandon the use of polluting high-sulphur coal. Trade in recycled inputs can help countries economize on resource use.

While trade liberalization is likely to reduce some protectionist barriers which are encouraging environmentally harmful activities, it is also possible that trade liberalization could worsen particular environmental problems in the absence of appropriate domestic environmental policies. Conceivably, an expansion of trade could produce negative environmental effects so large that they outweigh the conventional benefits from open markets (increased specialization, more competition and so forth), resulting in an overall decline in national welfare. However, this is possible only if a country lacks a domestic environmental policy that reflects its environmental values and priorities.[3] If that is the case, the most effective action is to concentrate on introducing appropriate environmental policies rather than

3 This proposition is demonstrated in Anderson (1992c).
**Note**: the full details of the references are provided in the list of references at the end of this chapter.



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trying to work around bad ones by foregoing trade liberalization or attempting to fine tune interventionist trade policies. A lack of appropriate environmental policies creates problems not just in the trade sector, but throughout every facet of a country's economic life. Manipulating trade policies is not only costly - in terms of a less efficient international division of labour - but also ineffective in dealing with the negative consequences elsewhere in the economy caused by the absence of appropriate environmental policies.

This is evident, for example, in efforts to promote sustainable development. Although that term means different things to different people, most definitions encompass two basic notions.[4] First, there is a need to place much greater emphasis on assigning values or prices to environmental resources, with a view to identifying and valuing the environmental effects of economic activity. Second is the idea that each generation should pass on to the next at least as much capital - environmental and man-made - as it inherited.

Neither aspect of sustainable development is intrinsically linked to international trade. A failure to place a value on environmental resources would undermine sustainable development even in a completely closed economy. Trade is seen, rather, as a "magnifier". If the policies necessary for sustainable development are in place, trade promotes development that is sustainable. Alternatively, if such policies are lacking, the country's international trade may contribute to a skewing of the country's development in an environmentally damaging direction, but then so will most of the other economic activities in the country. Clearly the correct action in such cases is to work for the adoption of an appropriate overall domestic environmental policy, rather than focusing attention on problems that are allegedly trade-related.

### The need for multilateral cooperation

Environmental issues can become internationalized in at least one of three ways. The first two, which can occur even when the issues are in principle purely domestic, are through concerns over the impact of environmental policies on international competitiveness, and through the assertion of jurisdiction over other nations' environmental priorities and practices. The third and most obvious way is through the transborder spillover of pollution into another country or the global commons (primarily the upper atmosphere and the oceans). Although current concerns with the environment encompass a wide range of issues, from water pollution to ozone depletion, and the treatment of animals to standards for pesticide residues in food, they all share a common need for multilateral cooperation, not only to minimize potential trade frictions, but especially to identify and implement workable and effective solutions to regional and global environmental problems.

As a result, it is no longer possible for a country to create an appropriate environmental policy entirely on its own. Even when environmental problems are domestic (in the sense that no pollution is escaping across the border), an attempt by countries to go it alone on environmental policies would sooner or later lead to frictions with trading partners and most likely to unilateral trade actions. What is needed is multilateral rules to guide countries in formulating their own environmental policies and in responding to domestic complaints about the impact of their own and other countries' policies on international competitiveness. To

4 The Annex in Pearce, Barbier and Markandya (1989) contains a compendium of definitions employed by different authors. See also Dasgupta and Maler (1990).



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back up the rules, a dispute settlement procedure is necessary for handling conflicts that cannot be resolved among the countries concerned. If existing rules and procedures are judged to be adequate for the task, fine. If not, some negotiated changes will be necessary.

When an environmental problem involves a transborder physical spillover, the only alternative to unilateral actions based on economic and political power is for countries to cooperate in the design, implementation and enforcement of an appropriate multilateral agreement for dealing with the problem at hand. This will often also be the case with assertions of jurisdiction over other countries' practices and policies, including the treatment of animals and endangered species.

Regardless of the nature of an environmental problem, the contribution of multilateral cooperation is to reduce the possibility that solutions are affected by differences in the economic and political strengths of the parties involved. Given the justifiable basis for a diversity of environmental standards among countries, it is important to minimize the risk of solutions being imposed by the larger or richer countries.

Negative incentives - in particular, the use of discriminatory trade restrictions on products unrelated to the environmental issue at hand - are not an effective way to promote multilateral cooperation. Alternatively, the use of positive incentives coupled with peer pressure can be a viable option - and all the more so since the likelihood of negative incentives being a workable and sustainable approach in the medium term and across a range of issues is open to serious doubt.

### The role of trade policy

This chapter argues, and there is much support for this view, that unilateral restrictions on trade would never be the most efficient instrument for dealing with an environmental problem. Of course it is always possible to find an example, hypothetical or taken from the real world, which appears to contradict that conclusion. But always at the base of such an example would be a national environmental policy that is considered inappropriate.

If all countries participated in all international environmental agreements, there would be nothing more to add. However, it is often a challenge just to get a critical mass of countries - let alone all countries - to participate in an international environmental agreement. As soon as participation is less than universal, trade policy re-enters the picture, albeit in a different role. Trade measures could be used as one type of "carrot" - or, despite the arguments noted above, as one type of "stick" - to encourage participation.

Past experience suggests that the organizers of an environmental agreement are also likely to consider including trade provisions - that is, measures affecting trade only in the product or products covered by the agreement - designed to minimize the extent to which trade between participants and non-participants could undermine the agreement. Recalling that a country's trade in a particular product is nothing more than the difference between production and consumption, there is also the option of controlling both production and consumption in the participating countries. In this case there would be no need to have separate controls on trade flows.



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### The risk of protectionist responses

There is much evidence which points to a serious risk of environmental issues and concerns being exploited by protectionists for their own benefit. This can occur at any of several stages: by promoting policies that discriminate against imports as part of the solution to environmental problems, by biasing the choice between positive and negative incentives in favour of trade sanctions, by pushing for the inclusion of unnecessary trade provisions in multilateral agreements, or by deliberately promoting product standards that place a proportionately greater cost burden on foreign producers. These concerns are heightened by the efforts of protectionist groups to draw environmental groups into implicit or explicit alliances.

If the use of inefficient policies to achieve environmental goals were costless for environmental interests, then practical politics might argue for embracing such coalitions whenever possible. But it is not likely to be costless, and certainly not in the medium and long term. Biases that protectionist interests introduce into the environmental policy package increase the costs of environmental improvements. In the longer term, this can only reduce the amount of improvement the society will be willing to undertake. When that happens, the protectionist interests gain not only at the expense of the rest of the economy, but also at the expense of the natural environment.

### Risks and opportunities for the trading system

There is a serious risk that the trading system could get badly bruised by a rush to deal with environmental issues which are viewed as urgent by important segments of the population in an increasing number of countries. To someone unfamiliar with, or indifferent to, the contribution of economic efficiency and the trading system to postwar economic prosperity, trade measures can too easily seem to be low cost and readily available tools for pursuing environmental goals.

As regards the design and implementation of environmental policies, GATT rules place essentially no constraints on the ability of countries to use appropriate policies to protect their environment from damage from domestic production activities or from the consumption of domestically produced or imported products. Concern over the possibility that technical or other kinds of regulations could create unnecessary obstacles to trade has led, it is true, to certain multilateral disciplines. But those disciplines contain qualified exceptions for actions related to protecting or improving the environment.

When the environmental problem is due to production or consumption activities in another country, the GATT rules are more of a constraint, since they prohibit making market access dependent on changes in the domestic policies or practices of the exporting country. The rationale for this is that to do otherwise would invite a flood of import restrictions as countries (especially those with large markets) either attempted to impose their own domestic environmental, economic and social policies on other countries, or used such an attempt as a pretext for reducing competition from imports.

Furthermore, the fact that GATT rules block the unilateral use of trade measures to dictate changes in the environmental policies of other nations does not mean that governments are powerless. They still have the possibility of negotiating a multilateral solution or, failing that, of requesting a GATT waiver. These options offer the prospect of resolving environmental problems and conflicts, while at the same time effectively guarding against the excesses that would result from unilateralism.

In other words, GATT rules could never block the adoption of environmental policies which have broad support in the world community. This is because in most instances the support of two-thirds of GATT's membership - currently 69 out of 103 countries - is sufficient to amend the rules or grant a waiver. What the rules do constrain is attempts by one or a small number of countries to influence environmental policies in other countries not by persuasion and negotiation, but by unilateral reductions in access to their markets.

The real risk, therefore, is not that trade policies will be used, but that they will be used unilaterally. If the door were opened to use trade policies unilaterally to offset the competitiveness effects of different environmental standards, or to attempt to force other countries to adopt domestically-favoured practices and policies, the trading system would start down a very slippery slope. Countries are not clones of one another, and will not wish to become so - certainly not under the threat of unilateral trade measures.

The opportunities presented to the trading system consist mainly in exploiting the various ways in which open international trade can contribute, in conjunction with appropriate national environmental policies, to the improvement and protection of the environment. From an institutional standpoint there is a need for a careful examination of the existing rules to be certain that they do not hinder multilateral efforts to deal with environmental problems. This will be one of the important tasks of GATT's recently activated Group on Environmental Measures and International Trade.

More broadly, the economic growth stimulated by open trade policies increases wealth and spreads knowledge and information, which in turn increase the range of choices available to consumers, including the option of choosing to enjoy the services of a higher quality environment.

# TRADE RESTRAINTS AND THE COMPETITIVE STATUS OF THE TEXTILE, APPAREL, AND NONRUBBER-FOOTWEAR INDUSTRIES

The Congress of the United States
Congressional Budget Office

December 1991

## SUMMARY

Restrictions on imports of textiles, apparel, and nonrubber footwear have been a recurring and nagging issue over the past decade. During that time, the Congress has come close several times to overriding Presidential vetoes of bills aimed at tightening existing quotas or imposing new ones on these imports. Running counter to those efforts, the Uruguay Round of negotiations to expand the General Agreement on Tariffs and Trade (GATT) has focused on, in addition to other issues, proposals to phase out the Multifiber Arrangement (MFA). This arrangement exempts textile and apparel trade from the standard GATT prohibitions on import quotas. Also, the proposed North American Free-Trade Area will probably reduce or eliminate tariffs and other restrictions on textile and apparel trade between the United States and Mexico.

The Congressional Budget Office (CBO) has studied the history of the economic health of the three industries and the economic effects of the major proposals for changes in protection and concluded that tariffs and import quotas are a costly and inefficient means of preserving jobs in these industries. Estimates of the annual costs to consumers of current and proposed restrictions are generally in the range of $39,000 to $74,000 for each job they retain in the textile and apparel industries and higher for jobs retained in the nonrubber-footwear industry. Most estimates of the annual net welfare costs of these restrictions to the economy (that is, the amount by which the costs to consumers and the government exceed the benefits to U.S. firms, workers, and the government) are in the range of $9,000 to 38,000 for each job retained in the textile and apparel industries. Estimates of costs in the nonrubber-footwear industry are higher.

Indeed, the estimated consumer costs are all higher than the average annual earnings of the workers who hold the jobs, and most of the estimated net welfare costs are also. Consequently, it would generally be more efficient for the government to allow the jobs to disappear and compensate any displaced workers who cannot find equivalent work. Most of the net welfare costs take the form of higher prices paid to foreign exporters and (in the case of quotas) lower tariff revenues collected.

## PROTECTION AND COMPETITIVENESS OF THE THREE INDUSTRIES

The textile and apparel industries benefit from some of the most substantial and long-lived trade protection that the United States has granted in recent times. High tariffs on textile and apparel imports date back at least to 1930. Quotas were imposed on imports from Japan in 1936 and again in 1956. (The term "quota" refers throughout this study to any kind of numerical limit on imports imposed by or as a result of pressure from the United States. In addition to standard quotas, these limits include those sometimes referred to as voluntary restraint agreements, voluntary export restraints, gentlemen's agreements, or designated consultation levels.) By September 11, 1991, the United States had extended such restraints to 41 countries that collectively accounted for 69 percent of U.S. textile imports and 88 percent of U.S. apparel imports in 1990. The quotas are aimed at developing countries. Although 4 of the 10 largest suppliers of U.S. textile imports and 1 of the 10 largest suppliers of apparel imports are industrialized countries, 40 of the 41 countries covered by quotas or restraint agreements are developing countries, and the one that is not--Japan--was a developing country when it first became subject to restraints.

The nonrubber-footwear industry is not as protected as the textile and apparel industries, but is more protected than most other industries. Except for one temporary set of restrictions from 1977 to 1981 on imports from Taiwan and Korea, the United States has not used import quotas to protect this industry. Import tariffs, however, have averaged two or more times the average tariff rate for all merchandise imports.

Although the three industries are frequently grouped together in discussions and legislation relating to trade, they have actually fared quite differently against foreign competition over the past 30 years.

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Domestic textile production is relatively competitive. The ratio of the value of domestically produced textile shipments to the value of domestic textile consumption has remained near 100 percent, which means that the textile trade deficit has never been very substantial. The apparel industry is less competitive. Its ratio has declined from near 100 percent to slightly less than 70 percent; equivalently, the apparel trade deficit has risen to slightly more than 30 percent of the domestic market. The nonrubber-footwear industry is even less competitive. Its ratio has declined from nearly 100 percent to less than 30 percent.

Corporations in the apparel, leather, and leather products industries taken together, and also those in the textile industry, have been as profitable as, if not more profitable than, the average for all manufacturing corporations in the United States since 1978, and have been reasonably competitive for an even longer time. They have consistently had, however, a significantly lower ratio of dividends to equity. The protection that the industries have received from imports has undoubtedly influenced their profitability.

## SIGNIFICANCE OF THE INDUSTRIES TO THE U.S. ECONOMY

Historically, the textile and apparel industries have been large and significant elements of the U.S. economy, but they have declined substantially over the past few decades. The nonrubber-footwear industry was much smaller to begin with, and has declined even more.

The textile industry's share of total nonagricultural employment in the United States declined from 1.71 percent in 1960 to 0.63 percent in 1990; the apparel industry's share declined from 2.28 percent to 0.93 percent; and the nonrubber-footwear industry's share declined from 0.45 percent to 0.06 percent. These declines continue trends that date back at least 50 years. Shares of the three industries in total assets of manufacturing corporations and shares in the value added by manufacture tell the same general story. Of course, the industries are not spread evenly throughout the country. They are more important to the economies of several Southeastern states, where they employ larger shares of the labor force than they do nationwide. Apparel workers in

California, New York, Pennsylvania, and Texas are numerous, but their shares of the large labor forces of those states are not far out of line with the national average.

Pay in the three industries is generally low. In 1990, average hourly earnings of production workers in the textile industry were only 80 percent of the average for all private nonagricultural industries, and the average for the apparel and nonrubber-footwear industries was only 66 percent. Thus, most workers in these industries would be better off financially if they were trained for and employed in higher-paying work and these low-paying jobs were allowed to go overseas. (Some workers in small towns might be worse off, however, if they had to move to obtain new jobs and were forced, as a result, to sell their homes at a loss.)

## CAUSES OF THE INDUSTRIES' PROBLEMS

U.S. apparel and nonrubber-footwear production have been unable to maintain market share because the industries are labor intensive, which causes them to be more heavily burdened than other industries by the relatively high cost of labor in the United States compared with that in developing countries. In conjunction with the competition from foreign production that uses low-cost labor, the high labor intensity helps explain why pay in these industries is so low in comparison with that in other industries in the United States. (Another part of the explanation is the relatively low levels of skill required by these jobs.)

The textile industry is approximately as labor intensive as the rest of U.S. manufacturing. Consequently, it has had little trouble maintaining its international competitiveness and market share. The inroads of foreign competition have not caused its declining employment. Rather, the cause has been rapid rates of growth in labor productivity. Labor productivity has grown faster in the textile industry than it has in the U.S. manufacturing sector as a whole. This growth has benefited the industry by improving its competitiveness. It has also benefited the consumers of textiles, who see the lower prices and higher quality that have resulted from it. Productivity has grown faster than the domestic demand for textiles, however. Thus, the industry needs fewer workers to fill that demand. Trade deficits and surpluses in this industry have never been substantial. Therefore, competition from imports cannot have seriously affected employment other than perhaps by forcing the domestic industry to improve productivity.

## PROPOSALS FOR CHANGES IN PROTECTION

Three recent proposals for changes in the protection accorded the three industries merit analysis. The first, a significant element of the Uruguay Round of negotiations, would gradually phase out the Multifiber Arrangement, which provides the legal basis under the GATT for the current quotas on imports of textiles and apparel. The second, currently under negotiation with Mexico and Canada, would set up a North American Free-Trade Area encompassing the United States, Canada, and Mexico. The third, proposed in several bills passed by the Congress and vetoed by the President over the past few years, would impose new global quotas on imports of textiles, apparel, and nonrubber footwear.

### Elimination of the Multifiber Arrangement

Eliminating the MFA would probably benefit consumers substantially and harm domestic textile and apparel production to a somewhat lesser extent in absolute dollar terms. Since the textile industry is fairly competitive, eliminating the quotas on apparel would have a greater effect than eliminating the textile quotas.

According to estimates from a study by the International Trade Commission, in 1987 the U.S. quotas on textile imports were equivalent to an average tariff of 21.8 percent and the quotas on apparel imports were equivalent to an average tariff of 28.3 percent. The study presented further estimates showing that eliminating all U.S. quotas and tariffs would cause a net welfare gain to the United States of $2.4 billion to $2.6 billion per year and reduce employment in the textile and apparel industries by 233,000 to 291,000 jobs. These numbers constituted 13 percent to 16 percent of all employment in these industries at that time. By these estimates, the annual cost of all current U.S.

textile and apparel import restrictions is roughly $9,000 to $10,000 for each job that the restrictions retain in the industries. Eliminating all U.S. trade restraints, however, would have greater effects than would the mere elimination of the MFA and the modest tariff cuts that are being negotiated.

The term "retained" is used here rather than "saved" because no jobs are actually saved in the economy at large. Trade restrictions have no permanent effect on the level of total employment in the economy. Rather, they affect the distribution of employment among industries. Trade restrictions on textile and apparel reduce the number of forced job changes from those industries to other industries, and thus can be said to retain jobs in the textile and apparel industries.

Estimates from other studies put the annual net welfare cost of these restrictions in the range of $13,000 to $19,200 for each job they retain in the apparel industry and $3,600 to $15,300 for each job they retain in the textile industry. Consumer costs, which are the net welfare cost plus transfers of wealth from consumers to domestic producers as a result of higher prices, are much higher. Estimates range from $39,000 to $46,000 for each job retained in the apparel industry and from $50,000 to $52,000 for each job retained in the textile industry.

The Uruguay Round will most likely result in a modest reduction, not complete elimination, of tariffs to accompany the elimination of the MFA. This combination of changes would result in smaller total dollar gains and smaller job losses in the industries, but the ratio of dollar gains to job losses (or, equivalently, the cost per job retained by the restrictions) should not be any lower. Similarly, the fact that other countries will also be getting rid of their import quotas at the same time that the United States does will reduce the dollar gains and job losses but should not have much effect on the ratio.

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## The North American Free-Trade Area

Because the United States already has a free-trade agreement with Canada, the effect of eliminating trade barriers between the United States and Canada is not an issue. The main issues are (1) the extent to which Mexican imports will replace U.S. products in the United States and Canada if the two countries drop their barriers to Mexican goods; (2) the extent to which U.S. exports to Mexico will increase if Mexico drops its barriers to imports from the United States; and (3) the extent to which increased Mexican production of apparel for export to the United States and Canada will increase Mexican demand for U.S. textiles.

Eliminating U.S. barriers to textile imports from Mexico is not likely to have much effect on the U.S. textile industry or consumers. To date, U.S. production has been competitive enough to keep textile imports from the rest of the world small, and Mexico supplies only a very small fraction of those textiles that the United States does import.

Eliminating barriers to imports of apparel could have a more substantial effect. The production of apparel in the United States is less competitive than textile production, and Mexico is the fifth largest supplier of U.S. apparel imports. The quotas on these imports are currently going unfilled, but the tariffs are clearly an impediment. Thus, eliminating the quotas and tariffs could increase imports, thereby hurting U.S. apparel production, having a mixed and possibly helpful effect on U.S. textile production, and aiding the U.S. consumer by promoting greater variety at lower prices.

The negative effect on U.S. apparel production would hurt U.S. textile production because it would lower demand for textiles by the U.S. apparel industry. That effect, however, would be offset--possibly more than offset--by increased demand for U.S. textiles by the Mexican apparel industry, a result of Mexico's increased production for the U.S. apparel market and its lower barriers to textile imports. Mexico is currently the second largest foreign market for U.S. textile producers.

## New Global Quotas on Imports

CBO has developed models of the textile, apparel, and nonrubber-footwear markets in order to estimate the effects of new global quotas on imports of these products. (A global quota is a quota on the total imports of a product from all countries. Current textile and apparel quotas apply to individual countries rather than all countries.) The quotas were assumed to be identical, except for a delay of one year, to the quotas mandated by the Textile, Apparel, and Footwear Trade Bill of 1990, which the Congress passed but the President vetoed. Thus, the textile and apparel quotas were assumed to be set at 101 percent of 1990 imports in 1991 and allowed to increase by 1 percent annually; the nonrubber-footwear quotas were assumed to be fixed permanently at 100 percent of 1990 imports. The revenues from the trial quota auctions specified in the bill were not factored into the cost calculations. Factoring them in would reduce the estimated cost of the quotas, provided the auctions did not lead the countries to retaliate.

The models indicate that such quotas would become increasingly restrictive. They would increase the price of apparel by 2.0 percent above baseline in 1991 and by increasing amounts thereafter, reaching 4.7 percent above baseline in 1995 and 9.8 percent above in 2000. They would increase the price of textiles by 0.5 percent above baseline in 1991, 2.0 percent above baseline in 1995, and 5.2 percent above in 2000. Finally, they would increase the price of nonrubber footwear by 3.3 percent above baseline in 1991, 15.6 percent in 1995, and 27.0 percent in 2000.

These price increases would burden consumers with costs that would rise over time, but they would retain in the industries increasing numbers of jobs that would otherwise shift to other parts of the economy. Estimates based on the model place the cost to consumers of textiles and apparel in 1991 at $1.7 billion, the net welfare cost to the United States at $0.8 billion, and the number of jobs retained in the textile and apparel industries at 18,000. For 1995, the respective numbers are $4.6 billion, $2.4 billion, and 65,000 jobs retained. For the year 2000, the numbers are $10.4 billion, $5.4 billion, and 141,000 jobs retained. After an initial high value caused by the slowness of domestic producers to respond, the consumer cost per job retained settles into a range of $59,000 to $74,000 per year. The annual net welfare cost per job retained settles into a range of $31,000 to $38,000.

The estimate of the cost to consumers of nonrubber footwear in 1991 is $470 million, the estimate of the net welfare cost is $350 million, and the estimate of the number of jobs retained in the industry is 3,200. For 1995, the respective numbers are $2.3 billion, $1.8 billion, and 23,000 jobs retained. After initial high values caused by slowness of domestic producers to respond, the consumer cost per job retained settles into a range of $97,000 to $113,000 per year, and the net welfare cost per job retained settles into a range of $74,000 to $86,000 per year.

# *Gist:* Andean Trade Preference Act of 1991

## Background

In September 1989, President Bush approved an Andean counter-drug initiative that expanded narcotics-related military, economic, law enforcement, and intelligence cooperation for selected Andean countries for the purpose of strengthening their counter-narcotics efforts. At the Cartagena summit in February 1990, President Bush joined Andean presidents from Bolivia, Colombia, and Peru in a commitment to fight drug trafficking through a strategy of mutually reinforcing actions to cut demand and supply. At that summit, the Andean presidents appealed to President Bush to provide new trade opportunities to create legal sources of employment to displace permanently the cocaine economy in their countries. Later, in July 1990, President Bush announced that he was sending to the US Congress the Andean Trade Preference Act (ATPA), designed to fulfill his commitment at the Cartagena summit with Bolivia, Colombia, and Peru, as well as Ecuador.

## Key Provisions of the ATPA

This proposal, which was signed into law on December 4, 1991, is designed to expand economic alternatives for those countries that have been fighting to eliminate the production, processing, and shipment of illegal drugs. It provides the basic authority for the President to grant duty-free treatment to imports of eligible articles from countries designated as beneficiaries according to criteria set forth in the act. The proposal is patterned after the Caribbean Basin Economic Recovery Expansion Act of 1990, which implemented the Caribbean Basin Initiative (CBI).

Key provisions of the proposal are:

- The President is authorized to designate Bolivia, Colombia, Ecuador, and Peru as beneficiary countries, based upon certain criteria specified in the act.
- Articles are eligible for duty-free entry if they are imported directly from a beneficiary country, consist of at least 35% value-added in a beneficiary country or countries (including CBI countries), and are made of components originating in the beneficiary countries or (if of foreign origin) have been substantially transformed in the beneficiary country or countries into new and different articles of commerce.
- Articles exempt from duty-free treatment include: textiles and apparel, footwear, canned tuna, petroleum and petroleum products, watches and watch parts, and rum. Handbags, luggage, flat goods, work gloves, and leather wearing apparel are subject to duty reduction over a 5-year period. Duty-free entry of sugar, syrups, and molasses is provided consistent with the tariff-rate quotas on these products.
- The proposal establishes import relief and emergency provisions in order to safeguard US domestic industries, including those producing perishable products (i.e., live plants and fresh cut flowers, certain fresh or chilled vegetables, certain fresh fruit, and concentrated citrus fruit juice).
- The US International Trade Commission and the Department of Labor are required to monitor and report annually on the impact of the act on the US economy and US labor, respectively.

The program will remain in effect for 10 years. ■

# FINANCE

# FINANCE

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Images of starving children in Africa draw millions of dollars in donations. But do these images represent a true picture of the impact of food relief on the Third World? Not exactly. The underlying reasons, the mechanics, and the effects of food aid are more complicated than the televised pictures lead one to believe.

By HEATHER HILL

In the heart of Alto Hama, a half-destroyed hamlet in central Angola, some 5,000 ragged rural peasants are assembled in a small field beside a church. Clutching empty sacks, pails, boxes, baskets, and bowls, they docilely form two long lines that terminate at makeshift checkpoints manned by young Europeans. Four large trucks, meanwhile, are aligning themselves on the other side of the checkpoints so that local day recruits can unload their cargo. Then, as an anticipatory buzz rises from the crowd, the com-



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plex and increasingly controversial exercise of food relief begins.

It goes like this: Each person surrenders a blue ticket to the Red Cross workers at the checkpoint and then goes to the trucks to collect a ration of cooking oil, beans, or maize meal. As the long, hot day creeps forward, the two lines advance almost imperceptibly: Beans spill from the improvised containers, old women have difficulty hoisting the 50-kg sack of maize meal onto their shoulders, and the tins of oil are awkward to carry away. But a note of picnic-like excitement dominates the proceedings, and by the end of the day, children are tossing discarded cardboard boxes back and forth like frisbees.

It's a picture that would warm the heart of anyone who is moved by the plight of the hungry in the Third World. But look again: Behind the fragile ribbon barriers are the ever-present dealers, tough young men in flashy clothes attempting to buy or steal the rations. In mid-afternoon, a melee breaks out when a thief grabs the food parcel of an Angolan who has fallen asleep after undergoing the queue. And on the fringes of Alto Hama, fat cattle are grazing and maize fields flourishing. Do these people really need free food from the European Community?

"The target of this operation is to get people *off* food relief," says Pierre Gauthier, a media spokesman for the International Committee of the Red Cross. "The effects of the war are ongoing. The emergency will be over only when the people become self-sufficient."

ICRC officials are anxious to impress upon a visitor that this food distribution—four months after Angola's 16-year civil war has ended—has the specific purpose of preventing rural Angolans from eating the seeds they will receive in several weeks when the agricultural season begins. The role of food aid is changing dramatically, and since so much of it depends on the generosity and political will of a public thousands of miles to the north, aid organizations are having to tread the fine line between traditional idealism and the somewhat more complex reality.

"Food aid does more damage than good," asserts an Oxfam official in southern Africa. "It destroys the rural economy. If you put [free] maize on the market, it lowers the price for the farmers. It can get to the point where the farmer won't bother growing food."

"It's easy to distribute food for free," observes an official in Angola's ministry of social affairs. "But it's also surprising the effects it can have on people's psychology to think they can have their stomachs filled without having to do anything for it."

For many people, disillusionment with food aid came in the aftermath of Band Aid, when pop star Bob Geldof, organizer of the 1985 global charity concert, described the subsequent failures in delivering food to Ethiopian famine victims as "a perversion of the act of human generosity." But people working in the field have been aware for more than a decade of the countless disasters wrought by well-intentioned but unregulated Western-based charities for whom food aid is a big business. More and more publications are documenting the errors of old-fashioned give-aways.

And the victims are invariably the recipients: farmers sabotaged by a sudden oversupply of their crop, people who are either dead or out of danger by the time the food gets to them, people who are given food inappropriate to their usual diet or their medical condition, people who become trapped in the aid dependency cycle, unwilling or unable to go back to growing their own food.

Because the pitfalls and weaknesses of food relief have become so apparent, a new phase in its evolution has begun: free food for sale. Instead of the food simply being given away directly to (most often) refugees, it is sold at subsidized rates to middlemen—established small traders or government agencies—as a way of maintaining the existing local economy. The sale of food aid is not well known, not just because it is new, but because it is a complex mechanism in the giant industry of food relief—and one not easily explained to a First World public which wants to save starving children.

"Some donor [agencies] don't accept it," said the Angolan government official who works in the social welfare department. "U.S. AID used to be appalled at the idea of selling food aid. But we [relief personnel] have to attack the idea that people are dying of hunger. It's a misconception that food is urgently required in an emergency situation."

At present, there are only a few cases of relief food being sold. One is Angola, where the World Food Programme has agreed to sales of its stocks to the Gabela railway line. The railway company needs the food for the workers who are building a rail link from Porto Aboim to Gabela. The money realized from the sales will then go into a fund run by the local peasants' association, which will use the money to rehabilitate day care centers.

"The fact that there aren't shops doesn't mean that food should be free," points out the Angolan government official. "We have to act as a substitute for the shops."

Another such scheme has been undertaken in Ethiopia's Ogaden desert, where the population has been swelled this year by the arrival of some 250,000 refugees from neighboring Somalia. The fragile livestock economy of the Ogaden has been devastated by the massive influx, and development officials were faced with the prospect of both Ethiopians and Somalis arriving en masse at refugee camps and food distribution centers. Save The Children and the World Food Programme decided to sell donated grain at low rates to desert traders in an effort to maintain the established market patterns of the rural areas.

"Nobody yet has managed to give out grain successfully," observes John Seaman, head of policy development at Save The Children in

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Ethiopia. "You give it out to some people, they end up selling it to others and it goes to market that way. The choice is really not whether you sell the grain, but who's going to sell it to whom."

Malawi provides perhaps the best illustration of the effects of free food on the local economy. In 1986, Mozambican refugees began pouring into this small agricultural enclave by the hundreds of thousands, fleeing a brutal, guerrilla-style civil war across the border. Today, the refugees number 1 million, packed into camps cheek by jowl with the national population of 7 million. Indeed, in the Nsanje region of southern Malawi, Mozambicans outnumber Malawians by three to one.

Since the Mozambicans are effectively forbidden to farm in Malawi, they receive food exclusively from the relief organizations. The country has become the World Food Programme's biggest recipient in Africa, which every month brings in 6,000 tons of maize, 300 tons of groundnuts, and more than 900 tons of beans. (The biweekly ration package distributed by the Red Cross also includes sugar, cooking oil, and salt.)

Aid officials working in Malawi agree that there is less "diversion"—theft—of food relief by government officials or subcontracted workers than in most other African countries. What that means is that there is far more food for the refugees to sell. Indeed, sales are so brisk along the roadsides that Malawi's business community, composed largely of East Indians, is complaining to the government that "they have a very strong and illegal competition," according to one relief worker.

Cooking oil is a particularly sore point. This is the most popular component of the ration package, and the Malawian cooking oil industry has seen its market shrink because the product is being sold widely and more cheaply by the refugees. In an attempt to curb the illegal sales, the WFP has decided to reduce the amount of oil given to the refugees.

But ultimately, the WFP, an agency of the United Nations, takes the view that its food is a present and the refugees are free to do with it what they wish. Furthermore, according to the WFP, once the food enters the country, it becomes the property of the Malawian government, upon whom the onus falls to police the illegal sales. Only a few sporadic arrests have been made, however, and the illegal sales continue.

**"Food aid does more damage than good. It destroys the rural economy. If you put free maize on the market, it lowers the price for farmers."**

But if the Malawian government receives no taxes or customs duties on the tons and tons of donated food entering the country, it is benefiting in other ways. The relief organizations have brought in vast amounts of hard currency. Medecins Sans Frontières, for example, runs its biggest operation in Malawi, with an annual budget of $3 million. Every major relief organization in the world is working in some way with the Mozambican refugees, hiring local people, donating vehicles, and building schools and hospitals as they go.

The beneficence of the international community toward the Mozambican refugees in Malawi has taken some ironic turns. The hard currency spent by the donor organizations has created an economic boom for Malawi. The urban shops, once nearly bare, have blossomed with South African consumer products ranging from chocolate to electrical appliances.

Another unforeseen development has been the disproportionate prosperity of certain groups of refugees, such as those who live in camps along the Ntcheu-Dedza highway. The stretch of road between these two small towns constitutes the border between Malawi and Mozambique. Along it, there are thick clusters of refugees' huts on the Malawian side; on the Mozambican side, there are miles and miles of farms which the refugees work during the day. "They sell their produce in Malawi, so they have a better life than the Malawians," a relief official explained.

Indeed, over the long-term, many of the refugees have better health and nutrition than the citizens of the host country. An MSF doctor has observed that the "hungry season"—the period between the two annual harvests—is becoming a greater hardship for Malawians. "More and more, we are getting Malawian children in the intensive feeding units."

One of the most noticeable health problems for Mozambicans can be traced straight back to the food rations they get when they come to Malawi. Even when they arrive, they tend to have "no grave problems," the MSF doctor said. But "two months after their arrival, we have noticed that there is severe malnutrition among the children," said the MSF doctor. "We suppose it's because the family sells the rations to pay for their passage [across the border].

"Refugee life is sometimes irrational," she said. "Sometimes these people have imperatives we don't understand. No matter how malnourished they are, they still use the food for other purposes." The MSF doctor cited refugees in Sudan who used their rations of grain and sugar to brew alcohol.

The subtleties and snafus of food relief, however, are not generally broadcast in the developed world, partly because of lack of interest, partly because the vast majority of people respond to the same old knee-jerk appeal. "We've all been guilty because we've all used images of starving kids to raise money," admits the Oxfam official.

"I think it's immoral. Black Africans don't like it because it's degrading. But it pulls at people's heartstrings. When we put a starving kid in the paper, we always get a good response."

# *Adjustment Lending Revisited*

## *Policies to Restore Growth*

*edited by*

Vittorio Corbo, Stanley Fischer, and Steven B. Webb

The World Bank
Washington, D.C.

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# *Overview*

The World Bank has been supporting structural adjustment in developing countries since the late 1940s. Initially, the support took the form of preparing and financing projects, especially in the area of infrastructure. By the late 1970s, however, it had become increasingly clear in many countries that correction of inappropriate policies could make a larger contribution to growth than additional investment could. Thus, when the second oil shock came, the Bank introduced adjustment lending, which provided quick-disbursing balance-of-payments support to assist member countries in implementing a less costly adjustment to external shocks. When commercial lending all but disappeared in the second half of 1982 and the urgency of and pay-off from reform increased, the Bank expanded its use of adjustment lending.

The volume has three main parts. Part I, Adjustment Lending Policy and Effects, contains four chapters that deal with the Bank's experience with adjustment lending and the evaluation of its effectiveness in the medium term. Part II, Macroeconomic Foundations for Sustainable Growth, presents four chapters that address the long-term objective of adjustment lending—the restoration of sustainable and equitable growth. Part III, Agenda for Adjustment Lending in the 1990s, consists of the roundtable discussion, which brings together issues from Parts I and II.

## Part I. Adjustment Lending Policy and Effects

In chapter 2, "Adjustment Programs and Bank Support: Rationale and Main Results," Vittorio Corbo and Stanley Fischer review the rationale for Bank financial support for adjustment programs. They conclude their paper with a summary of the main findings of the First and Second Reports on Adjustment Lending (RAL-1 and RAL-2) (World Bank 1988 and 1990). Concerning program design and implementation, the authors distinguish clearly between stabilization—defined as both the short-term measures and the structural reforms needed to sustain stabilization—and structural reforms aimed at improving the allocation of resources and achieving equitable growth. This distinction is especially important in countries experiencing acute macroeconomic imbalances (high fiscal deficits, balance-of-payments crises, and high open or repressed inflation). In such countries, reforms should start with policy and institutional changes that address the root causes of the acute macroeconomic imbalances.

Only after progress has been made in reducing inflation and the fiscal and balance-of-payments deficits should the country attempt other structural reforms aimed at improving the mobilization and allocation of resources for sustainable and equitable growth. The latter reforms typically address problems with public sector management, trade and domestic competition policies, labor market institutions and regulations, and policies specific to the agriculture, industry, energy, financial, and social service sectors. The appropriate sequence of the sectoral reforms depends mainly on country-specific characteristics. Hence, there is no escape from the need for a good evaluation of the main limitations to economic growth in each adjustment lending country.

The ultimate success of adjustment depends not only on getting the right policies in place but also on getting political support for the reforms. Political support is more likely when the government actively and honestly explains why the economy has problems and how the adjustment program will address them, why this option has been chosen, and how people will ultimately benefit from the reforms. The explanation phase is especially important in countries where many years of crisis and failed reforms have undermined the credibility of reform efforts. (Chapter 5 elaborates on this issue.)*

In chapter 3, "World Bank-Supported Adjustment Programs: Country Performance and Effectiveness," Vittorio Corbo and Patricio Rojas assess the effectiveness of adjustment lending. This evaluation requires a comparison of the performance of countries receiving adjustment lending with estimates of how they would have performed without it but with other conditions the same. Estimation of this counterfactual without-adjustment-lending scenario is central to the assessment of the effectiveness of adjustment lending.

The authors review the main approaches that have been used in the literature to assess the effectiveness of reform programs. They recommend and use a variation of the modified control-group approach. This approach corrects for the self-selection bias that arises because a government's decision to enter into a Bank-supported program depends on its expectation of better performance for the economy. Most importantly, the approach corrects for the effect of external conditions, terms of trade, and availability of foreign financing. Analysis with this approach leads to the conclusion that adjustment lending contributed to faster growth of gross domestic product (GDP) and higher ratios of exports saving to GDP in the latter 1980s in countries that used adjustment lending intensively, starting in 1985 or earlier. On the other hand, the ratio of investment to GDP decreased on average for these countries.

In some quarters it has been claimed that adjustment programs have negative effects on the poor. In chapter 4, "World Bank-Supported Adjustment Programs and Living Conditions," Anne Maasland and Jacques van der Gaag assess the effect of Bank-supported programs on living conditions. The authors identify three basic problems that make this assessment difficult. First, a counterfactual scenario has to be created (as was done in chapter 3). Second, data on the living conditions of the poor are scarce and often unreliable. Third, in most countries only a brief period has elapsed since the adjustment effort was started, whereas many of the distribution effects of adjustment programs are not expected to appear until several years after the program has been put in place. Nevertheless, interim evaluations can be conducted and are necessary to assess the short-term effects of programs on living conditions.

Maasland and van der Gaag found that living conditions, even in the short run, did not appear to have been systematically related to adjustment lending. Furthermore, most long-run indicators of living conditions continued to improve in early intensive adjustment lending (EIAL) countries. The exceptions were school enrollment ratios and the share of public expenditure in the social sectors; the authors observed a reduction in the share of education expenditures as well as a decrease in school enrollment in some EIAL countries. This phenomenon could affect not only the distribution effect of the programs but ultimately, through its impact on the formation of human capital, the long-run prospects for growth.

In chapter 5, "Designing and Implementing Adjustment Programs," Steven B. Webb and Karim Shariff review in detail the experience with the design and implementation of adjustment programs in the last 10 years. They organize the review according to policy area: macroeconomics; government finances and administration; trade; the agricultural, industrial and financial sectors; public enterprises; and the environment. Macroeconomic issues, for instance, are usually handled in conjunction with the IMF, but the World Bank is including its own conditionality in this area with increasing frequency. Agriculture, industrial and financial sector adjustment programs increasingly call for complementary reforms of institutions and commercial regulations. Another part of the chapter analyzes the way in which the specification of conditions has affected implementation. The chapter concludes with a discussion of how the design and presentation of an adjustment program can build the political support that is essential to sustaining and maximizing the supply response. For instance, moving quickly with reform in the wake of a crisis enhances the probability of political acceptance, because the discomfort of the crisis makes people more willing to try something new. Also, moving quickly makes the dislocations during adjustment more associated in people's minds with the pre-adjustment policies that led to the crisis.

## Part II. Macroeconomic Foundations for Sustainable Growth

In chapter 6, "Nominal Anchors, Stabilization and Growth (Some Thoughts on High-Inflation Economies)," Miguel A. Kiguel and Nissan Liviatan use the recent experience of Latin America to explore why, in spite of the potentially high pay-off from successful stabilization, most stabilization attempts in that region have failed. They start their analysis by distinguishing between chronic inflation countries and countries where the high level of inflation is a recent phenomenon. They conclude that it is much more difficult to stop chronic inflation than a sharp inflation with a short history. A chronic-inflation economy develops inflation-mitigation techniques, which make stabilization postponable in the medium run, and therefore less credible. This is one of the sources of the failures of many stabilization programs, in addition to the lack of adequate fiscal adjustment. Even in the successful cases, the stabilization is protracted because of lack of credibility about the resolve of the policy makers to persist with the fiscal effort and the commitment to the nominal anchor of the program, such as the exchange rate or the base-money target.

Chapter 7, "Economic Adjustment and Investment Performance in Developing Countries: The Experience of the 1980s," by Luis Serven and Andrés Solimano, examines the performance and determinants of investment in developing countries. Their central observation, based on a sample of 78 developing countries, is that the rate of investment increased to around 1982, and then took a sharp drop. This overall trend, however, conceals some important variation across regions. The authors examine analytically and empirically how adjustment and reform measures contributed to countries' investment performance, and in particular why the investment response has often been slow and weak. They conclude by pointing out three key reforms that are prerequisites for a vigorous private investment response: macroeconomic stability, adequate provision of infrastructure by the public sector, and sufficient external support for the reform programs.

In chapter 8, "Public Policy and Private Saving," Klaus Schmidt-Hebbel and Steven B. Webb examine evidence from a variety of studies, including two of their own, on the determinants of private saving. Private saving responds mostly to endogenous variables of the economic environment, such as fluctuations and trends of disposable income. Public policy can therefore induce greater private saving mainly indirectly, in the medium and longer term through policies that raise the growth rate. Reducing the government deficit, although it may lead to a partially offsetting decline of private saving in the short run, generally raises total national saving and contributes to macroeconomic stability, which helps restore growth and private saving in the longer term.

Chapter 9, "Endogenous Growth in Developing Countries with Government-Induced Distortions," by William R. Easterly, reviews the endogenous growth literature to study how policies can affect growth. In contrast to the neo-classical models of growth, the endogenous growth models imply that removing policy distortions can raise a country's permanent growth rate, as well as increase the base from which it is growing. Arriving at this intuitive result provides insights into the nature of the growth. One growth model is developed in the chapter, and it shows that large reductions in very high levels of initial distortions have a larger pay-off than either small reductions in large distortions or the elimination of small distortions.

## Part III. Agenda for Adjustment Lending in the 1990s

The roundtable discussion of the Agenda for Adjustment Lending in the 1990s was led off by Edmar L. Bacha, Gerald K. Helleiner, and Arnold C. Harberger. Their remarks indicate that adjustment lending will continue as an important component of the Bank's assistance strategy for developing countries but that it will also need to be modified to achieve its goals. The range of policy problems to address with structural adjustment continues to widen as environmental and social concerns come to the fore and as the former socialist countries rebuild their economies. Old problems, such as macroeconomic instability and agricultural stagnation, are increasingly recognized as symptoms of deeper needs for adjustment. Some of these will be addressed with adjustment lending, others by finding ways to support adjustment with more traditional lending instruments.

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## SELECTED TOPICS

# New Study Highlights Trends and Issues in Private Financing for Developing Countries

A new publication in the IMF's World Economic and Financial Survey series, *Private Market Financing for Developing Countries*, examines recent developments in private flows to developing countries and highlights several related issues—the restoration of access to voluntary market financing, the repatriation of flight capital, and the commercial bank debt of low-income countries.

### Recent Developments

The study, prepared by Alessandro Leipold, Mohamed A. El-Erian, Ajai Chopra, John Clark, Paul Mylonas, and Louis W. Pauly, notes that in recent years principal rescheduling and concerted new money loans have declined in importance as increased emphasis has been placed on comprehensive debt relief through market-based debt- and debt-service-reduction operations. These operations have played a central role in several major packages, notably for Mexico and Venezuela, and have helped expand and deepen the secondary market for developing country bank claims.

The authors conclude that comprehensive debt-relief operations, in the context of sustained adjustment policies, have significantly improved perceptions of country transfer and credit risk. This improvement, reflected in lower domestic real interest rates, narrower secondary market discounts on external bank claims, and declining yields on foreign bond issues, has been associated with significant private capital inflows from foreign bond and equity issues, foreign direct investments, and repatriation of capital.

Private market claims—that is, external bank loans and bonds—on developing countries virtually stagnated in the 1980s after debt-servicing problems first surfaced in 1982. In 1990 international banking activity in developing countries was dominated by a \$28 billion fall in claims on the 15 most heavily indebted countries, in large part attributable to comprehensive restructuring packages in Mexico and Venezuela.

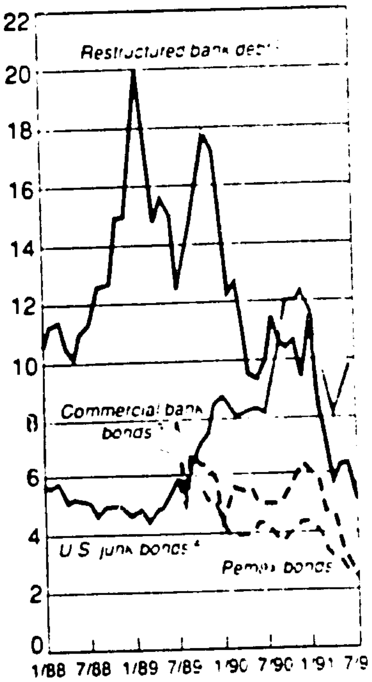
The first nine months of 1991 saw only two comprehensive debt-restructuring agreements negotiated (with Niger and Uruguay), two preliminary agreements concluded (with Nigeria and the Philippines), and a number of other countries still negotiating packages with commercial banks.

On the basis of these negotiations, the authors identify three current trends. (1) banks appear more insistent upon addressing interest arrears problems before negotiations on a comprehensive debt agreement would begin; (2) there are some indications of a lessening of banks' reluctance to consider debt-reduction operations for low-income countries; and (3) some countries continue to have difficulty negotiating comprehensive restructuring packages because of high and mounting interest arrears, low international reserves, and limited access to funding for debt- and debt-service-reduction operations, as well as, in some cases, because of records of weak policy implementation.

### Restoration of Access

In contrast to the early years of the debt crisis, when the refinancing of principal and concerted new money agreements constituted the chief forms of financing, the study notes that most recent re-entrants to the capital mar-

**Mexico: Yield Spreads on Selected Debt Instruments[1]**
(In percent)




[1]Premia over yields on U.S. treasury obligations of similar maturity
[2]After January 1990, rebased on stripped yields for par and discount bonds
[3]Average yield on unsecured issues by Bancomext, Somex, and Banca Internacional
[4]Merrill-Lynch index of high-yield corporate bonds (BB and CCC grade)

Data: IMF, *Private Market Financing for Developing Countries*



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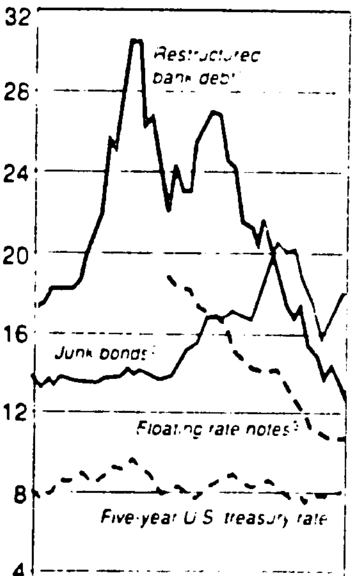
kets have mobilized new medium- and long-term financing through bond issues and equity placements. The authors cite, in particular, the experience of Chile, Mexico, and Venezuela, where the implementation of sound policies contributed to a significant change in perceptions of country transfer risk. "The most notable feature of Mexico's re-entry," the study finds, "has been the raising of medium-term capital through the issuance of bonds on U.S. and European markets, largely by public sector entities with established international reputations."

**Venezuela: Yields on Selected Debt Instruments**
(In percent)




[1]After October 1990, rebased stripped yields on par discount bonds.
[2]Merrill-Lynch index of high-yield corporate bonds (BB and CCC grade).
[3]Weighted average reported yield on floating rate notes issued in 1988-89 and maturing in 1993, 1994, 1995, and (from September 1990) 1996.

Data: IMF, *Private Market Financing for Developing Countries*

Mexican borrowers employed a range of financial techniques initially, including collateralization, and, more recently, placed a growing number of unsecured bond issues on increasingly better terms. In addition, Mexican financiers have raised significant amounts of capital through the placement of short-term Euro-certificates of deposit and through the overseas placement of commercial paper.

Venezuela, by contrast, had an earlier but unsustained re-entry into the capital markets. In 1988 and 1989, it raised approximately $520 million by placing several sovereign bond issues. Initially enjoying a narrowing of yield spreads, Venezuela saw its secondary market yields widen dramatically by mid-1989 and its yield on commercial bank debt nearly double following growing concerns about the country's balance of payments position.

Buoyed by the adoption of a comprehensive economic adjustment program and the prospect of a debt-restructuring agreement, however, yields again narrowed, and in 1990 three private corporations and a subsidiary of the state-owned petroleum company issued new securities. Within several months, initial yields on these securities had been traded down, with collateralized securities enjoying substantially lower yields.

For developing country borrowers, regaining access to international capital markets is often, the authors note, a matter of "their ability to address investor concerns about the risk of default (counterparty credit risk) and the risk that foreign exchange will not be available to meet debt-servicing obligations (country transfer risk)." Also a factor, the study adds, is the extent to which creditors are confident that they can trade debt instruments without undue impact on their price (liquidity risk).

The study also notes that while the financial strength of borrowing entities or countries plays a basic and critical role in addressing credit and transfer risks, the choice of instrument nonetheless complements this process. The authors review several major instruments, such as bond and equity issues, surveying their relative strengths and appropriateness and assessing the effectiveness of "enhancements" of such borrowing instruments as collateralization, early redemption and conversion options, and hedging techniques.

The authors note that bond issues, which provide continuous indicators of market expectations through the secondary market, can promote lower yields on future borrowings if perceptions of creditworthiness improve. On the other hand, equity or other instruments, which share risk between borrowers and lenders, may yield more enduring access to capital flows and may allow this access to be maintained and deepened. The study also finds considerable scope for the broader use of market-based hedging techniques.

The authors conclude that recent re-entrants have benefited from sharp improvements in both the volume of flows and the terms they received. Their experience also illustrates, they add, how quickly market sentiments can change and how important are both perceptions of underlying policies and "bandwagon" effects. "If lenders view current or prospective policies as inadequate," they note, "not only will they fear a borrower default, but also a retreat of other lenders, compounding changes in expected returns on potential new loans."

## Repatriation of Flight Capital

Capital flight, which beset many developing countries experiencing debt problems in the 1980s, both reflected and exacerbated the difficulties these countries faced. With the implementation of stabilization programs, many countries hope that expectations about relative returns and improvements in the comparative attractiveness of domestic assets will encourage the repatriation of flight capital.

The authors review the problems of defining capital flight and gauging its extent—problems that haunt any discussion of the subject—and survey the policies used to re-establish confidence. Some of the necessary underlying policies, the authors find, are (1) adjustment policies aimed at reducing financial imbalances and inflation; (2) establishment of effective markets for labor, goods, money, and foreign exchange; (3) structural reform, such as trade liberalization and deregulation of domestic financial markets; and (4) restructured external debt that eliminates potential investment disincentives.

In addition to policies, however, the authors find a number of mechanisms that, if used in conjunction with broad and effective policies, can, in some circumstances, facilitate the repatriation of capital. These include amnesties, capital account liberalization, foreign-currency-denominated domestic instruments, offshore securities, and debt conversions.

### Commercial Bank Debt

Little information is currently available on the commercial bank debt of low-income countries, the study notes. But while commercial debt has played a small and declining role in these countries, it may still represent a significant portion of interest due, since these loans were extended on a nonconcessional basis.

With a variety of debt-servicing problems and differing access to the market, the group is by no means a uniform one. The study finds it more useful to discuss three distinct types within this category.

The first group of countries, which includes Bangladesh, Ethiopia, Ghana, Kenya, Pakistan, and Sri Lanka, has serviced its debt and avoided rescheduling. These countries have maintained access to spontaneous long-term credits and short-term trade and interbank credits, but they have seen long-term claims fall and short-term claims rise sharply.

A second group, which includes The Gambia, Madagascar, Malawi, Senegal, and Togo, has experienced temporary difficulties in servicing debt and has rescheduled. Although these countries have remained current on their interest payments and, in some cases, have graduated to normal debtor-creditor status, they have not been able to attract spontaneous long-term loans.

The third group, comprising Bolivia, Guinea, Guyana, Mozambique, Sierra Leone, Somalia, Sudan, Tanzania, Viet Nam, Zaïre, and Zambia, has rescheduled but fallen into subsequent arrears. The authors note that apart from a small increase in short-term trade credit, these countries have not enjoyed new credit on a net basis since the mid-1980s.

Copies of *Private Market Financing for Developing Countries* are available for US$2[illegible] (US$12.00 for full-time university faculty and students) from Publication Services, Box S-338, International Monetary Fund, Washington, D.C. 20431, U.S.A.

## Debt Conversions, 1986–First Quarter 1991[1]

(In millions of U.S. dollars)

| | 1986 | 1987 | 1988 | 1989 | First Quarter 1990 | First Quarter 1991 |
|---|---|---|---|---|---|---|
| Argentina | — | — | 764 | 1,180 | 7,038 | — |
| Brazil | 176 | 336 | 2,095 | 942 | 483 | 52 |
| Chile | 974 | 1,997 | 2,927 | 2,767 | 1,096 | 161 |
| Costa Rica | 7 | 89 | 44 | 124 | 17 | . . |
| Ecuador | — | 127 | 261 | 31 | 42 | . . |
| Honduras | — | 9 | 14 | 47 | 32 | . . . |
| Jamaica | — | 4 | 5 | 16 | 23 | — |
| Mexico | 413 | 1,680 | 1,056[2] | 532 | 435 | . . |
| Nigeria | — | — | 70 | 304 | 217 | 30 |
| Philippines | 81 | 451 | 931 | 630 | 378 | 118[3] |
| Uruguay | — | — | 104 | 53 | — | — |
| Venezuela | — | 45 | 49 | 544 | 716 | — |
| **Total** | **1,651** | **4,738** | **8,320** | **7,170** | **10,477** | . . . |

[1]Face value of debt converted under official ongoing schemes. Figures do not include large-scale one-off cash buy-backs and debt exchanges.
[2]Does not include an estimated $6–$8 billion related to prepayment at a discount of private-sector debt since August 1987 signing of an agreement to restructure foreign exchange risk coverage trust fund debt.
[3]As of April 30, 1991.

Data: IMF, *Private Market Financing for Developing Countries*



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# Beyond Syndicated Loans

## Sources of Credit for Developing Countries

John D. Shilling, editor

# INTRODUCTION

The debt crisis of the 1980s has placed a number of burdens on the highly indebted developing countries. They have had to adjust to sharply reduced capital inflows, maintain or reschedule their service payments on existing debt, and cut domestic expenditures on current consumption and investment. This has been a painful process, and the subject of considerable dispute and debate in debtor and creditor countries alike. Substantial progress has been made in developing means of coping with the debt burden through rescheduling of official bilateral and commercial bank debt and through outright debt reduction in some cases. Debtors have made considerable progress in reforming their own economies and adapting to changed circumstances. Success on both debt relief and domestic adjustment is quite varied among countries and far from complete, but the broad outlines of what is needed and how to go about it are relatively clear. The crisis stage seems to have past, but it will be a long time before serious and widespread debt problems are behind us.

Major commercial lenders to the developing countries that encountered repayment problems have not gotten off lightly either. Many have had to shed assets and reduce staff to meet capital adequacy requirements and to stem losses. They have had to revise and often seriously curtail their business objectives and refocus their strategies. For many this has meant reducing or eliminating most their business activities in developing countries and releasing or reassigning staff with expertise in these areas. Loan Committees and Boards of Directors have been adamant about opposing new lending to developing countries with any suspicion of a debt problem. In addition, new business opportunities in Europe and other domestic markets have attracted more management attention and talent, while more recent crises in real estate and other sour investments have further sapped the banks' capacity for expansion. It is clear that for the most part, they have little appetite to return to the sovereign lending of the 1970s and early 1980s.

It has been widely accepted for a year or more that the halcyon days of jumbo syndicated loans to developing countries are over. Large scale commercial loans for essentially budget or balance of payments support are now recognized as inappropriate for both banks and borrowers. It is lamentable that this realization, so clear to many in the 1970's, arrived so late to the borrowers and lenders themselves. In fact, banks are exceedingly reluctant to engage any kind of lending to most developing countries with debt problems. This poses a severe problem to the developing countries themselves.

Taking a group of 46 highly indebted countries that the Bank uses as a reference, gross capital flows from commercial banks rose from $ 5.0 billion in 1972 to $ 31.9 billion in 1978 and a peak of $ 40.7 billion in 1982 before falling sharply to $ 22.5 billion in 1984. Gross flows have averaged only $ 4.7 billion in 1989-91. The situation with net flows (gross flows less amortization) is even more dramatic, with <u>net outflows</u> of $ 0.2 billion in the same years. Including interest payments, there has been an even larger <u>net transfer from the debtors to the creditors of $ 8.0 billion</u>! A situation which is anomalous and totally inconsistent with the medium term development requirements of these countries. Despite the debt problems on these countries, official sources have managed to sustain or increase their net flows, which averaged $ 2.4 billion in 1989-91 from bilateral sources and $ 3.9 billion from the Multilateral Development Banks to this set of countries.

It is clear that developing countries, including the severely indebted countries, are going to have to generate the vast majority of their own savings to finance their investment

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requirements. While this has always been true, it is all the more so now, with commercial banks reluctant to lend, and global demands for capital quite high in relations to expected savings. Domestic resources are generally most appropriate for developing countries to finance their investment. But generally, some complement of foreign resources is necessary to make best use of the domestic resources, primarily because foreign capital represents vital foreign exchange and often brings technical and marketing skills, resources in critical shortage in many of these countries. A key question is whether these developing countries can access a sufficient amount of foreign borrowing.

One continuing source of foreign exchange resources has been official lending. But this is limited, both by the capacity of the various sources of official lending -- bilateral aid programs, export credit agencies, and the multilateral lending institutions -- to expand their lending and by the fact that official lending cannot meet all the needs of developing countries for foreign resources. Official capital flows are critical for public sector investment projects, supporting adjustment programs, and providing resources for domestic financial intermediaries under certain circumstances. Official flows are not particularly well suited to support all elements of the widely applauded shift to greater emphasis on the private sector and commercial market forces as the major source of growth in developing countries. This shift will place more emphasis on expanding international trade, which will require more trade financing. Increased private sector activity will require and should attract more private source project financing. Promising activities may also allow debtors to access other financial markets beyond commercial banks -- private investors, pension funds, bond markets --especially since bonded and privately placed debt received much better treatment from debtors throughout the debt crisis.

Thus an important question facing severely indebted, and in fact many other, developing countries, is to what extent they can access private international capital markets for their very real development needs. In order to get a better understanding of the issues and possibilities for these countries to obtain resources from a variety of commercial markets, staff of the Financial Advisory Services unit of the Cofinancing and Financial Advisory Services Vice Presidency undertook several studies of sources of funding available to developing countries. This volume presents three of these studies, which cover the major sources of financing that should be available to severely indebted countries in varying degrees. The studies are not exhaustive, as it is unlikely any study could be in the fast changing world of international finance, but they give excellent background and indicate what potential exists. Some countries have already developed new forms of access, or a greatly expanded the range of possible sources of financing beyond what is described. But these countries -- Mexico, Chile, Venezuela -- are an exception and constitute the vanguard. The basic analysis remains valid.

The first paper, "The Role and Cost of Short-Term Trade Credit," by Sudarshan Gooptu and Richard Brun[1] addresses the most basic requirement for external finance -- trade credits. These are typically short term, often self liquidating, and absolutely necessary for efficient participation in world trade. Very few countries have totally lost access to trade lines, but some countries pay a high price for maintaining them. Trade credits can be structured to pose little risks for banks, but may still come at a relatively high cost to debtors, a trade-off which is discussed in the paper. Because of these features, they are typically the last forms of credit to be cut, and the first to be reestablished. Consequently,

1 Presented to the Symposium on African External Finance in the 1990s, Washington, DC, September 17-18, 1990 and published in the report of the symposium. This paper is reprinted here for convenience because it completes the range of financing sources available to developing countries.

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they offer the first step for a country which has lost its creditworthiness to begin to reestablish some credibility in markets. Trade credits are not only important in themselves to facilitate trade, they are also the basis for rebuilding access to medium term credit. This paper explains the the various forms of trade credits, how they are used, and the impacts of restricted access to trade credits on other economic activity. It focuses particularly on the Sub-Sahara African context, where the issue of retaining trade credits is most acute, but reference is also made to broader issues.

The second paper, "Promoting Limited Recourse Project Finance to Developing Countries," by Nirmaljit Paul addresses some promising forms of medium term project financing. As countries establish some basic level of creditworthiness, they can begin to seek out longer term financing. For most of these severely indebted countries, there is no appetite for sovereign lending, where the government is responsible for repayment. It was these same government who defaulted on the bank loans in the 1980s. But often there are attractive projects in a developing country that can attract foreign financing on the basis of the project's own potential and earnings expectation. Some foreign creditors are willing to take the "commercial" or "project" risk, but not the "country" or "transfer" risk in these projects. So they design financing packages that assure their returns are payable in foreign exchange. There deals are attractive to investment bankers, who are paid a fee for putting the deal together and who take little if any capital risk. They also offer needed capital and often foreign expertise to developing countries. Project financing offers debtors countries access to more financing and a way of establishing a better credit standing by maintaining impeccable payment records on these projects. Often it is the private sector which maintains the payment, but that also improves the reputation of the country and establishes that the government is undertaking sound policies that allow the private sector to prosper. This market is in constant evolution and the paper offers valuable insights into the structure and motivations of these operations.

The third paper, "The Reemergence of Developing Countries in the International Bond Markets," by Marcus J. J. Fedder and Mohua Mukherjee addresses a range of financing opportunities that open up as countries further enhance their creditworthiness and tap a wider range of investors. The bond markets offer both a larger variety of instruments for longer term financing and a deeper pool of funds. But access to this market is much more restrictive, and investors demand a high level of security. The paper describes the different national and cross border markets that together constitute the international capital market. (We are still a long way from a truly unified global market.) It profiles investor preferences in major markets and the principal characteristics of the instruments. Individual experiences of countries that have gained access to portions of this market are also presented as examples These demonstrate that it is possible for countries that have suffered severe debt problems to work their way back to credibility. This is an important statement, as it does confirm that successful adjustment programs can have positive results in paving the way to renewed market access on truly "voluntary" or "spontaneous" terms.

All three of these papers offer practical suggestions about how countries can improve their access to these various forms of credit. These are indicative and do not constitute formal advice, which can only be given after careful review of a country's institutions and objectives. They do provide a valuable overview of what will become the dominant forms of debt financing for developing countries in the coming years. In many regards, these forms of financing are more relevant and useful for the borrowers than the syndicated credits of the 1970s. They are directly linked to productive activities and have readily identified income streams that can be linked to repayment. This is clearly important for the lender, but also for the borrower, who is more likely to be assured that the funds being borrowed are put to productive use. What is most encouraging is that in the few months since the research was completed for these papers, the markets have become more

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open to a growing number of developing countries that have experienced debt problems and are working their way out of them. A surprising amount of private capital is again flowing into a number of Latin American countries. This seems to include both returning flight capital and new funds from other investors. Evidence is still very partial and anecdotal, but it is accumulating. Staff in CFS continue to monitor these developments and additional studies will be completed in the future.

John D. Shilling

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# Voluntary Market Financing

*Some Latin American countries are returning to global capital markets. An early assessment*

Mohamed A. El-Erian

After a prolonged and almost total reliance on debt reschedulings, some Latin American countries—notably Chile, Mexico, and Venezuela—have recently begun to attract voluntary financing from international capital markets. This provides them with a wider and more flexible range of financing instruments to fund productive activities, given the narrow, albeit expanding, domestic capital markets. It also signals to agents in other international and domestic markets that the risks associated with investing in these countries have been sharply reduced—a crucial step in encouraging other private inflows, such as foreign direct investment and the repatriation of flight capital.

Although the process of market re-entry is still at an early stage—so far, only three countries have made significant inroads, and the numbers involved are quite small compared with the overall size of these markets—it has nevertheless attracted considerable attention. This article draws upon the recent experience of these countries to provide an overview of the difficult task of regaining access to voluntary capital market financing.

## Re-entering the market

International capital markets were a major source of external financing for developing countries in the 1970s and early 1980s. Medium and long-term international bank credit commitments totaled some $225 billion in 1976–82. In 1982 alone, such commitments amounted to $42 billion, with Latin American borrowers accounting for $23 billion. On the bond side, developing country issues reached $27 billion in 1976–82, with $4 billion of that in 1982—half of which was accounted for by Latin American borrowers.

But with the outbreak of the debt crisis in late 1982, when Mexico, followed by several other countries, announced its inability to meet fully scheduled debt servicing, the picture changed sharply. All sources of voluntary private financing to the region, with the exception of short-term trade facilities, virtually dried up. As a result, the total amount of medium- and long-term bank and bond financing over 1983–88 dropped to an estimated $7 billion—less than a third of the amount committed in the first three quarters of 1982 alone. Almost overnight, "concerted" financing became the major source of private external credit for the region.

Since mid-1989, however, a few countries in Latin America have managed to regain access to voluntary sources of private financing. The process so far has been dominated by borrowers in Mexico and, to a lesser extent, Chile and Venezuela; some limited operations have also been undertaken by Argentinian and Brazilian entities. The return to voluntary financing has taken the form of international bond issues on US and European markets, attracting primarily institutional investor funding and residents' capital held abroad. Total bond issuance is estimated at some $3 billion in the 18-month period to December 1990. Market data point to stepped up borrowing in the first half of 1991, with over $2 billion being mobilized by Mexican entities alone.

At the same time, there has been a modest revival in voluntary bank lending to these countries, primarily in the form of trade and project financing and short-term interbank facilities. Moreover, several Latin American corporations have recently completed equity offerings in industrial country markets, thereby complementing the impact of a growing number of country funds. These were the first significant Latin American foreign stock offerings since the 1960s, reflecting in part a stepped up effort by some governments to privatize. Along that line, the $2 billion Mexican telephone company (TELMEX) issue is reported to be the sixth largest placement of shares in the world (nominal values) to date and the biggest ever for any Latin American country (see "Accessing the International Capital Markets" by Kumiko Yoshinari in *Finance & Development*, September 1991).

However, the large syndicated bank credits, which dominated private flows to developing countries in the 1970s and early 1980s have not resurfaced. Besides concerns about the higher rescheduling risk associated with such lending, this reflects the more difficult financial circumstances of banks in several financial centers, along with tighter regulatory requirements in some cases.

***Terms on voluntary financing*** The renewed availability of voluntary foreign financing has been accompanied by an improvement in market terms, as evidenced in the sharp drop in yields on Mexican and Venezuelan bonds (see chart). The first unsecured voluntary bond issue by a Mexican public enterprise since 1982 (Bancomext in June 1989) carried an initial yield of some 17 percent, implying a spread (or "risk premium") of about 820 basis points over US government bonds. But by the third quarter of 1990, the weighted average spread for new Mexican bond issues had declined to an estimated 320 basis points. Although it increased somewhat in the final quarter—reflecting the general market tightening associated with the Middle East crisis—the average spread fell again in the first half of 1991. For example, the April 1991 Bancomext issue carried an initial yield of under 10 percent (implying a spread of only 200 basis points), and a 300 million deutsche mark Mexican central government issue in February (used as a "benchmark" for tracking other bonds in that market) was marketed at an estimated spread of under 200 basis points over comparable German government bonds.

But a word of caution is in order, as these measures of creditworthiness are affected by

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*A more detailed analysis of the Mexican experience is contained in "Mexico's External Debt and the Return to Voluntary Capital Market Financing," IMF Working Paper WP/91/83. Both papers are available from the author.*



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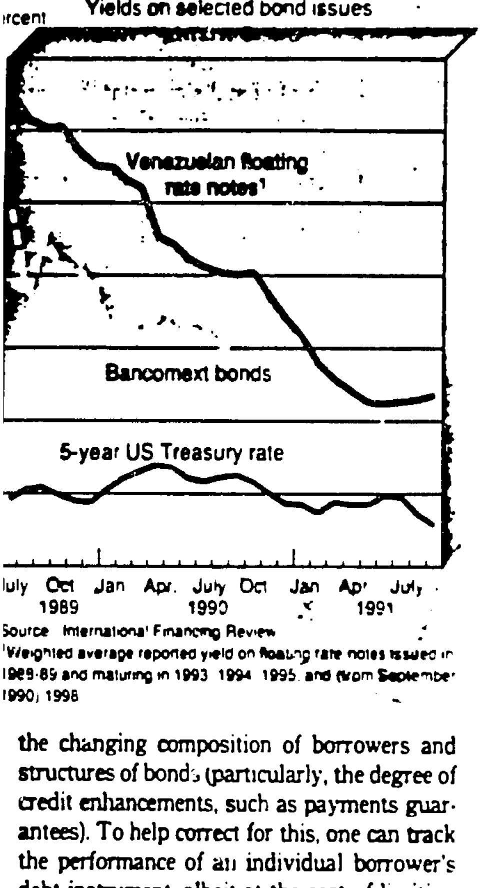
# for Latin America

**Reform pays off**

Yields on selected bond issues




Source: International Financing Review.

¹Weighted average reported yield on floating rate notes issued in 1989-89 and maturing in 1993 1994 1995 and (from September 1990) 1998

the changing composition of borrowers and structures of bonds (particularly, the degree of credit enhancements, such as payments guarantees). To help correct for this, one can track the performance of an individual borrower's debt instrument, albeit at the cost of limiting the coverage of the analysis. For example, the yield on the Mexican oil company (PEMEX) issue fell from 14 percent in mid-1989 to under 10 1/2 percent by end-May 1991, the yield on the Bancomext June 1989 issue dropped from 17 percent to around 10 percent, and the yield on the 1989 Venezuelan (11 1/4 percent benchmark) bond decreased from 18.5 percent to 10.4 percent. These movements reflected a significant fall in risk premia, which was compounded by lower international interest rates.

***Other private external inflows.*** In recent years, there has also been a resurgence in nondebt-creating private capital inflows—such as foreign direct investment and capital repatriation—providing additional resources to help support comprehensive economic adjustment and reform policies. In Mexico, for example, foreign direct investment in 1989–90 was twice the level reached in 1987–88, with the pipeline of new investments yet to be disbursed growing to over $5 billion. Similar developments were recorded in Chile and, to a lesser extent, Venezuela.

The magnitude of capital repatriation, however, is more difficult to quantify with any precision, although the majority of indicators point to a significant turnaround in the last two years. These include a recent study by Chartered West LB that estimates net total inflows of $14.1 billion for Chile, Mexico, and Venezuela in 1989–90, compared with an estimated outflow of $4.5 billion for 1987–88—a difference of almost $20 billion.

## Why re-entry was possible

***Implementing sound economic policies.*** Just as inappropriate economic policies, together with adverse exogenous developments, contributed greatly to the emergence of debt problems, the sustained implementation of sound macroeconomic and structural reform programs has done the most to restore access to voluntary financing. While these programs, which have been supported by the IMF and the World Bank, have varied from country to country, several common elements can be identified:

- reducing domestic financial imbalances through improved budgetary performance and prudent monetary policies. This involves reinforcing the fiscal revenue effort, containing expenditures, and allowing domestic interest rates to reflect fully the cost of compensating savers for the considerable risk premia in lending domestically;
- enhancing the supply response of the economy through appropriate pricing policies, such as promoting the tradable sector by maintaining a competitive exchange rate; and
- improving economic efficiency through fundamental structural reforms. This includes liberalizing the trade regime, reforming the tax system, divesting public sector enterprises, liberalizing the financial sector, improving legal and other procedures governing foreign investment, and deregulating domestic activities.

***Comprehensive restructuring of existing indebtedness.*** The experience of Latin American countries in the 1980s suggests that in some cases, the positive effects from the implementation of sound policies may not be fully realized due to high risk aversion on the part of the private sector on account of existing indebtedness. This aversion, which undercuts incentives to undertake productive investment activities, reflects concerns about expected financial returns, given the uncertainty about the country's ability to meet contractual debt obligations without further increases in effective taxation. Such adverse effects can become more pronounced if, as has been increasingly the case, the process of securing concerted new money loans from banks is subject to protracted negotiations that raise the risk of creditor debtor confrontations.

Against this background, Chile, Mexico, and Venezuela managed to reduce the burden of their bank debt in recent years through market-based debt and debt-service reduction operations. Chile cut back its stock of restructurable bank obligations by over 70 percent in four years (to some $4 billion) through a series of voluntary market-based conversions, supplemented by direct cash buybacks. Mexico and Venezuela adopted a different approach within the framework of the "Brady Initiative" that involved an agreement with bank creditors on a comprehensive restructuring package, incorporating debt and debt-service reduction options. For Mexico, the 1990 package resulted in an effective gross bank debt reduction of around $15 billion, or 31 percent of eligible debt (see "Mexico's Commercial Bank Financing Package" by the author in *Finance*

*& Development*, September 1990).

Venezuela's 1990 bank agreement involved an effective gross bank debt reduction of some $5 billion. This was achieved through a menu of five options, including a buyback of debt at a discount of 55 percent and conversions of claims into partially collateralized discount bonds (at 70 percent of face value), reduced interest rate (6 3/4 percent, fixed) par bonds, and bonds with below-market, but gradually increasing, interest rates in the first five years.

***Reducing market transaction costs.*** There has also been a reduction in the transaction costs for accessing international capital markets, largely because of regulatory changes in industrial country capital markets and more widespread market information on borrowers' creditworthiness.

Important regulatory changes have occurred in the US market; other countries, such as Japan, have also taken steps to facilitate developing country access to their capital markets. Before April 1990, the average costs of meeting US bond registration and disclosure requirements for first time developing country issuers were estimated at roughly $500,000–700,000, prompting many issuers to go outside the public market and try the route of private placements instead. But these placements carried costs of their own, including those associated with buyers being required to hold the issues for at least two years after the initial offering.

With the passage of Regulation S and Rule 144A in April 1990, however, it has become much easier for developing countries to tap US investors. Regulation S has facilitated the sale of Euro-issues to US citizens by clarifying what exactly constitutes the sale of a Euro-issue in the United States—these issues involve relatively fewer transaction costs. Rule 144A has reduced the loss of liquidity associated with private placements by relaxing the two-year holding period, provided that the sale of the financial instrument is to "qualified institutional buyers." Such buyers are defined as entities managing and owning at least $100 million in securities and, in the case of banks, with a net worth of at least $25 million. There are about 5,000 qualified institutional buyers in the United States—mainly insurance companies, commercial banks, and money managers.

These changes have accompanied the greater use of the American depository receipts (ADR) program, under which developing countries may access equity markets without meeting the full costs of offerings and listings on these markets. Under this program, each American depository share traded in the United States represents a specified batch of the company's trading shares in the local market. This route has been used by a number of Latin American corporate re-entrants, including Chile's telephone company, and Mexico's TELMEX and Vitro (a private glass manufacturer).

Increased interest among international investors in bond issues by re-entering Latin American entities has led to, and been reinforced by, the provision of market-credible credit ratings, thereby reducing some of the costs investors face in compiling investment information. In December 1990, for example, Mexico received its first credit rating by Moody's Investors Service—the ceiling rating for Mexican debt (excluding the debt restructuring bonds) was set at Ba2, just below investment grade. In July 1991, Moody's upgraded the credit rating on outstanding Venezuelan bonds to Ba1 from Ba3.

***Customizing financial instruments.*** In an environment of still significant—albeit declining—perceptions of credit and transfer risks, borrowers must pay particular attention to customizing their debt instruments to meet market requirements. This becomes particularly important when there is a general tightening of market conditions, as occurred temporarily during 1990.

In several of their bond issues, some Latin American re-entrants have attempted to make the instruments more attractive by providing explicit credit enhancements. This has been done, most often, through collateralization on the basis of existing assets or an expected stream of receivables. But other options have also been used, including preferential treatment in the case of privatization or early redemption clauses.

In addition to the intrinsic value in relation to the face value of debt, the attractiveness to investors of the collateral, and thus the extent to which it improves market terms, depends on the collateral's location, and the costs involved in taking possession and disposing of it, should the need arise. Several borrowers have provided collateral in the form of assets and receivables located, or generated, outside the country, thereby enabling them to address investors' concern about both credit and transfer risks. TELMEX, for example, provided investors protection in the form of a claim on payments due from AT&T on account of international

## Glossary

***American depository receipts.*** US dollar-denominated equity-based instruments backed by a trust containing stocks of non-US companies. ADRs may be traded directly among US investors, with clearance and settlement handled by the custodian bank in the United States.

***Cash buybacks.*** The repurchase for cash of debt, often at a discount.

***Collateralized bond exchanges.*** These exchanges have tended to involve the conversion at a discount (either on the face value or contractual interest rates) of bank loans into longer-term bonds, the principal and/or part of the interest on which is guaranteed through the use of "risk-free" instruments (e.g., US Treasury zero coupon bonds for principal collateralization).

***Concerted bank lending/new money loans.*** Proportional increases in commercial bank exposure, coordinated by advisory committees negotiating, on behalf of creditors.

***Country funds.*** These funds allow investors in industrial countries to pool their resources and invest them in specific emerging capital markets.

***Credit enhancements.*** Attributes of financial instruments that improve the underlying value of these instruments. They include collateralization (on the basis of existing assets or an expected stream of income), early redemption possibilities, and preferential treatment in the case of privatization.

***Credit ratings.*** Ratings, issued by established market agencies, that seek to measure the degree of credit and transfer risks. For example, Moody's Investor Service assigns ratings of Aaa, Aa, A, and Baa for investment grade; Ba and B for non-investment grade; and Caa, Ca, C and D for default grade. In addition, numbers from 1 to 3 are often attached to differentiate borrowers within a given grade, with 1 being the highest. Similar classifications are used by other rating agencies, such as Standard & Poor's.

***Credit risk.*** Risk associated with the possibility that the other party to a financial contract (the counterparty) will be unwilling or unable to fulfill the terms of the contract. This type of risk is to be distinguished from ***transfer risk***, which arises from the possibility that foreign exchange may not be available to the counterparty to meet its obligations.

***Options.*** The contractual right, but not the obligation, to buy or sell a specified amount of a given commodity or financial instrument at a fixed price before or at a designated future date.

***Principal rescheduling.*** Formal deferment of principal obligations, with new maturities applying to the deferred amounts.

***Syndicated bank credit.*** A financial credit involving several bank lenders who are linked through various legal clauses governing both the distribution of payments made by the debtor and the conditions for changing the terms of the credit.

communications. Accordingly, investors' exposure to TELMEX credit and Mexican transfer risks was effectively transformed into an exposure to AT&T credit and US transfer risks. Other forms of collateralization have included bank deposits, electricity payments, and credit card receivables.

But the use of collateralization also involves actual and potential costs for the borrowing entities. In effect, by pledging existing assets or future receipts, borrowers may lose future financial flexibility, as well as lower the seniority of creditors with unsecured debt. Moreover, other re-entrants may find themselves similarly having to pay higher borrowing costs, a development that would be of concern to government officials.

Finally, in customizing borrowing instruments, a relatively small number of entities have also resorted to the wider range of financial risk management techniques that are now more feasible thanks to the entities' improved creditworthiness. These include interest rate and commodity hedging mechanisms, which allow borrowers to reduce their exposure to price volatility. By limiting their "open positions" (contracts not fully offset by futures transactions or fulfilled by delivery), borrowing entities thus minimize the risk of adverse price developments being translated into their international obligations and receipts. Such an approach may also be used by country authorities, as illustrated in the case of Chile (relatively widespread use of interest rate hedging) and Mexico (commodity hedging through the sale of future oil contracts consistent with the price assumed in the government budget).

### The years ahead

The success achieved so far by some Latin American countries in regaining international capital market access, while still limited, is a welcome development. But further progress will depend largely on the sustained implementation of sound economic and financial policies. This needs to be supported by continued efforts to avoid excessive new indebtedness and to reduce exposure to adverse developments in exogenous prices (e.g., through greater use of market-based risk management techniques). This should be accompanied by a careful use of collateralization and other credit enhancements, with an eye to maintaining an appropriate balance between the immediate gains of lower borrowing costs and potentially adverse longer-term implications for liquidity management.

Industrial creditor countries can also contribute to the process by helping to expand the pool of investors that may be tapped by developing countries and opening up their markets for developing country goods and services. With mutually reinforcing actions in both developing and industrial countries, entities with solid financial prospects will be increasingly able to complement their access to domestic sources by taking advantage of the broader opportunities offered on international capital markets. ■

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# Innovations in Debt Relief:

*Creditor countries have increased concessions in granting debt relief to reduce the debt burden of indebted countries*

Thomas Klein

*Debt and International Finance Division, The World Bank*

Recent moves by the Paris Club have opened the possibility of reducing the debt burden of severely indebted low-income countries through debt cancellation and restructuring. In doing so, the Paris Club has attempted to broaden the approach taken in September 1988 under "Toronto Terms," moving to encompass some of the ideas expressed in a proposal by then UK Chancellor of the Exchequer, John Major, of September 1990, known as "Trinidad Terms."

The Paris Club is the multilateral forum that helps developing countries restructure their debts to governments and officially guaranteed export credits. Traditionally, the Paris Club helps indebted nations resolve temporary international liquidity problems by restructuring maturities falling due in one to three year consolidation periods. Interest on rescheduled debt is usually at concessional rates for ODA (official development assistance) debt and at market rates for non-ODA debt. Over the past few years, creditor governments have realized that many developing countries, especially the severely indebted low-income nations, face intractable debt problems that demand a more flexible and longer-term approach and that repeated reschedulings through the capitalization of interest have been a major cause of the increase in the stock of debt in some cases.

This prompted Mr. Major's proposal that the entire stock of debt up to an agreed cut-off point be restructured. Two thirds would be canceled under this proposal, and the repayment period for the remainder would be 25 years, with 5-years' grace. For countries facing severe cash flow problems, moratorium interest (interest on restructured debt service obligations) could be capitalized (i.e. added to the principal) for five years and later payments could be graduated and linked to the country's export capacity.

More extensive debt relief for severely indebted low-income countries was endorsed by the July 1991 Group of Seven summit in London and by the Interim Committee and the Development Committee during the Annual Meetings of the IMF and the World Bank at Bangkok in October 1991.

In December 1991, the Paris Club introduced new terms for two low-income countries Nicaragua and Benin, and in January 1992 these terms were applied to Bolivia and Tanzania. At first sight, the new menu of terms may appear short of the original Trinidad Terms proposal. The agreements dealt only with maturities falling due during 15-30 month consolidation periods plus arrears (which accounted for a substantial portion of Nicaragua's Paris Club debt). Also, the accords called for a 50 percent reduction in the net present value of debt, rather than a uniform cancellation of principal of 66 percent.

The agreements, however, also included a "good will" clause under which the Paris Club agreed to consider further debt relief after the expiration of the consolidation period, and a commitment to meet at the end of three to four years to consider the matter of the stock of debt. At that time, the debtor country would be expected to have fully implemented its earlier agreements (captured in the "Agreed Minutes" of the Paris Club), made comparable debt relief arrangements with other creditors, and continued appropriate arrangements with the IMF.

If the remaining stock were to be restructured on no less favorable terms than the initial agreements, these terms would allow creditors to partially write off their debts in stages successive Paris Club agreements dealing with current maturities of three to four years, followed by a final agreement on the remaining debt.

Creditors will reschedule ODA loans on a long-term basis at concessional interest rates. (Many creditors have already canceled their ODA claims on the poorest countries.) For non-ODA loans, creditors have two main options: (1) write off 50 percent of the consolidated debt and reschedule the remainder at market rates, with repayment over 23 years, including a grace period of six years, or (2) reschedule debt at concessional interest rates so as to reduce by 50 percent in net present value terms the payments due, with a 23 year repayment period, but without a grace period. For those creditor countries that are currently unable to grant concessional relief, the agreements allow a third option, which consolidates debt at market rates, with repayment over 25 years, including 14-years' grace.

In September 1990, the Paris Club introduced new terms for lower middle-income countries (see box for details). One feature of these accords was to permit voluntary swaps of debt for local currency obligations, such as debt-for-nature swaps. ODA debt can be exchanged without limit; the swap ceiling for

# The Paris Club

non-ODA debt is normally equal to 10 percent or $10 million, whichever is higher. These swap possibilities were incorporated in the Poland and Egypt agreements of 1991 and also in the new terms of low-income countries.

## Innovations, in brief

Broadly speaking, five major changes have been introduced by the Paris Club over the past few years to help the low-income countries:

- Under exceptional circumstances, the Paris Club will consider canceling or providing equivalent restructuring of the entire stock of a country's official debt contracted before a cut-off date.
- The interest rates on consolidated nonconcessional debt can now be substantially below market rates.
- Longer repayment periods for rescheduled nonconcessional debt.
- A menu approach for creditors, under which they can choose the modality of debt relief; and
- A move toward equalizing burden sharing among creditors so that each creditor's debt relief agreement would achieve an agreed net present value target.

The Paris Club is not likely to respond with restructuring of concessional debt or debt cancellation for countries that need debt relief only to bridge temporary liquidity problems. Conventional Paris Club agreements are likely to continue in those cases.

## Paris Club's exceptional rescheduling terms

### *Toronto Terms: October 1988–June 1991*

*Eligibility:* Countries designated by the World Bank as "IDA-only" borrowers (i.e., eligible for concessional assistance from the International Development Association) that have very heavy debt-service obligations, low per capita income, and chronic balance of payments problems that render the country unable to service debts on conventional terms. The countries must have comprehensive adjustment programs in effect that are supported by IMF upper-credit tranche, or SAF or ESAF arrangements. Eligibility is determined on a case-by-case basis.

*Repayment terms*

| ODA Debt | Non-ODA Debt |
|---|---|
| Maturity: 25 years<br>Grace: 14 years<br>Interest: No higher than original rates | *Option A*: Cancel one third of eligible maturities and reschedule the remainder with a 14 year maturity including 8-years' grace. Market-related moratorium interest rates<br>*Option B*: Same repayment period as for ODA debt but market-related moratorium interest rates<br>*Option C*: Same repayment terms as Option A but moratorium interest limited to 3½ percentage points below market rates or 50 percent of the market rates, whichever is the smaller reduction |

### *New terms for lower middle-income countries: September 1990*

*Eligibility:* Per capita below $1,195. Countries must also have a high proportion of debt to official creditors and must demonstrate a heavy burden of overall indebtedness. Beneficiary countries must have comprehensive adjustment programs supported by upper-credit tranche IMF resources. Eligibility is determined on a case-by-case basis.

*Repayment terms*

| ODA Debt | Non-ODA Debt |
|---|---|
| Maturity: 20 years<br>Grace: 10 years (maximum)<br>Interest: No higher than original rates | Maturity: 15 years<br>Grace: 8 years (maximum)<br>Interest: Market-related |

*Swap Arrangements:* Paris Club eligible debt can be exchanged for local currency obligations, such as debt-for-nature and debt-for-equity swaps. Participation on a voluntary basis. No limits on ODA debt. For non-ODA debt, 10 percent usually of eligible maturities or $10 million, whichever is higher.

### *New exceptional terms for low-income countries: December 1991*

*Eligibility:* Same as for Toronto Terms.

*Coverage:* Agreements reschedule arrears and current maturities for 12-18 month periods with an understanding that the remaining stock of debt will be considered for debt relief after a three-to-four year period.

*Repayment terms:* Graduated repayment schedule.

| ODA debt | Non-ODA debt |
|---|---|
| To be rescheduled on a very long-term basis. | Menu approach.<br>*Option A*: Write-off 50 percent of debt and reschedule the remainder at market rates. Maturity: 23-years, grace: 6 years. Market-related moratorium interest rates<br>*Option B*: Consolidate at concessional rates so as to reduce by 50 percent in net present value terms the payments due. Maturity: 23-years, no grace period<br>Consolidate at market rates. Maturity: 25 years, grace: 14 years (Same as Option B on Toronto Terms.) |

*Swap arrangements:* Same as under the new terms for lower middle-income countries.

IMF SURVEY

# Debt Conversion Is Neither Curse nor Cure

While some observers hail debt conversion as the salvation of Latin American debtor countries, other experts warn that it is a deceptive and dangerous debt-management tool. In *Debt Conversion in Latin America: Panacea or Pandemic?*, Mary L. Williamson of the Overseas Development Council (ODC) argues that "debt conversion remains an important element of external debt management in several of the largest Latin American debtor countries." She observes, however, that "because Latin American debt conversion strategies vary considerably in their policy content and macroeconomic underpinnings, assessments of their costs and benefits must be made on a country-by-country basis, in a way that addresses differing goals and contexts."

Williamson's essay focuses on the debt-conversion experiences of four Latin American countries—Chile, Argentina, Brazil, and Mexico. The case of Chile is presented in detail, while the experiences of Argentina, Brazil, and Mexico are discussed more briefly and are used to illustrate the diverse roles that debt conversion can play in reform strategies.

As highlighted in Williamson's case study of Chile, large-scale debt reduction is only one possible priority for a debt-conversion program. Other ountries—such as Brazil and Mexico—have emphasized more selective policies that use the debt-conversion subsidy to attract particularly desirable types of foreign investment. The trade-off between the quantity and quality of debt conversions, Williamson points out, has sparked considerable debate in each of the countries studied, underscoring the inherent limitations of the debt-conversion tool.

## Lessons from Chile

"Chile was one of the first countries to introduce a formal debt conversion scheme in the wake of the 1982 debt crisis," Williamson observes. Its long conversion program has successfully converted a large portion of the country's external debt. According to Williamson, "the country's open business climate and permissive debt con-

### Chile's External Debt Service

| | 1980* | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|---|---|---|
| | (billion U.S. dollars) | | | | | | | | | |
| **Total debt service** | **2.3** | **3.2** | **2.9** | **2.2** | **2.3** | **2.1** | **2.0** | **1.7** | **1.7** | **1.2** |
| Amortization | 1.4 | 1.8 | 1.2 | 0.9 | 0.5 | 0.4 | 0.4 | 0.3 | 0.6 | 0.3 |
| Interest | 0.9 | 1.4 | 1.7 | 1.3 | 1.8 | 1.7 | 1.6 | 1.4 | 1.0 | 0.9 |
| Exports[1] | 6.0 | 5.0 | 4.6 | 4.6 | 4.5 | 4.5 | 5.0 | 6.3 | 8.3 | 8.1 |
| | (percent) | | | | | | | | | |
| Debt service/exports | 38 | 64 | 63 | 48 | 51 | 47 | 40 | 27 | 20 | 15 |
| Interest/exports | 15 | 28 | 37 | 28 | 40 | 38 | 32 | 22 | 12 | 11 |

Note: Figures may not total because of rounding.
[1]Export figure for 1989 includes only exports of goods and is a preliminary estimate; earlier export totals cover both goods and nonfinancial services and thus give a higher base in calculating the debt service.
Data: *Debt Conversion in Latin America: Panacea or Pandemic?*



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version norms have fueled an especially rapid drop in the private sector's foreign debt and have contributed to a far-reaching privatization initiative."

Chile's initial debt-conversion program, much of which still operates today, encompasses three formal mechanisms: Chapters XVIII and XIX of the Compendium of Foreign Exchange Rules, and Article 1e of Decree Law 600 (D.L. 600), the statute governing foreign investments made through either equity purchases or project loans.

Chapter XVIII is open to investors without regard to nationality; however, only Chilean residents use it because foreigners can obtain special tax and financial advantages by channeling conversions through either Chapter XIX or D.L. 600. The Central Bank allocates participation in Chapter XVIII on the basis of a biweekly central bank auction.

Foreign investors making debt-equity conversions in Chile usually channel funds through Chapter XIX. Central bank regulations governing this mechanism are flexible and open-ended, and many of the norms are unwritten and developed case by case. The crucial advantage to converting debt under Chapter XIX, as opposed to Chapter XVIII, according to Williamson, is that investors can obtain a right of access to the foreign exchange market to remit future dividends and capital.

In reviewing Chapter XIX applications, the Central Bank extends priority to investments that establish new enterprises or that will improve the trade balance by expanding existing enterprises. In addition, policy revisions made in 1990 make implicit new-money requirements for foreign purchases of existing Chilean assets.

D.L. 600, Chile's general foreign investment law, permits foreign investors to capitalize existing loans to Chilean entities. However, only 3 percent of debt conversions between 1985 and 1989 took this form, perhaps because the Central Bank preferred to retain maximum policymaking discretion by channeling conversions through Chapter XIX.

Chile pursued an ambitious agenda through debt conversions, including foreign bank debt reduction, privatization of state-owned enterprises, and strengthening of existing private firms, according to Williamson. In pursuit of these objectives, it rejected alternative projects for debt conversion and justified several controversial results of the program on the basis of the program's more important objectives.

***Debt Reduction.*** From the inception of Chile's debt-conversion program in 1985, the Government's highest priority was to cut the national debt-service burden—an urgent task given the sagging domestic investment rate and the huge drain that interest and amortization payments were placing on foreign exchange earnings. A permissive regulatory structure expedited approval and implementation of debt conversions and supported the program's debt-reduction goal.

The Chilean Government declined to maximize its own financial yield from debt conversions under Chapter XIX by forgoing an auction process (like that used to allocate Chapter XVIII participation) that could have earned it a greater portion of the discount accruing to foreign investors. According to Williamson, policymakers did not want to divert the focus of Chapter XIX from promoting debt conversions to generating public revenues.

Although debt reduction was the immediate goal of the program, its long-term goal was to return Chile to the good graces of international financiers so that voluntary lending could resume. According to Williamson, "the country appears to be well on its way to rebuilding a solid credit rating with the international financial community."

***Investment Promotion.*** One bonus to promoting debt conversion through Chapter XIX and D.L. 600 was the incentive it gave to foreign direct investment. Williamson notes that this stimulus complemented Chile's other efforts to attract foreign investment as a way to generate new foreign exchange flows, improve domestic investment rates, gain access to advanced technologies and management expertise, and encourage export production and market expansion.

While the impact of Chile's debt-conversion program on direct foreign investment levels cannot be quantified precisely, Williamson contends that "evidence suggests that conversions have accelerated the pace of foreign investment since 1985." Among other things, the debt-conversion program generated a wave of favorable publicity concerning Chile's business climate and economic prospects. After being ranked by *Institutional Investor* as one of the 45 least attractive global investment prospects in 1983, Chile registered the second highest rating in Latin America and the most improved score of any nation in 1989.

***Strengthening Private Sector Finances.*** Chile's debt-conversion program has complemented government efforts to strengthen the domestic private sector in the wake of the damage wrought by the debt crisis. Capital infusions from abroad were needed, but investors were understandably wary of the investment climate in Chile. Chapter XIX, however, sparked new interest by effectively subsidizing investors' purchases of local equity. And Chapter XVIII helped lower private debt and raise overall private investment levels, although its specific contributions are difficult to document.



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because resident investors were not obligated to declare how they were using Chapter XVIII funds.

Williamson points out that both the Chilean Government and the commercial banks placed top priority on resolving the private sector debt crisis. "The Government's philosophy of relying on private-sector-led growth complemented the banks' desire to consolidate and strengthen their loan portfolios by eliminating risky private sector exposure," she notes. In addition, loan covenants initially prohibited prepayment or conversion of public sector debts, thus channeling early conversions into private debt.

***Export Promotion.*** A final goal of the debt-conversion program was export promotion, which, in turn, was to provide Chile with higher foreign exchange earnings to finance debt service and imports. Although Chile's export earnings have increased dramatically since 1985, Williamson notes that there are no figures to quantify how much of this improvement was produced by conversion-related investment. However, she contends, "it is safe to say that debt conversions have played a constructive role."

### Argentina's Experience

Debt-conversion policy has only recently become a leading component of Argentina's debt-management efforts, according to Williamson. Although the country operated a formal debt-conversion program from 1987 to 1990, the program was subject to intermittent revisions and suspensions. Williamson points out that roughly two thirds of debt conversions undertaken during this period were devoted to purchases of Argentine equity by both domestic and foreign investors, which assisted the Government's uphill struggle against domestic capital flight and the heavy net capital outflow associated with the foreign debt. The remaining one third of debt reduction arranged under the 1987 program stemmed from an on-lending scheme and a mechanism whereby various private sector debts to the Central Bank could be canceled in exchange for contributions of foreign exchange.

The Argentine conversion program incurred the same costs as those identified in the Chilean case, Williamson points out, "but in the context of chronic macroeconomic instability those costs eventually became unbearable." Purchases of foreign debts for conversion exacerbated pressure on the parallel rate for Argentine currency, destabilizing the Government's attempts to manage exchange rates. Debt conversions were not the primary culprit in Argentina's macroeconomic difficulties, Williamson observes, but "managing the program's costs within a chaotic economic context proved impossible, and the Government eventually closed the conversion window to concentrate on fundamental stabilization and adjustment measures."

**The Chilean Government and the commercial banks placed top priority on resolving the private sector debt crisis.**

### Debt Conversion in Brazil

Debt conversions have been taking place in Brazil since at least 1982, but no formal program has survived long in the country's unstable policy environment, Williamson says. She continues that "the history of debt conversions in Brazil parallels the country's difficulties in many areas of economic management, where political pressures and destabilizing economic forces have caused the failure of a long series of reform programs." Investor confidence in Brazil has been dismal, she says, and in such an atmosphere, neither a formal nor a free-market-based approach to debt conversions is likely to achieve the desired results.

Conversions registered under Brazil's formal mechanism were dwarfed by a flow of informal conversions during 1987–88, with the result that the Government's investment and capital remittance guidelines did not affect the majority of investments made through debt conversion. The most significant contribution of the debt conversions, therefore, was to reduce the stock of foreign debt.

The high volume of debt conversions in 1988 provided few long-term benefits to Brazil beyond its debt-reduction impact. At the same time, it generated high costs. Purchases of foreign debts for conversion and demand for foreign exchange to safeguard conversion-related profits strained Brazil's foreign exchange reserves to the limit. In addition, the monetary effects of the debt-conversion program contributed to hyperinflationary pressures. These concerns and persistent political criticism of the subsidies involved led the Government to cancel its formal program in January 1989.

### Mexico's Debt Reduction

Mexico's leadership in terms of the Latin American debt crisis does not extend to the debt-conversion arena, according to Williamson. Debt conversions have not played a central role in any of Mexico's international economic policies. However, Mexico's 1985 and 1987 rescheduling agreements with commercial banks created a legal framework for debt conversions, and two stages of conversions have ensued.

Mexico's first debt-conversion program, which began in 1986, was designed to complement the country's early structural adjustment efforts. Through this program, Mexico converted a total of $3.2 billion in commercial bank debt. The program's inflationary effects prompted the Government to shut it down, presaging decisions taken later in Argentina and Brazil. According to Williamson, "Mexico thus provides another example of a large economy unable to undertake substantial debt conversions because its capital market could not absorb long-term instruments that would offset the liquidity generated by trading foreign debt for domestic funds.".

*A winery in Chile: the country's open business climate and permissive debt-conversion norms have fueled an especially rapid drop in the private sector's foreign debt.*

### Conclusions

Williamson concludes that, "not surprisingly, the success of debt conversion policies in achieving the goals a government has selected for them—and in minimizing negative side effects—depends on the overall coherence and stability of a national economic program." She points out that, in Brazil, debt conversions have produced destabilizing short-term capital flows far more often than additional long-term investments, although this does not reflect an offcial policy. She maintains that "Brazil's failure to stabilize its national economy extends to impotence in stemming informal conversions."

At the opposite end of the spectrum, two successive Chilean Governments have overseen debt-conversion programs, involving both formal and informal transactions. Only minor exertions were required to counteract the negative side effects of these programs because the economy has been stable and could be fine-tuned with available policy instruments.

Copies of *Debt Conversion in Latin America Panacea or Pandemic?* may be obtained from the Overseas Development Council, 1717 Massachusetts Avenue, N.W., Suite 501, Washington, D.C 20036.

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# Time to Forgive Old Soviet Debt

By Garry Kasparov

As was to be expected, the disappearance from the world political arena of the Soviet Union has not solved all the problems engendered by the existence of this monster-state. Time, first and foremost, is required to overcome the chaos inevitably arising from the disintegration of an empire suffering from a fatal disease.

The multi-stage reform process will be protracted, although certain constitutional reforms should come as quickly as possible. But in principle, it can already be confidently asserted that the new Russian leadership will shift the state juggernaut, which during the years of Mikhail Gorbachev's *perestroika* merely imitated movement. Unfortunately, the Western media, which were so responsive to the promises and plans of the last general secretary, are reacting very cautiously to the structural transformations carried out by the democratically elected president of Russia, Boris Yeltsin, and the radically inclined economists in his government.

It is not difficult to understand the disillusionment of those who, after falling victim to Gorbomania, do not wish any further to associate their political or journalistic careers with the new Russian leader. But the pessimism openly expressed in the Western press also creates a distorted picture of events—just as the excessive optimism that everywhere accompanied Mr. Gorbachev once did.

The price of Mr. Gorbachev's legacy is well known, and therefore, at the very least, it is unreasonable to demand of Boris Yeltsin and the other CIS presidents an immediate miracle.

> *The West gave billions to save Gorbachev from "terrible conservatives." The foreign debt is a debt with which none of the new leaders has any connection.*

## Hardly a False Alarm

It does no harm to review what happened in the former U.S.S.R. last year. Rumors about an imminent military coup caused panic both within the U.S.S.R. and abroad, and although in the end nothing happened, the alarm was hardly false. Consider the facts of last summer. The central government was trying to inflame the territorial dispute between Russia and the Ukraine. Mr. Gorbachev convened a meeting of generals. Russian Vice President Alexander Rutskoi was fiercely attacking President Yeltsin's government with appeals to military-industrial institutions. So-called "pro-state democrats" were preparing demonstrations in support of maintaining the Soviet Union.

It is also not hard to imagine what the reaction of the West would have been to the creation of a new "State Emergency Committee" with a human face. The Gorbachev-Rutskoi axis, supported by the authority of other "democrats," would have satisfied the West's need for "stability." It was Mr. Yeltsin's decisive action—concluding the agreement about the CIS on Dec. 6, 1991, and finally finishing off the scheming imperial center—that saved us from impending catastrophe.

But Mr. Yeltsin is finding it much harder to carry out economic reforms. An understanding of this requires a precise analysis of the balance of power.

The tanks that appeared in the early morning of Aug. 19 on the streets of Moscow provoked almost unanimous hostility from all of society—the people did not want to return to slavery, while the state machinery basically regarded the path to capitalism as the surest means of becoming rich. (The rapid downfall of Mr. Gorbachev has the same underlying cause—having outmaneuvered himself, the architect of perestroika turned out to be not required by anyone—within his own country, of course—and was forced to leave the political stage.) But as soon as the implementation of global economic programs begins, unanimity disappears and the balance of forces changes sharply.

Whereas productive forces in society and rapidly growing private business need the constitutional securing of the right of private ownership, state organs are aiming to prolong the period of economic confusion. What the officials want is perfectly obvious—to exploit their current position for a smooth transition to newly formed private structures or simply to guarantee their future. The numerous criticisms of the team of the Russian vice premier, Yegor Gaidar, rightly indicate the need for a rapid beginning of the privatization program. But for some reason these criticisms ignore obstacles this government faces, for example the powerful opposition by the state apparatus to constitutional amendments by the Russian Parliament.

The so-called patriotic forces in Russia hope to exploit this split. This red-brown coalition (left-leaners and heirs to fascists) nevertheless intends to keep ideology to a minimum. Most probably we will be dealing with an ultra-right nationalistic party, like that of Jean-Marie Le Pen in France.

Today, Mr. Yeltsin faces an exceptionally complex situation. In making decisions he must take into account the growing irritation of the population, the dissatisfaction of the private sector, the pressure of the state apparatus, the sinister shadow of the red-browns.

The West can have a serious influence on what happens. It must develop a program of cooperation with the Russian government that would allow Mr. Yeltsin to create a long-term base of support for his reform program. For example, the start of Russian-American military cooperation, or the investment of high-technology Western firms in demilitarized enterprises, would force the military-industrial institutions to form a coalition with the Russian government. But the main trump card in the government's struggle with anti-reformers may be the foreign-debt problem.

The mention of this problem may in itself raise in many a skeptical smile. Parallels with Latin America are quite inappropriate here. The debt of Russia and the other states has not yet reached the point where even repaying the interest becomes an intolerable financial burden. Indeed, even to give an exact evaluation of the debt liabilities of the former Soviet Union is extremely difficult. The information given by different authoritative sources varies in the fantastic range of $55 billion to $80 billion.

Whatever the overall sum of foreign debt, one thing is clear. Debt relief and to some extent debt forgiveness are the most effective way for the West to influence development of events in the CIS. It is highly unlikely that debt relief or even debt forgiveness for Russia, as the principal successor of the Soviet Union's financial obligations, would be a serious blow to the world credit system.

Recall that President Bush's decision to write off Egypt's $7 billion debt at the time of the Gulf War was accepted calmly. The agreement of Hosni Mubarak to participate in the anti-Iraq coalition was deemed a sufficient argument. By this logic, it would be interesting to see what weight would be given to the neutralization of 30,000 nuclear warheads. But the main argument in favor of debt relief is that it would pave the way to the New World Order—an order in which, in contrast to the past's *Realpolitik*, morals and politics cease to be incompatible.

Let us imagine for an instant that the Castro regime in Cuba should fall—an event likely to occur this year. Without doubt, the new Cuban government would refuse to pay Fidel Castro's debts to Moscow. It would be impossible to dispute the logic of this decision—after all, the money poured into the communist regime in Cuba by the Kremlin has in the end brought endless repression and poverty to the Cuban people. Now let us remember the last two years of Mr. Gorbachev's rule, when the Soviet foreign debt made a truly cosmic leap. These were years when the republics grew in power.

To make communism stronger, using Western credit—this was Mr. Gorbachev's ultimate goal. What we encountered in this case was not the dismal tradition of *Realpolitik*, by which the West offered credit to totalitarian regimes, but a conscious preference of the imperial communist center to rapidly strengthening democratic forces. The West was ready to give billions to save Mr. Gorbachev from the "terrible conservatives." All attempts by prominent officials of the democratic movement to appeal for common sense (here we should mention Andrei Sakharov) encountered a dense wall of incomprehension, and even hostility.

The outcome is well known. Communism in Russia has been overthrown, and the victors have inherited not only a broken economy and interethnic enmity, but also an enormous foreign debt. It is a debt with which none of the new leaders has any connection; a debt that was used for it is not known what purposes, but most probably for the struggle against themselves. And it is a debt that now has to be paid at the expense of the good of the economy.

Among Mr. Gorbachev's creditors a special place is occupied by Germany. Germany granted the former Soviet Union the greater part of its Western credit, whether it was $30 billion or $40 billion. But in contrast to its Western partners, who essentially paid for their own fear and lack of vision, Germany lent money for a concrete purpose: German unification.

## Paying for Reunification

The dream of the German people, which had seemed unrealizable, became a reality in literally a few months, and one can understand the determination of Chancellor Helmut Kohl not to spare means for achieving the sacred goal. In the eyes of Mr. Kohl, the removal of Soviet troops from the territory of East Germany was a big enough prize to allow him to close his eyes to the use of the Soviet army against peaceful demonstrators. And the price paid for this "very nice piece of real estate" was much lower than its real worth.

Why then today, after being ravaged by communists, should Russia essentially pay for the reunification of Germany?

Western diplomats are now facing certain difficulties in establishing working relations with the states of the CIS. This is not surprising, since radical changes on the geopolitical map demand new conceptions and, most importantly, an unequivocal rejection of stereotypes. It will be remembered how tense and uncomfortable President Bush was over the weekend with President Yeltsin. After all, even mentioning Mr. Yeltsin's name in the corridors of the White House was until recently considered bad form. Mr. Bush's pragmatism nevertheless played a positive role.

Let us hope that this approach reflects the readiness of the West to offer Russia a new and balanced cooperation program. Cooperation, which in the New World Order should gradually become union, is necessary so that together we can meet the challenges ahead with confidence.

*Mr. Kasparov, the world chess champion and head of the Moscow region branch of the Democratic Party of Russia, is a contributing editor of the Journal.*

# The IMF Strikes Back

Last week came the announcement that Russia and the International Monetary Fund have reached an agreement on a quota, an essential step toward a program for Russia that can be financed by the IMF. But this news may produce a new round of criticism of the fund. In fact, an early and loud critical voice has been that of Robert L. Bartley, editor of this newspaper. On April 2, he wrote on the Journal's editorial page: "What economy has the IMF ever salvaged?"

That Mr. Bartley could ask this is ironic. In recent years IMF advice has acquired an almost universal acceptability

## Counterpoint

### By Vito Tanzi

and is giving positive results in many countries. But a small group of commentators continues to castigate the IMF as if it were a scourge. If IMF policy advice is so fatal, why are so many countries making an effort to adopt it? Perhaps it is because the advice draws from the extensive experience of the IMF's 156 members.

The IMF's critics seem to believe, rightly, that these countries need a climate of growth. But they are wrong in believing the climate can be fostered only by low taxes. Such critics certainly ignore the fact that providing an essential minimum level of high-quality public services can improve the climate for economic growth and development.

The critics of the IMF sometimes commit an analytical error in the instances when they speak of tax rates and tax revenue as if they were synonymous concepts. They suggest that when the IMF asks a country to "increase taxes" it really asks for the tax rates to be raised. This is far from the truth. Fund missions are often faced with tax systems that exhibit high tax rates but are unproductive in terms of revenue because of poor administration and large loopholes.

In most cases IMF missions have recommended often large reductions in the tax rates on personal or corporate income, while recommending the widening of the tax base and other administrative reforms aimed at preserving or occasionally raising revenue. In fact, a unifying theme of the technical advice given by the IMF to member countries has been the need to reduce rates while preserving or, when necessary, raising revenue. In 1990-91 the IMF was asked to make recommendations on tax policy in 36 member countries. In 19 of these countries the IMF recommended a reduction of basic tax rates. In only eight cases was an actual increase in tax rates for personal and corporate income recommended, and then only as a temporary measure. In 13 other cases no changes in tax rates were proposed.

Why is the IMF interested in preserving tax revenue? This question is best addressed in the context of a specific country, like Peru. The political upheaval there this week provides hard evidence for the depth of the problems in that country. Some years ago the level of tax revenues of Peru as a share of its gross domestic product was about 17%. To put this level in its proper context, I should mention that the average tax level as a share of GDP for all developing countries is about 18%.

Peruvian tax revenues fell to as low as 5% of GDP, partly because of poor tax administration and partly because of excessive use of tax incentives and other factors. They fell also because the resulting fiscal deficit was financed largely by monetary expansion. Monetary expansion produced inflation so steep that the lag time between the levying of taxes and the time these tax revenues reached state coffers caused a loss in the real value of collections. The longer the lag and the higher the inflation rate, the lower the real value of the revenue the government receives.

Despite of recent efforts by the current government, including reducing the top marginal rate for personal income taxes to 37% from 45%, and the top corporate rate to 30% from 40%, tax revenues are even now only about 8% of GDP, still one of the lowest levels in the world. Such low tax revenues might presumably please some IMF critics who would argue that free marketeers can function better in this environment, but not the Peruvian authorities. The problem is simply that a tax level of 8% of GDP does not generate enough money to pay teachers, to repair roads, and to provide the basic economic and social infrastructure necessary for a modern society. And, of course, without this infrastructure, growth is unlikely to take place.

Although government spending also as a share of GDP has fallen dramatically to a level that is creating lots of difficulties (anyone who has been in Lima can see that), the fall in spending has not matched the fall in revenue, thus widening the fiscal deficit and leading to high inflation. The Peruvian authorities are aware of the difficulties and are trying to correct this situation with IMF assistance and not through IMF pressure.

The IMF's critics do not seem to pay much attention to the consequences of fiscal deficits. They seem to feel that a deficit is no problem because either it will force a reduction in public spending, or it can be financed without inflation and other difficulties, say by selling bonds to the public, as happens in industrial countries. They sometimes think low income tax rates are the only answer. But on the average, personal income taxes in developing countries produce less than 2% of GDP, compared with about 11% in the U.S. And what if public spending is already at such a low level as to bring social and economic disintegration to the country? Or, if for political reasons, public spending does not come down, as seems to have happened in the U.S. in the past decade? Or if the deficit can be financed only by monetary expansion?

These are not theoretical possibilities but reality – a reality that seems to escape the critics. In such cases is there really an alternative to trying to raise revenue in the most efficient way? Or do the critics believe that inflation is costless and that a large fiscal deficit financed by monetary expansion can coexist with fixed exchange rates? This is the impression they give when they refuse to consider the need for reducing fiscal deficits while simultaneously criticizing the IMF for occasionally advocating an adjustment in exchange rates.

Of course, Peru is an extreme example of a country with a very low level of tax revenue. But my argument applies to other countries as well.

Let us now consider Russia, another country under scrutiny by the critics. In 1991 the Russian fiscal deficit was reported to have exceeded 20% of that country's gross domestic product. As one would have expected, the deficit was financed largely by monetary expansion, which led to repressed and open inflation. It would be nice if, without a social explosion, public spending could be reduced immediately by 20 percentage points of GDP to eliminate the deficit. This, of course, is not going to happen. But then how can one avoid some increases in tax revenue? The IMF will assist Russia in developing an efficient tax administration and in raising needed revenue with the lowest possible rates. Russia will obviously need a law, a commercial code, private property and a currency. It will also need sound public finances. To fail to accept this is to live in Wonderland.

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*Mr. Tanzi directs the IMF's Fiscal Affairs Department.*

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# Sound Money for Russia

By AMITY SHLAES

As anyone who has seen the TV pictures of Russian citizens selling their [illegible] to buy [illegible] can testify, sound money [illegible] for Russia [illegible] Boris Yeltsin's government is doing its best to get hold of a [illegible] currency. Bankers and development [illegible] are putting their minds to the problem, and the International Monetary Fund's first [illegible] of the ex-Soviet [illegible] are expected within a few weeks.

There is a group of thinkers out there who believe the quickest path to stable currency is the one that gets the money supply out of the hands of Mr. Yeltsin and the IMF. Some of these [illegible] bankers met last week at the Cato Institute's annual monetary conference in Washington. The site of the meeting was the [illegible] Willard Hotel [illegible] the street from the U.S. Treasury [illegible] the Cato outfit lives the tradition of [illegible] a radical movement [illegible] state control [illegible] and the speeches given at the Willard [illegible] as a feat of big government.

Several concrete proposals for a new currency system in Russia [illegible] the conference. The hottest idea—and one that was [illegible] addressed on this page—was the currency board approach. Under this system, a country replaces the traditional central bank with a currency board that issues notes and coins convertible into a foreign reserve currency. A currency board [illegible] reserves equal to [illegible] of the value of the national currency. Once established, a currency board has only one [illegible] exchange [illegible] currency [illegible] This is a system under which Russia would [illegible] spiral.

## Currency Board

Steve Hanke of Johns Hopkins and Kurt Schuler of George Mason University [illegible] that for Russia a currency board [illegible] Messrs. Hanke and Schuler think [illegible] would be a sufficient base for a currency board, and argue that [illegible] Russia has the resources for [illegible] of the exchange rate [illegible] Russia [illegible]

The Cato types like the currency board idea because it's simple and workable—Singapore and Hong Kong already have currency boards. [illegible]

which private banks, not the government, issue money.

A gold standard for Russia was topic number two at the Cato meeting. Antonio Martino, who holds a chair in monetary history at the University of Rome, gave the gold bugs some welcome fodder with a graph showing that 1870-1914, when Italy was on the gold standard, were years of stability compared with the rockier course Italy's economy took later.

Alan Reynolds of Indianapolis's Hudson Institute took on the more practical aspects of the work ahead for Russia, pointing out that Russia still has enough gold for Moscow to start minting coins denominated in troy ounces. He and fellow gold bug Judy Shelton of Stanford's Hoover Institution noted that gold has even helped communists: the gold-backed *chervonets*, a project of Lenin's, stabilized the Soviet economy in the 1920s. Not to be beaten to the punch, Fed Governor Wayne Angell told Mr. Reynolds that he reckoned he was more of a sound money man than [illegible] and outlined a proposal that would convert the current ruble stock into equity shares in industry and create state money with a specific gold price target.

> *Some people believe the quickest path to stable currency is the one that keeps control of the money supply out of the hands of Yeltsin and the IMF.*

Other ideas floated around the Cato meeting—most notably the pitch by [illegible] Anderson for free banking; George Selgin's [illegible] the ruble to the Western European Monetary Union; and A. [illegible] program to skirt the central bank problem altogether and make Eurodollars Russia's transition currency.

Cato also invited important Easterners. Nikolai Petrakov, director of the Institute of Market [illegible] at Russia's Academy of Sciences and until recently an aide to Mikhail Gorbachev, accused Mr. Yeltsin's [illegible] of making a fetish of Poland's shock therapy. Mr. Petrakov argued [illegible] Eastern currency union. [illegible] Mr. Yeltsin [illegible] warned about the [illegible] Russian [illegible] Harvard economist Jeffrey Sachs [illegible]

The Cato conference was interesting [illegible] of the differences it revealed. [illegible]

loving [illegible] when he discussed new and "alternative institutional arrangements" like the currency board proposal with the announcement that Eastern Europe had already seen enough economic experiments in the past [illegible] years. Mr. [illegible] also jumped all over Ms. Shelton when she talked about "creating" competition. That kind of dirigiste approach, he said, was the main mistake which can come from American professors.

But the big enemy here was an absent one: the International Monetary Fund. The IMF has been a more than welcome [illegible] in the former Soviet Union—every one of the 15 new republics has applied for membership, with the last application, [illegible] Georgia's, coming just yesterday. Since the Fund doesn't routinely publish the deals it makes with countries for the help it gives them, its critics will have a hard time pinning it down on Russia.

## 'Moderate' Inflation

The Cato crowd worries that the IMF will do in Russia what it has done in other countries, from Mexico to Poland to Yugoslavia: worry about the balance of payments and other "mercantilist" issues at the cost of neglecting important growth-oriented reforms such as tax cuts. Lars Jeurling, a division chief at the World Bank, was one of the few international development bank representatives present. If his words are any guide, the sound money team has cause to worry. He argued that a "moderate" inflation of [illegible] was acceptable.

To whom is the Cato message addressed? To Boris Yeltsin and his economics czar, Yegor Gaidar, both of whom [illegible] pinned their hopes on a [illegible] stabilization fund. To [illegible] who will tell the Russians what it needs [illegible] first. And to Congress, which has been asked to approve America's [illegible] share of a $60 billion increase in the IMF's resources.

But this conference, with its focus on Russia, also sends a message to the American citizen. The conference [illegible] dismay at what government has [illegible] the U.S. economy has made them eager to turn their attention toward Russia, where a fresh start is possible. [illegible]

*Miss Shlaes is deputy features editor of the Journal's editorial page.*

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# Reforming Prices

# The Experience of China, Hungary, and Poland

## SUMMARY


i. This paper reviews the experience of price reform in China, as well as selected East European countries. Price reform is an essential element of any program that seeks to achieve sustained and rapid economic growth in China via improvements in factor productivity. The need for price reform is made particularly urgent by the increase in the share of price subsidies in the government budget and its implications for development expenditure and macroeconomic stability in a context of relatively inelastic fiscal revenue.

ii. For price liberalization to generate sustainable growth, reform must occur within a framework that takes account of the interdependencies between the real sector and financial and institutional elements of the economy. Reforms to the price system must thus be supported by a host of accompanying actions that, taken together, will enable the successful restructuring of the economy and allow the associated productivity gains. The evidence from the reform experience, in China and elsewhere, suggest that price reform must be part of a larger reform strategy that recognizes the importance of macrostability, coordinates reforms along a broad front to facilitate restructuring, and moves at a fairly brisk pace so as to minimize transitional costs.

iii. The experience of Eastern Europe suggests that cycles of progressively more severe macro-instability can significantly reduce the degrees of freedom available to the authorities, undermine gradual reform attempts and substantially raise the costs of the eventual adjustment. For example, repeated experiences of inflation can lead to the buildup of inertial elements in the system and cause a fundamental alteration of the expectations of agents which makes reforms harder to accomplish. Subjecting an economy to extended periods of uncertainty about the ultimate objective and strategy of reforms is also harmful to the development of entrepreneurial skills and, especially, the growth of private foreign investment.

iv. It is critical to strive after macroeconomic balance over the medium term to prevent inflationary pressure from undermining the reform. Policy makers in China have demonstrated that, when the need for monetary discipline is most necessary, they can successfully fashion a national consensus to control inflation. A similar understanding of the need for fiscal and monetary restraint must underpin any program of economic reforms.

v. As China proceeds with price reform, complementary pricing actions will be required in a number of areas so as to maximize the allocative gains. These include:

(a) the hardening of budget constraints on state enterprises;

(b) measures to facilitate the exit of inefficient enterprises especially housing reforms and the creation of a social safety net to minimize the costs of transitional unemployment;

(c) the effective use of a tax-based incomes policy to moderate wage demands; and


The World Bank, 1992

(d) the rationalizing of tax system.

vi. Consistent with progress on other fronts, the eventual goal of price reform should be to achieve full price liberalization since partial measures are likely to preserve inefficient producers who must then be supported with subsidies. Since such subsidies quickly attract new claimants, the attempt should be to provide an even playing field for all industries: the market.

vii. Side by side with the liberalization of domestic prices exchange rate adjustment and reform of the trade regime allows for a closer link between domestic relative prices and international relative prices. China has already taken steps to unify the exchange rate and promote trade. Over time, current restrictions on trade (quotas, licenses and tariffs) should be replaced by a relatively low and uniform tariff. Industries which have good medium-term prospects for being competitive but cannot survive behind a low uniform tariff in the short term could be provided additional time-bound tariff protection.

"Interest Rate Liberalization: Some Lessons from Africa"

Prepared by Bart Turtelboom, Africa Department, International Monetary Fund



December 1991

## Summary

This paper reviews the experience of The Gambia, Ghana, Kenya, Malawi, and Nigeria in liberalizing interest rates. Since the mid-1980s these countries have put in place programs for structural reform of their financial sectors. Substantial progress has been made in developing market-oriented instruments of monetary control and in strengthening prudential bank supervision. Financial liberalization, however, has only partially affected the level and variability of interest rates. Lending rates were affected least, while deposit rates moved downward in some cases after the liberalization, leading to an increase in the spread between lending and deposit rates.

An analysis of the experience of these five countries shows that macroeconomic and financial instability, oligopolistic financial markets, the absence of well-developed bond and equity markets, the sequencing of the financial liberalization programs, and asymmetric information available to lenders and borrowers contributed to this behavior of interest rates.

Macroeconomic instability at the end of the 1970s and the first half of the 1980s rendered a large part of the commercial banks' assets non-performing and required precautionary reserves to make up for loan losses. Moreover, it led to the breakdown of the market for long-term credit and deposits. The problem of nonperforming assets induced banks to widen the spread between deposit and lending rates to generate profits. They did not, however, increase the lending rates, for several reasons. First, an increase in the lending rates would deter well-established borrowers. In that case, banks would have had to attract new borrowers, whose creditworthiness was virtually unknown. Second, despite an official policy of interest rate liberalization, there was often implicit government pressure not to raise lending rates since this would increase the cost of financing government deficits.

Moreover, the absence of well-developed bond and equity markets gives the banking sector a monopoly in attracting deposits. Under the system of administered interest rates and credit ceilings, the absence of profitable investment opportunities led to excess liquidity in the banking sector, thereby reducing the need for deposits.

The sequencing of the financial liberalization programs and the oligopolistic structure of the banking sector contributed to this evolution of interest rates. Except for Kenya, interest rates were liberalized early in the financial liberalization programs to send a strong signal about the government's commitment to the creation of a market-based financial system. Indirect monetary instruments were developed at the same time, and the governments were implementing a stronger regulatory framework for the financial sector. Until this became fully effective, interest rates were not completely determined by (competitive) market forces.

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"Successful Rural Finance Institutions"

World Bank Discussion Paper 150 by Jacob Yaron, 1992

## EXECUTIVE SUMMARY


This paper reviews the overall performance of four rural finance institutions (RFIs) operating in three developing countries: the Badan Kredit Kecamatan (BKK) and the Bank Rakyat Indonesia Unit Desa (BUD) in Indonesia, the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, and Grameen Bank (GB) in Bangladesh. These RFIs have been included in the study because they are among the few public rural financial institutions which are widely perceived to be successful. The fact that the performance of many RFIs which have been sponsored by state and international donors has often fallen short of their stated goals necessitate an analysis of the causes of the few cases of RFI success.

RFIs have frequently failed in the past; the necessity of continued subsidization drained budgets and deprived other sectors of the economy of funds. In general, RFIs have not mobilized savings effectively. They have been characterized by poor financial reporting, a lack of or inadequate provisions for bad debts, and legal ceilings on interest rates. To keep transaction costs and risk per dollar lent down, RFIs often gave preference to large farmers who took out large loans and benefitted from concessional on-lending interest rates.

This paper defines two prime criteria for RFI success: (i) self-sustainability and (ii) the level of outreach achieved with the targeted population. Financial self-sustainability of an RFI is achieved when the return on equity, net of any subsidy received, equals or exceeds the opportunity cost of funds. Many RFIs have long been sustained by various types of implicit or explicit subsidies to ensure continued operations. To eliminate subsidy dependence, an RFI needs to have positive on-lending interest rates that cover costs, adequate deposit interest rates, a high rate of loan collections (in itself a popular criterion for judging an RFI's success), and reasonably low administrative costs.

Outreach can be measured by (i) the value and number of loans extended, (ii) the value and number of savings accounts, (iii) the types of financial services offered by the RFI, (iv) the number of branches and village post/units, (v) the percentage of total rural population served, (vi) the real annual growth of RFI assets over recent years, and (vii) womens' participation. The growth rate of an RFI's assets might, under given conditions, also serve as a crude proxy to new clients' access to the financial services. The RFIs surveyed can be divided into two groups: those that served the very poor (BKK and GB with average outstanding loans of less than $100) and those that served lower- to middle-income farmers (BAAC and BUD with average outstanding loans of $300 to $500). The relatively large gap between these two groups is crucial to understanding much of the difference in the delivery mechanism and procedures applied. Furthermore, low loan and deposit sizes increase significantly the RFI's administrative cost per dollar lent and dollar saved and thus reduce self-sustainability when on-lending rates are not adjusted to compensate for the additional administrative cost and risk involved. This also suggests that an RFI's financial performance




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should be evaluated in the context of the clientele served, for which the typical loan size and loan characteristics may serve as proxies.

FINANCIAL POLICIES

All four RFIs reviewed have charged positive real interest rates, yet they were below those of informal credit markets. Some of the RFIs would have had to increase the rates or reduce their lending volume if their access to cheap sources of funds had been eliminated. All four institutions have also provided savings services, though with varying degrees of success. Deposit rates have been positive for BUD and BAAC, with the average value of deposits significantly higher than those of BKK and GB. The RFIs have used various financial incentives such as obligatory savings, interest rebates for timely repayment, and a gradual increase in borrowing eligibility upon timely loan repayment (used by all of the RFIs reviewed) to introduce financial discipline among inexperienced first-time small-scale borrowers, and to reduce the financial risk to the RFIs. The use of strict collateral requirements is frequently not compatible with the goal of extending small-scale loans to the poor or to low-to-middle-income clients, so most of the RFIs studied have used various alternative methods. Some have used character references, while others have used joint liability.

DELIVERY MECHANISMS

Two common problems in developing delivery mechanisms are (i) how to ensure efficient and relatively low-cost operations and (ii) how to guarantee sound selection of loan applicants and ensure adequate loan collection so that the RFI can continue to operate without constant reliance on state or donor funds.

All of the RFIs reviewed, unlike the majority of RFIs, have been efficient in processing loans, though they have applied different procedures tailored to their different clients. In general, loan applications have been processed rapidly. The repayment patterns have been very flexible in the two Indonesian institutions, so as to adjust the loan repayments to the wide variety of activities financed and their typical cash flow patterns. Given the small loan amounts, flexible repayment terms and the delivery mechanisms tailored to client needs, some RFIs have offered flexible delivery mechanisms similar to those provided by moneylenders.

All RFIs have made use of some social or peer group pressure techniques. Some have used small self-help groups, and others have used the established village leadership or local officials to ensure (i) appropriate borrower selection and (ii) on-time repayments — two areas in which the problem of asymmetric information puts the formal RFI at a distinct disadvantage compared to the informal moneylender. In Indonesia, the village head often helps to determine the creditworthiness of potential borrowers in the community, in this way resolving one of the longstanding difficulties faced by RFIs. With group lending, the small size of the group and its socioeconomic homogeneity have drastically reduced the emergence of "free riders."



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The four RFIs have applied very different procedures regarding loan repayment. All the RFIs studied have developed components of "mobile banking" as a means of providing low cost savings and lending services to low income clients, thereby markedly reducing transaction costs for the RFIs and their clients. All four RFIs have used staff incentive programs (including profit redistribution and promotions linked to loan collection and deposit mobilization) that tied employee bonuses to quantifiable performance criteria, thereby achieving increased accountability, a high degree of staff motivation and enhanced performance.

## EVALUATING THE RFIs' SELF-SUSTAINABILITY AND OUTREACH

All four RFIs have presented profits, but these figures do not adequately account for subsidies received by the RFIs, and the use of profits as the sole criterion for success neglects the outreach dimension of rural credit. The Subsidy Dependence Index (SDI) developed in this paper measures explicit and implicit subsidies (including the imputed cost of the RFI's net worth) as a percentage of the RFI's loan portfolio times the average on-lending interest rate. The resulting SDI yields the percentage increase required in the RFI average on-lending interest rate in a given year to compensate for the elimination of subsidies (i.e. to equate the return on equity, net of any subsidy received, with the opportunity cost of funds). The four RFIs reviewed differed to a great degree in their level of subsidy dependence: one RFI had attained complete subsidy independence, two are moderately subsidy dependent, and one has a high degree of subsidy dependence.

The data indicate a significant level of outreach as measured by the volume of the outstanding loan portfolio and savings, the number of loan accounts and savings deposits and the fact that the four RFIs had a positive real annual growth rate over the last three years. The target clientele is defined through the stated objectives of each RFI. Only BAAC has devoted funds exclusively to agricultural producers, while the other three institutions have financed rural income-generating activities, with a concentration on non-farm operations. GB has even incorporated social programs into its lending activities. The RFIs have differed widely with respect to some indications of the outreach level including the level of centralization of loan approval, the average workload of a staff member and the average loan size. The most recently established RFIs (BUD and GB) have had significantly higher annual growth rates. A high correlation exists between RFIs with smaller loan size and high levels of women's participation due to the fact that women have limited access to other sources of material and human resources.

## SIMILARITIES AMONG RFIS REVIEWED

The four programs have many features in common. All four RFIs have applied positive interest rates. These interest rates compared favorably to the informal interest rates. This data confirms findings in several earlier research studies showing that it is the access to credit and not the subsidy embodied in the negative interest rates that has been so important for the ultimate borrowers. All four RFIs have offered some savings services. The



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success of the four RFIs in loan collection is very likely the prime factor that distinguishes them from the majority of traditional, poorly performing, supply-led credit programs. The high collection performance is due in large measure to the fact that all have used financial incentives to encourage prompt repayment and have been able to disburse funds efficiently and rapidly, but they differ in the structure of their loan approval process. Some have used a centralized procedure and some a more decentralized process, but all have used some kind of peer group mechanism or the local officials or village heads in selecting and approving borrowers, and all emphasized staff training and incentives. The types of loan security accepted have gone beyond traditional forms, often resembling those used in informal credit markets.

## DIFFERENCES AMONG RFIS REVIEWED

Notable differences among the RFIs exist. The four RFIs reviewed can be classified in two distinct groups based on average loan and deposit size, and also with respect to the targeted clientele. Hence the level of outreach achieved has differed among RFIs, as has the level of womens' participation. The RFIs also have differed significantly with respect to savings mobilization. The RFIs that lend to the very poor have included an obligatory savings program as part of their lending activities in order to introduce first-time, very small-scale borrowers to other types of financial services and in order to reduce the default risk. One RFI that serves a slightly wealthier clientele has been able to increase savings to an amount greater than that of the loan outstanding. This finding is of crucial importance as it might suggest that, for this type of clientele, (i) demand for savings has often been overlooked by traditional supply-led credit institutions and (ii) financial assistance extended by the state or donor could, and possibly should, be limited to the period required for the value of savings to match the outstanding bankable loan portfolio. Although the RFIs have used social mechanisms for loan approval, the types of social mechanisms used differed.

The data indicate an extremely wide range of RFI performance in terms of administrative costs measured against the RFI's outstanding loan portfolio. In general, RFIs designed to benefit rural poor or small farmer populations are notorious for their high administrative costs per dollar lent, which are frequently a deterrent for commercially-oriented financial intermediaries. The programs which targetted the lower strata of the rural poor have been heavily involved in intensive training, frequent repayment of small loans and handling of small deposit accounts, and are likely to incur significantly higher administrative costs per dollar lent or per dollar saved. The stage of growth of an RFI (new versus mature branches) and the rates at which cost per dollar lent and cost per dollar saved decline as a typical branch matures, are important determinants affecting this financial ratio. Additionally, RFIs which target the poor have often had greater access to concessional funds from the government or donor agencies and thus financial costs have constituted a lower percentage of total costs than have administrative costs. For those RFIs with larger loan sizes, but less access to concessional funds, the opposite has been true.

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The factors exogenous to RFI policy which have influenced the success of the RFIs include the fact that all four institutions reviewed have operated under stable economic conditions, in countries with annual inflation rates of under ten percent, which has reduced uncertainty and risk. The liberalization of the financial markets has allowed adequate pricing of RFI operations in Indonesia and has encouraged BAAC in Thailand to decrease its subsidy dependence gradually.

REPLICABILITY

Any attempt to replicate and technically imitate the mode of operations of one of the RFIs should be carried out with great caution; a solution that was found adequate in one socio-economic environment, where a specific set of social values exists, is not necessarily the right approach in tackling the complex issue of providing financial services to the rural poor in a different socio-economic environment. A social mechanism that could serve to lower transaction costs, while supplying effective peer pressure for the sound screening of loan applicants and for high rates of loan collection would likely be a key factor, as long as such a social mechanism does not serve to reinforce existing social inequities; a member of the existing power structure could conceivably abuse powers of loan approval to channel funds to the village elite of traditional patronage groups. Replication will also depend, to some degree, on the exogenous economic and political factors found in a certain country or region. Previous credit experiences, the strength of the informal sector and cultural acceptance of certain modes of operation, such as group lending and mutual insurance, could determine a program's relative success.

STATE OR DONOR FINANCIAL SUPPORT

State or donor financial support, in the form of making financial resources available (not necessarily at a subsidized interest rate) can constitute an important contribution to a newly established RFI during the initial, negative cashflow stage of the RFI development. There is no way to define the appropriate time period and the pace of a phasing out of support in a given case. Savings mobilization should definitely be emphasized. Care taken in institution building is often the prime difference between an RFI that could eventually become self-sustaining after a few years of support granted during its start-up period, and an RFI that would need permanent subsidies and bail-outs.

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# FY 1993 Foreign Assistance Request—Partnership for Peace

Secretary Baker

Statement before the Subcommittee on Foreign Operations of the House Appropriations Committee, Washington, DC, February 24, 1992

Over the last 3 months, I have visited 11 of the 12 new states of the former Soviet Union. I have met leaders everywhere, explained our policies to them, and listened to their hopes and concerns. Last week, I completed a trip to Russia, Uzbekistan, Turkmenistan, Tajikistan, Azerbaijan, Armenia, and Moldova. For many Americans, several of these states were just obscure names on a map just a year ago; now they stand in the front ranks of our efforts to enlarge the world's community of stable, democratic nations.

This was my first-ever visit to several of these states. I return convinced that we face a once-in-a-century opportunity to shape the course of history and to define a new age for our children and grandchildren. And, I am convinced that it is an opportunity that we, in concert with our allies, must seize. The promises and risks are great.

## The Promises

Those promises would have been unimaginable even a few years ago:

- The prospect of close to 300 million people emerging from 70 years of totalitarian rule and charting their own democratic destiny;
- The possibility of 12 new countries beginning the difficult process of converting from a crippling command economy to vibrant free markets; and
- Perhaps most importantly, the real prospect of putting the nightmare of great power nuclear confrontation behind us.

## The Risks

But, we should not forget that there are also risks. Most of the states of the former Soviet Union are struggling bravely to create new societies based upon representative and accountable government, the rule of law, and the free market. But they do so burdened by over 70 years of political and economic misrule. The temptations of ethnic conflict and authoritarianism remain strong. And, despite dramatic progress on arms control, nearly 30,000 nuclear weapons remain in the states of the former Soviet Union.

## Engaging the New Independent States

I addressed both promises and risks during my trip to the former Soviet Union. My trip had three purposes: to see off Operation Provide Hope; to meet face-to-face with the leaders of Moldova, Azerbaijan, Turkmenistan, Tajikistan, and Uzbekistan and to visit Armenia; and to meet with the Russian leadership to discuss security, economic, and political issues.

In Frankfurt, I joined [German] Foreign Minister Genscher as Operation Provide Hope began at Rhein Main Air Base. I was pleased to see that over 10 countries participated directly in this American initiative—especially Turkey and Japan, whose participation made it far easier and economical to reach cities in the Caucasus, Central Asia, and the Russian far east. We expanded the number of US sorties from 54 to 64 and were able to send shipments to 24 different cities across the former Soviet Union during Operation Provide Hope's 2 weeks of operation.

The Russian leadership was particularly pleased that we were able to get food and medicine to hard-to-reach cities in Siberia, the Urals, and the far north. All reports from the other independent states were very positive, with many saying that these American assistance flights were the first humanitarian shipments they had received.

We understood from the beginning that these flights were substance and symbolism. The power of both should not be underestimated. Our message of hope was heard clearly across the former Soviet Union. For those whose lives were eased—perhaps even preserved—by the timely arrival of medicine and foodstuffs, these flights were substantive, indeed.

We are assessing the results of Operation Provide Hope and, with our allies, looking for ways to accelerate and expand our emergency assistance programs.

From Frankfurt, I traveled to Kishinev, Baku, Ashkhabad, Dushanbe, and Tashkent to discuss with the leaders of these new states the question of diplomatic relations. At each stop, I outlined the various principles the United States expects these new states to adhere to in terms of democratic political practices, responsible security policies, and free market economics.

At each stop, the Presidents of these new states gave me the assurances we need to move ahead with diplomatic relations. We have no illusions. We realize that the quality of these commitments will vary from state to state and leader to leader. That's why, at each stop, I made it clear, that even as we moved ahead with diplomatic relations, the nature and depth of those relations would depend upon continuing adherence to our principles and the fulfillment of the assurances given us.

We also felt it important to move ahead with diplomatic relations so we could have a permanent American presence in these new states. At each stop, I found a large degree of goodwill toward America with people lining the streets to greet my delegation; in each of these states, a unique window of opportunity exists where both governments and publics are hungry for our help and advice.

To take advantage of this opportunity, it is important to have Americans on the ground in each of these states during a difficult time of transition. We also feel this is the way to help American business assist in developing those sectors that clearly hunger for American know-how, investment, and goods. There are clear opportunities for American business, especially as



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markets develop and expand. And there are clear political opportunities as well to see the seeds of democracy planted in a region long thought inhospitable to political and economic freedom. Accordingly, I have set a goal of establishing embassies by March 15 in each of the states I visited.

I also went to Armenia to lend our support to Armenia's fledgling democracy. In both Yerevan and Baku, I discussed Nagorno-Karabakh and told both the Armenians and the Azerbaijanis that they had their hands full with building their own independent states and that they needed to resolve Nagorno-Karabakh peacefully. I made it clear we supported Russian and Kazakh efforts to mediate the conflict, as well as the CSCE [Conference on Security and Cooperation in Europe] rapporteur mission.

I began my trip to Russia at the Institute for Technical Physics at Chelyabinsk-70 in the Urals. At this top secret facility in what was a closed city until a few weeks ago, I was welcomed by workers who came out to greet me and my delegation warmly and openly. With the scientists of this facility—which is comparable to our Los Alamos or Livermore labs—I discussed how we might come up with "brain gain" solutions to the "brain drain" problem. This helped us further refine the joint proposal that we have subsequently announced with Germany and Russia to set up an international scientific center to help Soviet weapons scientists. We are pleased with the positive and wide-ranging international response to this initiative which will help designers of weapons of mass destruction in all the new independent states shift their work to civilian purposes.

In Moscow, I met with President Yeltsin and Foreign Minister Kozyrev for two productive days of talks. In terms of security issues, I think we've begun to define what you might call a new security partnership between Russia and America. We made real progress on a range of issues, particularly nuclear safety, security, and dismantlement.

**First,** the United States will provide Russia with 25 safe, secure rail cars designed to transport nuclear weapons.

**Second,** we have offered Russia 250 large specialized containers for transportation of nuclear weapons.

**Third,** we have offered safe and secure containers for nuclear weapons components, and, if these containers meet their needs well, the United States has committed to producing them in quantity.

**Fourth,** our experts will meet next week to discuss alternative ways to address Russian needs to store plutonium and highly enriched uranium.

**Fifth,** we will cooperate with Russia in helping improve the Russian accounting system for nuclear material, including providing computers and software.

**Sixth,** we will establish a technical working group to discuss the ultimate disposition of plutonium and highly enriched uranium in ways that would be beneficial to both countries.

**Finally,** our experts will meet to discuss how we can cooperate to ensure a swift and appropriate response to any nuclear accident or incident.

In terms of arms control, we made progress in combining elements of our two Presidents' proposals in a way that will enhance stability for both sides. We also discussed START [Strategic Arms Reduction Treaty] and CFE [Conventional Armed Forces in Europe] ratification. We agreed that Russia will be the party to ratify START and that Byelarus, Kazakhstan, and Ukraine should provide us a written commitment expressing their legal intention to observe and implement START.

Most importantly, we've begun to leave the era of competition decisively behind as we've taken steps toward defense cooperation between our countries. In Moscow, we agreed to accelerate our discussions on strategic defenses. As a first step, we will consider setting up a Joint Ballistic Missile Early Warning Center that would display warning information from the United States, Russia, and other participating nations.

We also agreed to expand our space cooperation efforts. We will cooperate in environmental monitoring from space, in flights of each other's astronauts, in talks on civil space issues, and in possibly using Soyuz crew recovery vehicles.

Reflecting the spirit of Camp David, we also made progress in political and economic issues. We agreed to set up a US-Russian POW/MIA [prisoner of war/missing-in-action] commission that would be a joint body led by the executive branches but including representatives from our legislatures. We will also participate with Russian experts in an archival search to find whether there is additional information that might shed light on missing servicemen.

On economics, we discussed our overall approach to emergency humanitarian assistance, technical assistance, and macroeconomic reform. President Yeltsin requested $600 million in additional grain credit guarantees. We are considering this request and looking at creative ways we might target our food assistance in a way that would promote the growth of free markets. I made it clear that we want to see Russia—and the other new independent states—become members in the International Monetary Fund (IMF) and [the] World Bank as soon as possible and to have the IMF work with Russia and the other states as they continue to develop their economic reform plans. Early membership in international financial institutions will make these states eligible for funds and support their efforts to build market democracy.

### Challenges Remain

My visit to the new independent states brought home to me the extraordinary opportunities presented by the collapse of the Soviet Union. But we can't neglect the other challenges confronting us today.

Proliferation of weapons of mass destruction remains a deadly menace to international peace. Revelations about Iraq's advanced nuclear program and the specter of a buyer's market in Soviet nuclear know-how drive home a clear lesson: Only by constant, concerted vigilance—the sort of vigilance that brought us victory in the Cold War—can we ensure our national and international security.

In this regard, we welcome China's written commitment of February 1, confirmed publicly on Saturday [February 22], to abide by the Missile Technology Control Regime guidelines



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and parameters as agreed by Foreign Minister Qian and myself in Beijing last November. This important step, like China's agreement to accede to the Non-Proliferation Treaty, constitutes real progress—but progress we must monitor very closely in the months and years ahead.

We also welcome President Yeltsin's announced intention to adopt legislation regulating dual-use technology and the decision of Brazil and Argentina to adopt full scope safeguards under the IAEA [International Atomic Energy Agency].

Regional conflicts have abated—but not everywhere and not at the same pace. Old adversaries in Central America, Southeast Asia, and Southern Africa have started bridging decades of distrust. Even the Middle East—scene of generations of war, bitterness, and hate—saw ancient enemies sit down to talk, a first but necessary step on the road to peace.

Over the last year, we have, indeed, seen a remarkable expansion of multilateral peace-making and peace-keeping initiatives. Less than a month ago, the President joined 13 world leaders at the [UN] Security Council in a demonstration of support for the UN's revived importance to international peace and security.

But peace-making remains painfully protracted. India and Pakistan, for example, have just begun the daunting process of reconciliation. Peace-keeping in El Salvador, Cambodia, and elsewhere will be expensive. We and the world community must be persistent in our support of both. It is the price of success.

Opening markets to American goods and services presents a particularly complex challenge. Bilaterally, we must negotiate to ensure that our goods and services are not shut out of individual foreign markets. Globally, we must take the lead to ensure that the Uruguay Round [of the General Agreement on Tariffs and Trade] succeeds and trade barriers come down worldwide. This is vitally important not only to the United States but also to developing countries and the emerging democracies of Central and Eastern Europe and the former Soviet Union.

We must maintain momentum toward a North American Free Trade Agreement that will eventually create the world's largest market with annual production of $6 trillion and a population of more than 360 million people.

Finally, let us not forget the task of consolidating democratic values. The victory of democracy has not been universal. It is certainly not inevitable. In much of the world, representative government and the rule of law remain fragile or even a distant dream. The example of Haiti is a tragic case in point.

We must remember that the United States is more than our military might and economic power. We are the spokesman for democratic values everywhere.

I believe we can meet these and other challenges. I believe we can forge an effective policy in pursuit of our interest in a free, prosperous, and peaceful world. I believe this budget will bring us closer to that goal.

## Overview of Our Funding Request

In FY [fiscal year] 1993, we seek $22.1 billion in discretionary budget authority for international affairs programs and $20.6 billion in outlays. This compares to FY 1992 figures of $22.2 billion in requested or enacted budget authority and $20.1 billion in outlays. Our request is within the limits on budget authority and outlays set by the Budget Enforcement Act of 1990.

For accounts under the jurisdiction of this subcommittee, we request $15.1 billion in FY 1993 discretionary budget authority and $13.7 billion in outlays.

As Secretary of State, I am daily faced by the challenges confronting the United States around the world. But I am also a public servant acutely aware of my duty to husband the taxpayer's dollars during a period of economic hardship here at home. This budget reflects both these facts. It is a lean budget for lean times.

But it is also a flexible budget, one that reflects the changed international environment in which we live. I would like to highlight two initiatives—our aid package for the former Soviet Union and support for international peace-keeping—before moving on to a general overview.

## Partnership for Peace

Just over a month ago here in Washington, the United States joined over 50 other nations and international organizations in a coordinating conference to help the new independent states of the former Soviet Union. Our objectives were twofold: first, to plan emergency measures to stem the short-term rise of human misery; and, second, to chart longer term strategies to bring the new independent states more fully into the community of prosperous, peaceful, and democratic nations. We compared notes, developed joint action plans, and discussed ways to divide our labors. For we all realized that a truly global problem called for nothing less than a global solution.

In short, we forged a new coalition here in Washington—a coalition no less important than the one that freed Kuwait. Our aid to the new independent states must, therefore, be considered in the context of this broad coalition effort: It is our part in an international partnership for peace.

We seek $620 million in new appropriations for aid to the former Soviet Union in fiscal years 1992 and 1993; most of this funding would be provided by this subcommittee:

- $500 million for a special humanitarian and technical assistance account to meet emerging humanitarian and special assistance needs ($150 million in FY 1992 and $350 million in FY 1993);
- $100 million in Economic Support Funds to promote democratic reforms, economic restructuring, and defense conversion;
- $10 million in development assistance targeted at the poorer republics; and
- $10 million in PL 480 Food for Peace for a "Farmer to Farmer" technical assistance program.

The funds you appropriate will augment $860 million in funds available under existing legislation, including:

- $210 million in food assistance ($165 million in food aid and $45 million in surplus Department of Defense stocks);
- $100 million from Defense for transportation of humanitarian relief;
- $400 million from Defense to help states of the former Soviet

Union eliminate nuclear and chemical weapons;

- $30 million from [the] US Agency for International Development (USAID) for emergency medical supplies; and
- $120 million from USAID and the Commodity Credit Corporation (CCC) for technical assistance programs in priority sectors, such as democratic and economic institution-building.

Finally, the CCC has announced $3.75 billion in food credit guarantees for the former Soviet Union. About $3.1 billion is already being used to buy and ship more than 20.2 million tons of US commodities.

US assistance and credit guarantees to the new independent states will total more than $5 billion. Our success in actually delivering food and assistance to the former Soviet Union is second to none.

## Paying for Peace-Keeping

In peace-keeping, as with our help for the new states of the former Soviet Union, we intend to seize the opportunities offered by changing international circumstances. We seek to reinforce the new solidarity of the United Nations that was first displayed during the Gulf crisis and to support its key role in defusing regional conflicts.

We, therefore, propose $350 million as an amendment to the FY 1992 budget and $350 million in the FY 1993 budget to support our fair share of new and expected peace-keeping activities in Cambodia, El Salvador, Africa, the Middle East, and, perhaps, Yugoslavia. Although peace-keeping falls within the jurisdiction of the Commerce, Justice, and State Appropriations Subcommittee, I ask for your support in obtaining funding in FY 1992 through the peace-keeping operations account. We consider these funds nothing less than an investment in peace.

We also request $257 million in voluntary contributions to international organizations, such as the UN Development Program ($124 million) and the UN Children's Fund ($60 million) during FY 1993.

## Foreign Assistance

Foreign assistance remains an essential tool in advancing US interests in the 1990s. It permits timely, flexible support for our interests in political pluralism, free market economic development, peace-making, strong alliances, and the war on drugs. About 30% of all foreign assistance will go to Israel and Egypt, reflecting our commitment to peace in a volatile region. Salient features of our bilateral assistance program for FY 1993 include:

**Military Assistance.** Our proposal will decrease military assistance by 11% from $4.7 billion to $4.2 billion. This decline reflects lessening international tensions. Israel ($1.8 billion) and Egypt ($1.3 billion) will receive about 70% of all military assistance; the balance will go to other friends and allies, including Turkey ($547 million), Greece ($345 million), the Andean countries ($142 million), and Portugal ($101 million).

**Economic Support Funds.** Our program will cut Economic Support Funds from $3.2 to $3.1 billion. Israel ($1.2 billion) and Egypt ($815 million) will receive about 65% of all funds under this program. Other major recipients include the Andean countries ($250 million), El Salvador ($160 million), Nicaragua ($125 million), and the states of the former Soviet Union ($100 million).

**Eastern Europe.** Our plan will increase assistance to Eastern Europe by $50 million from $400 million to $450 million, with a focus on strengthening democratic institutions and the free market.

**Development Assistance.** Our proposal will keep development assistance roughly constant at $2.5 billion, including the Development Fund for Africa ($776 million). We expect to provide assistance to 70 countries with programs emphasizing sustainable, broad-based economic growth.

**Capital Projects Fund.** Our program includes a special $100 million Capital Projects Fund to help recipient countries invest in the infrastructure critical to development.

**Asian Environmental Initiative.** Our plan also includes a $25-million Asian Environmental Initiative to address the serious environmental problems that constrain Asian economic growth. We will implement the initiative in concert with 16 other US Government agencies, the US private sector, and Asian countries.

**Enterprise for the Americas Initiative (EAI).** Our plan asks for $286 million under the second year of the EAI to reduce debt owed the United States by countries undertaking economic liberalization. The United States has increased its exports to Latin America and the Caribbean by nearly 30% over the last 2 years. We consider the EAI an investment in our own economic recovery.

## Multilateral Development Institutions

For FY 1993, we seek $1.8 billion for multilateral development institutions that foster economic reform and growth in developing countries. This includes $100 million for the EAI Multilateral Investment Fund to be administered by the Inter-American Development Bank; the fund will offer technical advice and financial support to countries liberalizing their investment regimes. Japan, Canada, Spain, and Portugal have also pledged to help the fund. We also propose a new 4-year replenishment for the Asian Development Fund, with an initial installment of $170 million in 1993, to provide concessionary loans to the smaller, poorer countries of Asia.

Finally, we believe it critical that the United States meet our commitment to an IMF quota increase. This increase is urgently required if the IMF is [to] take a leading role in fostering economic reform in Russia and the other new states of the former Soviet Union.

## Refugee Programs

The United States has long played an important, even critical role in addressing the plight of the world's refugees—nowhere more evident in 1991 than in our timely assistance to the Kurds. We estimate that more than 16 million refugees will require some sort of international help in FY 1993. Our request includes $550 million for Migration and Refugee Assistance and $20 million to replenish the Emergency Refugee and Migration Assistance Fund.

For our refugee programs overseas, we seek $265 million to assist international efforts providing protection,



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care, resettlement, and repatriation assistance to refugees. To finance our refugee admission and resettlement program, we seek $208 million. This will cover the expenses of an estimated 122,000 refugees planned for admission into the United States. Finally, continuing a program begun in 1973, we propose $50 million to support refugee resettlement in Israel.

### The War on Drugs

In FY 1993, we request approximately $580 million for international counter-narcotics programs to combat the flow of illegal drugs into the United States. The war on drugs remains a top national priority, as reflected by President Bush's upcoming participation in the San Antonio summit with the Presidents of the Andean nations and Mexico. One hundred seventy-three million dollars will fund activities of the Bureau of International Narcotics Matters. These include demand-reduction programs in Latin America and Asia, the Department's counter-narcotics air-wing, and improving the coordination of international efforts to combat drug trafficking. Economic Support Fund assistance of $250 million will help Colombia, Peru, and Bolivia revitalize their legal economies and create alternatives to coca cultivation. FMF [foreign military financing], USAID, and USIA [US Information Agency] programs round out the international affairs counter-narcotics package.

### Peace Corps

In FY 1993, we request $218 million for the Peace Corps. This will support high-priority activities in Central and Eastern Europe and up to 500 volunteers in the republics of the former Soviet Union without lessening our efforts elsewhere, especially in the developing world.

### Conclusion

After this quick tour of our foreign assistance budget, I would like to conclude with a personal note.

On my way to Moscow 2 weeks ago, I stopped in Frankfurt to help inaugurate Operation Provide Hope, our military airlift of emergency food and medical supplies to the states of the former Soviet Union. As always, I was impressed by the professionalism of the young men and women of our military services. I was impressed, too, by the enthusiasm with which they embarked on this mission of mercy.

But, most of all, I was struck by the powerful symbolism of the moment: For 40 long years, the men and women of our military services had served as the foot soldiers of the Cold War. For 40 years, they had fought and died in places like Korea and Vietnam. For 40 years, they had readied themselves for the moment when they would be called upon to halt the Soviet war machine.

Yet, there in Frankfurt were young men and women of our military services preparing to take off for Moscow and Minsk, Baku and Bishkek, Kiev and Kishinev, not with a cargo of destruction but with a message of peace. They understand that it is not enough for us to win the Cold War. We must also win the peace. That is their—and our—challenge. ■

## Diplomatic Relations With New Independent States

*Statement by White House Press Secretary Marlin Fitzwater, Washington, DC, February 19, 1992, and remarks by Secretary Baker prior to meeting with Georgian Prime Minister Sigua, Moscow, February 18, 1992.*

### White House Statement

The President has decided that the United States will take immediate steps to establish diplomatic relations with Azerbaijan, Tajikistan, Turkmenistan, and Uzbekistan. The United States had recognized their independence on December 25, 1991. Following Secretary Baker's recent visit to these countries, the President believes US interests will be best served by having diplomatic ties to their governments. Secretary Baker conducted detailed discussions with the leaders of the four countries on the political, economic, and security principles of most importance to the United States. The depth, extent, and richness of United States relations with each of these countries will depend on their commitment to these principles.

With this step and yesterday's establishment of diplomatic relations with Moldova, the United States now has diplomatic relations with 11 of the 12 former Soviet republics. The United States does not intend or seek to isolate the people of Georgia, as Secretary Baker said in Moscow. But, at this time, the United States is not in a position to establish diplomatic relations with Georgia.

The United States will open embassies in these countries by March 15. In addition, the United States will support their membership in relevant international organizations, including the International Monetary Fund and World Bank.

### Secretary's Remarks

**Q:** Mr. Secretary, what must Georgia do before the United States will extend diplomatic recognition? Does President Gamsakhurdia have to be reinstated?

**Secretary Baker:** I just completed about a 40-minute press conference at which I was asked the question: Why am I seeing Prime Minister [Sigua]? I said that I thought it was important that the people of Georgia know that the United States has no desire or intention of isolating them. Georgia is the only state which I have not visited—the only state that was a republic of the former Soviet Union that I have not yet visited.

The purpose of this meeting is simply to let the people of Georgia know that the United States has no desire to ignore or isolate them. It does not represent an implicit extension of diplomatic recognition. I will say that the United States has recognized the independence of Georgia. The meeting today is for the purpose that I've just expressed and not as an endorsement of a particular government in Georgia.

I will tell the Prime Minister that we have concern about the violent manner in which a democratically elected leader was overthrown by force. But I will also tell him, as we have made very clear to the world, that we have great concern about actions that that democratically elected leader took after becoming President, actions that—in our view—do not comport with the principles of CSCE [Conference on Security and Cooperation in Europe], with respect for human rights, [or] with respect for minority rights. I will want to hear the Prime Minister on his view of CSCE principles, the five principles which the United States had articulated back in September. So we're looking forward to having that discussion. . . . ❑

CONGRESSIONAL QUARTERLY
Weekly Report

FOREIGN AID

# Stopgap Bill Becomes Law After Deadline Threat

Congress gave final approval on April 1 to a $14.6 billion stopgap foreign aid bill that includes $270 million in increased funding for U.N. peacekeeping operations and permits expanded efforts to aid the former Soviet Union.

The same day, President Bush signed the bill (H J Res 456 — PL 102-266), which funds international aid programs for the nearly six months that remain in fiscal 1992. The measure fills the vacuum created by the failure of a full-year appropriations measure that became entangled in the administration's dispute with Israel over loan guarantees. *(Weekly Report, p 733)*

The continuing resolution provides most of the $350 million increase in international peacekeeping funds that the administration sought for fiscal 1992. The funding is for assessed contributions to the United Nations and will support U.N. operations aimed at preserving fragile peace agreements in Cambodia, El Salvador, Yugoslavia and other nations.

While attention was focused on the administration's broad new legislative proposal for the former Soviet republics, the continuing resolution will also permit the administration to provide $150 million in technical and humanitarian assistance in fiscal 1992. *(Soviet aid, p. 883)*

Although the measure appropriates no new aid, it makes it easier for the administration to shift aid previously allocated for other countries to the former republics. The continuing resolution also repeals a pair of Cold War-era laws that prevented most Export-Import Bank lending to the Soviet Union.

The rush to pass the continuing resolution began hours before the expiration of a similar measure (PL 102-145) on March 31. The House approved the $14.6 billion measure, 275-131. *(Vote 63, p. 910)*

When the March 31 deadline passed without Senate action, the Office of Management and Budget prepared an order that would have required the Agency for International Development (AID) effectively to shut down. The order would have forced more than 2,000 furloughs at AID. The Senate approved the measure, 84-16, on April 1, just before the order was to be executed. *(Vote 62, p. 914)*

By Carroll J. Doherty

Lautenberg Simpson

**Senate action on the measure was followed by a floor debate on the administration's hard line toward loan guarantees for Israel.**

The House then cleared the measure, accepting without objection an unrelated amendment attached by the Senate that provides $107 million in additional funding for the Small Business Administration's disaster loan program.

The brief hangup in the Senate was caused largely by the continuing dispute over Israel's request for $10 billion in U.S. loan guarantees. Dennis DeConcini, D-Ariz., and other supporters of Israel said they intended to amend the measure with loan guarantees despite Bush's pledge to veto any legislation that did not also require Israel to freeze the construction of settlements in its occupied territories.

The regular foreign aid bill for fiscal 1992 was scuttled after the administration and members of the Senate failed to reach agreement on the loan guarantees, which Israel is seeking to absorb a wave of Jewish immigration from the former Soviet Union. Angered by the administration's tough stance, some supporters of Israel were eager to challenge the president, although there appeared to be no prospect to override a veto.

But officials from American Jewish organizations feared another showdown with the White House and persuaded the senators not to attach the loan guarantees to the continuing resolution, according to congressional sources.

In an arrangement negotiated by Senate leaders, the lawmakers settled instead for a vaguely worded, nonbinding resolution (S Res 277) that expressed support for "appropriate loan guarantees" for Israel.

The resolution, originally sponsored by Frank R. Lautenberg, D-N.J., was approved 99-1, with only Sen. Robert C. Byrd, D-W.Va., casting a nay vote. *(Vote 63, p. 914)*

But the vote provided little indication of how the Senate would approach a substantive loan guarantee proposal. Many of those who agree with the administration's position, such as Minority Leader Bob Dole, R-Kan., also voted for the resolution.

### Modest Funding

Although the stopgap spending bill reduced aid more than $1 billion below the level enacted in fiscal 1991, lawmakers approached it with a distinct lack of enthusiasm.

"I'm quite surprised at the strong vote, but I don't think it indicates support for foreign aid," Rep. William S. Broomfield, R-Mich., said after the House vote.

The debate in both chambers was brief and perfunctory, as few members spoke in support of the bill.

But faced with a suspension of nearly all aid programs as well as the impending layoff of thousands of employees at AID, the Peace Corps and other agencies, most lawmakers felt they had little choice but to approve the continuing resolution.

Recognizing the anti-foreign aid mood that has gripped Congress, Rep. David R. Obey, D-Wis., who managed the bill, emphasized the relatively modest level of spending that would be provided. Obey is the chairman of the Appropriations Subcommittee on Foreign Operations.

Foreign aid funding in the bill is $700 million below the fiscal 1992 leg-

# Foreign Operations Appropriations

*(In thousands of dollars)*

| | Fiscal 1991 Appropriation | President's Request | House Bill | Continuing Resolution |
|---|---|---|---|---|
| **Multilateral Aid** | | | | |
| World Bank | | | | |
| Paid-in capital | $ 110,592 | $ 70,126 | $ 70,126 | $ 70,126 |
| *Limitation on callable capital* | *(2,899,610)* | *(2,267,418)* | *(2,267,418)* | *(2,267,418)* |
| Global Environmental Facility | — | — | 50,000 | — |
| International Development Association | 1,064,150 | 1,060,000 | 1,060,000 | 1,060,000 |
| International Finance Corporation | 40,331 | 50,000 | 40,331 | 40,331 |
| Inter-American Development Bank | 91,299 | 90,389 | 90,389 | 90,389 |
| *Limitation on callable capital* | *(2,235,077)* | *(2,235,077)* | *(2,235,077)* | *(2,235,077)* |
| Enterprise for the Americas investment fund | — | 100,000 | 100,000 | — |
| Asian Development Bank | — | 25,526 | 25,526 | — |
| Asian Development Fund | 126,854 | 174,955 | 158,793 | 126,854 |
| African Development Bank | 10,136 | 8,987 | 8,987 | 8,987 |
| African Development Fund | 105,452 | 135,000 | 135,000 | 105,452 |
| European Development Bank | 70,021 | 70,021 | 70,021 | 70,021 |
| International Monetary Fund (U.S. quota increase) | — | 12,158,000 | — | — |
| State Department international programs | 284,730 | 250,212 | 300,612 | 234,730 |
| Other | 10,601 | 50,001 | 3,001 | — |
| TOTAL, **Multilateral Aid** | **$ 1,914,166** | **$ 14,243,217** | **$ 2,112,786** | **$ 1,856,890** |
| **Bilateral Aid** | | | | |
| Agency for International Development (AID) | | | | |
| Development assistance | 1,313,683 | 1,277,000 | 1,376,635 | 1,313,683 |
| Sub-Saharan Africa, development aid | 800,000 | 800,000 | 1,000,000 | 800,000 |
| Operating expenses | 474,884 | 521,039 | 519,039 | 519,039 |
| Enterprise for the Americas: debt reduction | — | 304,340 | 65,000 | — |
| Economic Support Fund | 3,991,000 | 3,228,000 | 3,216,624 | 3,216,624 |
| Multilateral Assistance for Philippines | 100,000 | 160,000 | 160,000 | 100,000 |
| Assistance for Eastern Europe | 369,675 | 400,000 | 400,000 | 369,675 |
| Other | 214,341 | 170,218 | 337,218 | 237,420 |
| **Subtotal, AID** | **$ 7,263,583** | **$ 6,860,597** | **$ 7,074,516** | **$ 6,556,441** |
| State Department | | | | |
| International narcotics control | 150,000 | 171,500 | 150,000 | 150,000 |
| Migration and refugee aid | 520,648 | 510,557 | 680,000 | 680,000 |
| Anti-terrorism assistance | 12,026 | 15,000 | 15,000 | 12,026 |
| **Subtotal, State Department** | **$ 682,674** | **$ 697,057** | **$ 845,000** | **$ 842,026** |
| Peace Corps | 186,000 | 200,000 | 200,000 | 200,000 |
| Overseas Private Investment Corp. *(loan levels)* | *(290,000)* | *(400,000)* | *(400,000)* | *(400,000)* |
| Other | 38,000 | 74,393 | 53,143 | 55,330 |
| TOTAL, **bilateral aid** | **$ 8,170,257** | **$ 7,832,047** | **$ 8,172,659** | **$ 7,653,797** |
| **Bilateral Military Aid** (appropriated to the president) | | | | |
| Foreign military financing | 4,663,420 | 4,640,000 | 4,150,900 | 4,150,900 |
| *Estimated loan program* | — | *(313,961)* | *(404,000)* | *(404,000)* |
| International military education and training | 47,196 | 52,500 | 47,196 | 47,196 |
| Special defense acquisition *(limitation on obligations)* | *(350,000)* | *(275,000)* | *(275,000)* | *(275,000)* |
| Other | 664,862 | 48,000 | 38,000 | 38,000 |
| TOTAL, **military aid** | **$ 5,375,478** | **$4,740,500** | **$ 4,236,096** | **$ 4,236,096** |
| **Export Assistance** | | | | |
| Export-Import Bank | 750,000 | 555,778 | 650,613 | 650,613 |
| Export assistance *(loan levels)* | — | *(9,525,000)* | *(11,000,000)* | *(11,000,000)* |
| Trade and development | 35,000 | 35,000 | 40,000 | 35,000 |
| International peacekeeping | — | 350,000 | — | 270,000 |
| Small-business emergency loans | — | — | — | 107,025 |
| **GRAND TOTAL** | **$ 16,245,401** [1] | **$ 28,026,342** [2] | **$ 15,196,946** [3] | **$ 14,596,721** [4] |

[1] *Fiscal 1991 total included $500,000 in other assistance for Eastern Europe*
[2] *Administration request included $270 million to refinance already concluded foreign military sales*
[3] *House bill included a 1 percent cut in most categories and $135 million for deficit reduction*
[4] *Continuing resolution applies a 1.48 percent cut, totaling $212.7 million, to all categories except earmarked aid*

SOURCE: House Appropriations Committee

islation (HR 2621), which the House approved last June. It is also $13.1 billion below the administration's budget request for fiscal 1992, primarily because the continuing resolution did not include the requested $12.2 billion increase in U.S. financial backing for the International Monetary Fund (IMF). *(Chart, p 891)*

Obey said that Treasury Secretary Nicholas F. Brady urged lawmakers to approve the IMF funding request, the centerpiece of the administration's aid package for the former republics. But Obey said "the IMF request cannot pass unless the president engages in a major national campaign" and makes "a personal effort to round up votes for it."

The bill generally retains the spending formula from the stopgap bill that expired at the end of March. It funds programs at the level enacted in 1991 or the level in the House-passed bill for fiscal 1992, whichever is lower.

A number of important programs were exempted from the formula, including aid for refugees around the world and operating expenses for the Peace Corps and AID. Without the waiver for operating expenses, AID would have had to furlough an estimated 4,000 employees about one day a week for the remainder of the fiscal year, according to agency officials.

The legislation also retains earmarks from the House-passed bill for a host of popular humanitarian programs, including $250 million for AID's child survival programs and $10 million for the United Nations Children's Fund.

In order to provide additional peacekeeping support, however, Obey reduced all assistance programs — except those going to a few countries for which Congress has usually earmarked aid, such as Israel and Egypt — by an additional 1.48 percent, which saved more than $200 million.

Obey also tweaked his Senate counterparts by eliminating 16 earmarks from the fiscal 1991 bill, many of which were included by senators.

For example, the legislation ends earmarks for military aid for Morocco and for a host of international environmental programs that have been backed strongly by GOP Sen. Bob Kasten, Obey's Wisconsin colleague.

The Senate, which typically sets more funding requirements than the House, was in a weak position to challenge the action. Administration officials worked with Obey and other House members in crafting the measure and would have opposed efforts by senators to reattach the earmarks.

Aid for the Philippines was also cut. Under the Multilateral Assistance Initiative, the Philippines was due to receive $160 million in fiscal 1992, but the continuing resolution cut that to $100 million.

### El Salvador Compromise

The bill includes a compromise on military aid for El Salvador, an issue that has divided Congress and the executive branch for more than a decade.

The measure lets the administration spend for non-lethal supplies $21.3 million in previously approved assistance to the Salvadoran military. But the legislation transfers the remainder of the administration's request for fiscal 1992, $63.8 million, to a fund to rebuild the country and retrain combatants.

**The measure allows the administration to spend $21.3 million for non-lethal aid to El Salvador's military but shifts $63.8 million to a fund to rebuild the country.**

The government of El Salvador and left-wing guerrillas signed a peace agreement in January, ending the country's long-running civil conflict.

The continuing resolution places tighter restrictions on the administration than a draft authorization bill approved by the House Foreign Affairs Committee in March. Unlike that proposal, the stopgap spending bill requires that the administration seek the approval of key congressional committees before spending the remaining aid for fiscal 1992. *(Weekly Report, p. 627)*

Rep. Joe Moakley, D-Mass., chairman of a House task force on El Salvador, expressed disappointment that the measure provides any aid for the country's military forces. "While it's not the agreement we'd like," he conceded, "it's the best one we can get."

### Middle East Concerns

Most of the discussion in the Senate concerned what was not included in the bill — the loan guarantees and restrictions on aid to Jordan.

Sen. Hank Brown, R-Colo., had intended to offer an amendment requiring the administration to certify that Jordan is observing the U.N. embargo on Iraq before giving the kingdom any assistance. Numerous news reports have alleged that Jordan has been helping Iraq circumvent the embargo.

But Brown dropped his amendment after Secretary of State James A. Baker III personally provided assurances that he will ensure that Jordan abides by the U.N. resolutions.

That outraged Sen. Alfonse M. D'Amato, R-N.Y., who called it an "absolutely contemptible act" to provide aid for Jordan without requiring presidential certification. D'Amato was one of 16 senators to oppose the continuing resolution.

After approving the stopgap bill, which did not mention Israel's request for loan guarantees, the Senate conducted the first extended congressional debate on the request when it took up the non-binding resolution.

Lautenberg attempted to cast the symbolic resolution in positive terms. "It simply puts the United States Senate on record in support of loan guarantees for Israel," he said.

But Dole and others said the measure was so ambiguous that it could be interpreted to mean almost anything, including support for the administration's Middle East policies.

Kasten vowed to include loan guarantees on future legislation, possibly the administration's aid plan for the former Soviet republics. "This is only the beginning" of congressional efforts to enact the guarantees, Kasten said.

The debate touched on presidential politics as Sen. Malcom Wallop, R-Wyo., who supported the measure, lambasted those who would brand the administration's policies as anti-Semitic.

Without naming Arkansas Gov. Bill Clinton, Wallop accused him of making "incendiary remarks about the subtle anti-Semitism of the president of the United States and this administration."

Clinton, a contender for the Democratic presidential nomination, charged in a March 31 speech that Bush had "broken down the taboo against overt anti-Semitism" in his attacks last September on U.S. Jewish organizations.

The Senate debate came as the State Department released a report that could further strain U.S.-Israeli relations. The department's inspector general accused Israel of engaging in a "systematic and growing pattern" of unauthorized transfers of U.S. military technology to third countries. But the State Department found separately that there was no evidence that Israel had provided Patriot missile technology to China. ■

# Stop Bashing Foreign Aid

## Guest Column

**By Richard M. Walden**

The current presidential primaries are adding to an unfortunate consensus among Americans that foreign aid is wasteful, counterproductive and done at the expense of Americans in need. At the recent Democratic candidates' debate in South Dakota, Jerry Brown stated that "not another penny in foreign aid should be sent until all Americans in need are taken care of." And foreign aid fares little better among some Republicans — with Pat Buchanan regularly lambasting foreign aid as part of his "America first" candidacy.

These men know better. (*See Monday Developments, February 17, 1992*) To go to a farm state and decry foreign assistance is to ignore a major source of farm income: each year the US government spends billions of dollars purchasing food from large and small growers to send abroad as food assistance; billions more in loan and price guarantees are given to foreign governments to enable them to purchase American food. US-administered food aid is budgeted at just under $1 billion for 1993 in addition to approximately $2 billion in multilateral assistance to development banks and international organizations.

While there is certainly a legitimate debate regarding the appropriate mix of foreign aid — e.g., humanitarian and development assistance on one hand versus military and economic aid to "crony" governments — most experts agree that foreign aid is a necessary and wise expenditure if the US wants to remain an influential world power.

The American public, however, has had it with non-humanitarian foreign aid. A Roper survey done for a network of American foreign aid organizations yielded only a 12 percent positive response to maintaining a foreign assistance program — the lowest positive rating of all US government programs. If a deepening recession and the proximity of national elections are added to an already weak base of support, continuance of foreign aid is in grave danger.

This must be viewed in light of the ever-expanding demands made on our shrinking foreign assistance budget: a persistent famine in Africa; the dissolution of the Soviet Union; six new Eastern European aid recipients with the possibility of four to six nations arising out of what was Yugoslavia; large-scale natural disaster recovery programs in Bangladesh and the Philippines; the need to keep vital commitments made to Nicaragua, El Salvador and South Africa to further governmental reform; the urgent need to reverse the political assault on environmental and population programs; and long-term obligations to Israel and Egypt under the Camp David peace accords with new obligations of a similar nature foreseen should the Israel/Palestinian talks and the Cambodia peace accords succeed.

Rather than pander to people's fears and ignore the link between the welfare of Americans and the welfare of recipients of our aid, presidential candidates should focus their discussion of foreign aid on the following priorities:

- supporting the United Nations' new effort at coordinating all of its humanitarian aid programs under one person's direct leadership;
- increasing funds for multilateral and multisectoral aid with an emphasis on having 'process' aid projects (e.g. democracy programs) carried out by international organizations;
- supporting conversion of significant US military resources to a new humanitarian role which has already begun with US military support for the Kurdish, Bangladeshi and Commonwealth of Independent States' relief efforts;
- creating a cabinet or at least White House-based human rights and humanitarian aid coordinator who would bring up these concerns regularly at White House meetings;
- developing a set of criteria for all foreign assistance expenditures which promotes self-sufficiency, encourages regional peace initiatives with recipients' neighbors, responds quickly to natural disasters and expands free trade and democratic institutions; and
- insisting that foreign governments which receive direct, bilateral aid attempt to distribute that aid through nongovernmental organizations free of discrimination based on political, racial, religious or tribal affiliation, while at the same time enhancing the NGO share of USAID funding and streamlining the bureaucratic procedures to encourage broader participation in US government programs by both for-profit and non-profit groups.

None of these ideas is new and they are simple enough to be explained to the American electorate without fear of negative backlash or political vulnerability.

*Richard M. Walden is president of Operation USA, an InterAction member based in Los Angeles which has sent assistance to 50 countries*

# Roskens Outlines Vision for US Development Assistance

Agency for International Development Administrator Ronald Roskens testified before the House Foreign Affairs Committee on February 20. He presented AID's budget request for fiscal year 1993. He also provided details on this request, as well as AID's reorganization and management reforms. Future issues of *Monday Developments* will discuss these elements. The following excerpts are focussed on Dr. Roskens' vision of the future of US development assistance:

"In considering the future directions of the AID program, permit me to address three myths that frequently underlie and shape discussions about foreign assistance. First, there is the myth that the United States must choose between its pressing domestic problems or a continuing active engagement in international affairs, but it cannot do both. The second myth is that our foreign assistance funds are wasted because we do not know what works and what doesn't, and as a result we have nothing to show for over 30 years of AID work. Finally, the third myth is that AID may not be able to manage our foreign assistance program effectively in the future. ...

"... (O)ur national interests — including the solution to our domestic problems — are best served by a world in which the promises of justice and improved standards of living are being realized by rich and poor nations alike. This is only possible if developing countries, as well as those newly independent states struggling to create a new democratic society, share with us the benefits of expanding trade, dynamic market economies, democracy and justice within nations, and basic fairness between nations. This will help remove the occasion for armed conflict within and between nations, strengthen international cooperation and provide expanding markets for US products and services. ... By the year 2000, four out of five consumers will reside in the developing world.

"But poor people make poor customers. For these markets to expand, the opportunities for jobs and higher incomes of all citizens in the developing world must increase. Our foreign assistance programs are intended to be an important contribution to this objective. ...

"Increased prosperity in developing countries means greater security for Americans. The effects of pollution and environmental degradation are not limited by international boundaries. They threaten the health and safety of all of us. The web of illicit drug production and trafficking entangles countries all around the globe, and only their cooperation can bring it under control. Poverty, disease and ignorance reach across national borders in their search for victims. The AIDS epidemic affects rich and poor nations alike, and it cannot be overcome by a single nation working in isolation. Increasing the participation of the poor in their governance and their economic progress will reduce their willingness to engage in armed struggle internally and across borders.

"The fact is that the achievements of the US economic assistance program are many. This has been particularly true when AID has supported innovations and new approaches to development problems. Examples include our critical support for the agricultural research that led to the 'Green Revolution' and our pioneering role in introducing oral rehydration therapy for infants. ...

"One key lesson to emerge from the past three decades is that economic policies and institutions are critical determinants of development — not just economic growth, but social and economic progress as well. Development investments are most productive when economic policies foster both domestic and international competition. ...

"Efficient and growing economies also require substantial investments in the development of human resources. These include sustainable systems to provide basic health care and opportunities for education and training. In some cases, these investments may best be made by the private sector. In others, it is the government that must provide essential services to those who cannot participate fully in the market process — the poor. ...

"Over the past six months, our regional bureaus have reviewed each country program to reduce the number of areas within which AID will work. We have also reduced, adjusted or terminated assistance levels where the performance of the host government has been disappointing and economic reforms have not moved forward (Guatemala and the Philippines Multilateral Assistance Initiative, for example) or human and political rights have been violated (Kenya, Zaire and Haiti, for example). ...

"We are privileged to live in an extraordinary time in which we face opportunities which were unimaginable only a few years ago. This is also a time that tests our imagination, creativity and capacity for change."

InterAction members wishing to receive a complete copy of Roskens' remarks may contact Stephanie Gordon at InterAction, 202/667-8227.

**PERSPECTIVE ON THE AID SUMMIT**

# Where to Find a Quick $6 Billion

## Why keep spending on Cold War programs like Radio Free Europe, now that our former enemy is our friend in need?

**By JOHN W. SEWELL**

When Old Mother Hubbard went to her cupboard, her dog was probably hoping for more than a display of concern. This week, leaders from 60 nations will gather in Washington at President Bush's invitation to coordinate humanitarian relief to the republics of the former Soviet Union. Unless the United States and other industrial nations search their cupboards more thoroughly, there will be no international effort to coordinate, and the republics will likely remain as hungry as the dog in the nursery rhyme.

Across the former Soviet Union, cupboards are bare and winter is deepening its grip. When the people of the republics stood up to the tanks in August, the West cheered and exhorted them on to free markets. But as the harsh realities of free prices and failed production began to bite, the people found they had been stranded in the cold.

The United States has extended agricultural credits and approved $100 million to assist distribution of relief, but the bulk of assistance so far has come from the Germans. They plan to make it clear that Washington needs to back up its expressions of sympathy with increased material support.

Unfortunately, this historic opportunity to help a former enemy comes at a time of growing domestic malaise. We don't have to look across the ocean to find empty cupboards and people left out in the cold.

Are great needs at home and great needs at abroad irreconcilable?

Not necessarily. The demise of the Soviet Union created new demands for American help, but it also eliminated the primary justification for much U.S. budgetary spending. The Cold War has ended, but our budget is still fighting it. Phasing out Cold War programs from both the defense and foreign-aid budgets could free significant funds for pressing needs at home and abroad.

The Administration has begun to cut the defense budget, and has proposed an additional $50-billion reduction over five years. Senate Majority Leader George J. Mitchell has called for cutting $100 billion, and many analyses suggest that even greater cuts could be made without jeopardizing national security.

Most of what we save must go to meeting domestic needs and reducing the deficit, but some funds might logically be applied to maintaining stability in the republics. Having spent $12 trillion (in 1992 dollars) since World War II to destroy them as enemies, we should be able to spare a tiny fraction of that to feed them as friends.

> **'Overall, 30% of the foreign-aid budget is military assistance, [which belongs] in the defense budget.'**

Secretary of State James A. Baker III has said that the only source for additional funds for the republics would be cuts in assistance to developing nations. "There is no other choice."

There are other choices, of course. Some of them present a wonderful opportunity to help new friends by getting rid of programs that made sense only when they were enemies.

We continue to give foreign aid for the rights to maintain bases in Portugal, Greece and Turkey (the eruption of Mt. Pinatubo took care of the Philippines). These arrangements cost U.S. taxpayers $1.5 billion a year. The threat that justified these bases no longer exists. These "rent" payments should be eliminated. If the United States desires a continued presence in these countries, the costs should be funded under a multilateral defense arrangement.

Overall, 30% of the foreign-aid budget is military assistance. Military expenditures belong in the defense budget. If the programs are worthwhile, let them compete with other defense expenditures. Savings: $3.3 billion annually.

Another prime candidate for cuts is broadcasting aimed at the former Soviet Bloc. Radio Free Europe has done its job: Eastern Europe is free. (Ted Turner is doing them one better, anyway.) Ending broadcasting activities for Eastern Europe would save $1.3 billion over five years.

Despite the ravages of seven decades of Marxism, the republics have the foundations for future growth—abundant resources, an educated populace and an industrial base. Support for the republics is in the United States' interest, as are measures to bring them into the global economy. Huge markets for U.S. products would open up once the economies got on their feet—assuming we have gotten our foot in the door. The strong German presence in the former Soviet Bloc is not entirely altruistic. The republics will remember their friends when they settle down to business.

International lending institutions such as the International Monetary Fund and the World Bank are best equipped for assisting the republics with long-term economic restructuring. The United States has advocated IMF and World Bank membership for republics that demonstrate commitment to economic reform, but has yet to authorize funds for a 50% capital increase that would help the IMF to undertake these new activities, even though it would involve no net budgetary outlays.

Communism has been discredited in the former Soviet republics, but democracy and free markets have not yet triumphed. America's "cupboards" aren't empty, but they do need some serious cleaning (and we can't wait for spring). Restructuring our defense and foreign-aid spending in response to the Soviet Union's demise would allow us to take better care of our own and to throw our friends more than a bone.

*John W. Sewell is president of the Overseas Development Council in Washington. Timothy A. Johnston, a research assistant at the ODC, contributed to this commentary.*

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OPINION

**The main dangers faced by the United States come not from a military adversary but from a more complex array of domestic and overseas challenges.**

THE GLOBAL ECONOMY

# Greatest US Threat Is Nonmilitary

By Richard Feinberg and Peter Hakim

THE more Washington spends on military defense, the less it has to respond to other-than-military challenges to United States security. In the post-cold-war world, this leads to the paradoxical conclusion that the higher our military budget, the less secure we may be. It is not hard to understand why US leaders continue to identify national security with military defense. For a half-century the main threat to US security came from the military prowess of a hostile superpower. Now, however, the main dangers we face come not from a military adversary but from a more complex array of challenges. Military outlays are irrelevant in addressing these problems.

There is little risk that any nation or group of nations will launch an armed attack against the US in the foreseeable future. To be sure, some of our security problems are still military in nature. Saddam Hussein reminded us that the collapse of the Soviet Union did not end aggression. Several US allies in the third world are vulnerable; Washington should be prepared to help defend a Kuwait or a South Korea against aggression, and aid friendly democratic governments against local insurgent forces (though guerrilla wars are a declining phenomenon).

Other military hazards include the spread of nuclear weapons technology and new and old forms of terrorism. But even taken together, these concerns do not add up to any clear and present dangers for the US.

Moreover, US military operations may not provide the best response to armed conflicts or threats in today's world. Multilateral peacekeeping is more effective in many cases. United Nations brokered settlements have ended many civil wars – and UN forces are helping to structure new political orders in places as different as Cambodia and El Salvador. Yet UN peace efforts are starved for funds while Congress refuses to fulfill basic US commitments to the UN. Making good on these commitments would take less than one-fifth of 1 percent of the Pentagon's budget, and surely enhance our security more than another fighter bomber or nuclear submarine.

Nor can US armed strength halt the instability caused by the breakup of the Soviet Union, or reduce the likelihood of violent conflict in or between new republics. The most effective help is economic and best comes from the International Monetary Fund and World Bank. The president and Congress, however, have failed to approve any new US funding for the IMF.

The truth is the greatest international danger to US security has little to do with military issues. Yet the dollars we spend on defense deprive us of resources needed to deal with them. The greatest threat may come from the steady deterioration of the global environment. This is an issue the president and Congress have decided to postpone action on for reasons of economy.

MOST importantly, it is more evident that the main sources of our insecurity in the post-cold-war world will be domestic, including such critical concerns as:

- Whether the US economy will provide good jobs and satisfactory incomes for American citizens. This depends on our ability to invest in needed infrastructure, education, and scientific and technical research. Most dollars that go to defense are lost for these other activities.
- Whether we can make the investments needed to save our environment and keep our water mains, highways, ports, and electric facilities in shape.
- Whether we can stop the violence that has overwhelmed our urban areas. No one has an easy formula, but there is wide agreement that we must invest more in children, schools, housing, and drug treatment facilities.

Circumstances have changed. Our security is no longer at risk from foreign forces. Our own military cannot do much to shield us from the dangers we face. The dollars we spend on defense – some 1.5 trillion over the next five years – are not available to confront these other dangers. This does not mean the Pentagon should be closed down. It does mean the defense budget should compete for national security dollars – not have automatic privileged access to them.

The US debate on the defense budgets is cast much too narrowly. It should not be limited to how much to spend on the military, but should focus on how to use scarce resources to deal with the full range of threats to national security – military and economic, social and environmental, domestic and international.

*Richard Feinberg and Peter Hakim of the Inter-American Dialogue write regularly on global economics.*

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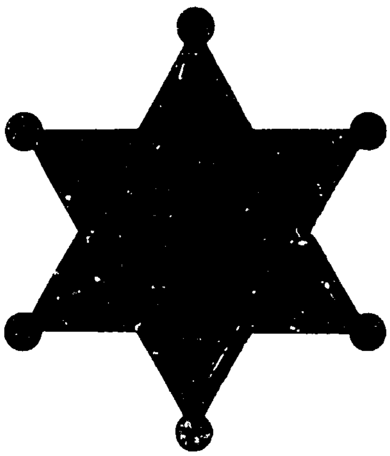
NATIONAL SECURITY

DAVID C. MORRISON

# GLOBAL POLICEMEN



A key lesson of the Vietnam war, Army Gen. Maxwell D. Taylor said in 1965, was "the need for a strong police force . . . to assist in identifying the symptoms of an incipient subversive situation." In 1962, in fact, the Agency for International Development (AID) had created an Office of Public Safety to help develop just such forces. Over the next 12 years, Michael T. Klare and Cynthia Arnson estimate in *Supplying Repression* (Institute for Policy Studies, 1981), AID trained a million foreign cops while sending some $325 million in arms and riot gear overseas.

During those dark days, fostering "democracy" was not necessarily a pretty profession. In *Hidden Terrors* (Pantheon Books, 1978), an account of the 1970 execution of Office of Public Safety trainer Daniel A. Mitrione by Uruguayan guerrillas, A.J. Langguth describes the 1969 torture of Brazilian journalist Flavio Tavares Freitas by U.S.-trained policemen. "The guards administered electric shocks with a small gray generator about a foot and a half long. On the side facing Flavio was a familiar symbol: the red, white and blue shield of U.S. AID. His guards wrapped wires around his penis. They stuck wires up his anus. They jammed wires around his ears. . . . The pain was excruciating."

In the general reappraisal of "national security" policies following the Vietnam war, Congress in 1974 enacted section 660 of the Foreign Assistance Act, banning aid to foreign police. But now that the Cold War is over, training for overseas cops is again moving up the policy agenda. "As one of those who fought—and would do so again if conditions did not change—to get such restrictions put in place in the bad old days of the Cold War," Sen. Alan Cranston, D-Calif., argued in a March 5 floor speech, "I can say that section 660 no longer serves its purposes and issues it addressed cry out to be dealt with in a more affirmative way."

The exemption-riddled section 660 is undeniably a mess. "These exceptions have become so numerous and so confusing that the status of the law is now completely unclear," the Lawyers Committee for Human Rights complained in a report earlier this year. A comprehensive review to identify and regularize all police assistance programs must be undertaken, the report urged. As it happens, responding to a request from Cranston and four other Senators, the General Accounting Office (GAO) issued just such a study of police training in early March. In fiscal 1990, the GAO reported, five U.S. agencies spent about $117 million to train or assist police in 125 nations. In 46 of those nations, two or more U.S. programs were at work. This patchwork of programs, the auditors found, lacks "a clear policy . . . , clearly defined program objectives [and] a focal point for coordination and decision making."

Among this welter of U.S. efforts are international narcotics control and antiterrorism assistance programs run by the State Department, Pentagon support for police forces in the Andes and Central America and the International Criminal Investigative Training Assistance Program (ICITAP), which State pays for but the Justice Department administers. Founded in 1986, ICITAP spent $7 million in 1990 training about 1,000 students from the Caribbean and Latin America in police management, criminal investigation and forensic medicine. After the 1989 U.S. intervention in Panama, ICITAP was also tasked with shaping 5,500 police officers there into a professional civilian force.

Washington has been sharply criticized for pressing Andean nations to involve their militaries in the cocaine crackdown, and President Bush seemed to back off from that position during the recent San Antonio "drug summit." But human rights groups that monitor Latin America report no notable abuses associated with ICITAP, which shies away from involvement in general policing matters, counterinsurgency and riot control. In a letter to Cranston last September responding to his inquiry about post-Cold War police training, assistant attorney general W. Lee Rawls attributed the bad odor surrounding the defunct Office of Public Safety merely to "allegations" and "public and media perception." But, he continued, "in the current world situation, where poverty and illegal drug activity overshadow ideology, the nature of police training has changed. Ideological objectives have been replaced by the need for professional, competent law enforcement."

As part of his long-running drive to mobilize a post-Cold War push to help improve the "administration of justice" in foreign lands, especially in Eastern Europe, Cranston wants ICITAP's budget increased and its mandate broadened. To forestall "the abuses associated with past U.S. police training programs," Cranston said, four stipulations are vital: no aid to nations not well on their way to "meaningful democracy," no participation by U.S. intelligence agencies, assignment of "the best available" U.S. trainers and police assistance only as an integral part of larger efforts to improve the administration of justice in the recipient countries.

"I think it's a very convincing argument, and I have no problem with ICITAP, per se," said Bonnie Tenneriello, who tracks police training programs for the Washington Office on Latin America, a human rights group. "But what I think needs to be added is a program by which this stuff is strictly conditioned on human rights, and where Congress has a say when that's not the case." Whenever Congress tries to attach strings to foreign aid, of course, it is accused of trying to wrestle the foreign policy steering wheel away from the White House. When Cranston and several colleagues tried to accomplish some of the above goals last year with an Omnibus Eastern European Security Assistance Act, they were stonewalled by State.

Within a few months, Cranston, whose Senate career ends in January, will sponsor a new bill that would place all administration of justice programs under the Justice Department, according to Cranston aide Martin E. (Nick) Andersen. "We're saying," he said, " 'Put it under one big tent, give it some political direction to lend it a purpose and meaning in helping over-militarized Second and Third World societies to civilianize.' " ■

NEWS RELEASE

CATO INSTITUTE

For Immediate Release
February 27, 1992

Contact: Linda Clark
(202) 546-0200

**Study Urges End to Military Aid Programs**

Washington - Military aid programs are both expensive and morally offensive, says David Isenberg of the Center for Defense Information in a new study from the Cato Institute.

Isenberg points out that the United States is the world's largest supplier of arms, yet the Bush administration has requested $7.38 billion for taxpayer-subsidized military aid programs in FY 93. He goes on to charge that

* Washington wants to increase commercial sales of military equipment as a way of keeping the military-industrial complex happy when the Pentagon budget is cut.

* U.S. arms are routinely used by repressive regimes to menace their neighbors or brutalize their own populations. The United States is then an accessory to those crimes.

* If one of those governments is overthrown, the United States may be blamed for the misdeeds of the ousted regime, as it was in Iran, Nicaragua, and the Philippines.

* American soldiers could end up fighting a country that the United States has armed.

"The Sins of Security Assistance Programs" is no. 18 in the Foreign Policy Briefing series published by the Cato Institute, an independent public policy organization in Washington, D.C.

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# Link Economic Aid to Military Limits

By Nicole Ball
and Robert S. McNamara

WASHINGTON
When some 60 countries meet here later this month to discuss aid for the former Soviet republics, they should link long-term economic and technical assistance to progress in shifting priorities from the military to economic development. This demand would not be unprecedented: lenders to some third-world countries have started to put such conditions on their aid.

Although 11 of the new republics agreed last month as members of the Commonwealth of Independent States to a unified nuclear command and a timetable for destroying or removing nuclear weapons from Belarus (the former Byelorussia) and Ukraine, substantial uncertainties remain.

Kazakhstan has said it intends to remain a nuclear power as long as Russia does. Neither the Start treaty, which would reduce strategic weapons by about 25 percent, nor the treaty on conventional forces in Europe, has been ratified. Ukraine, Azerbaijan and Moldova are setting up independent armies. Ukraine alone has plans for a standing force of 450,000 troops. And Boris Yeltsin, Russia's president, is challenging Ukraine's claim that it should control the Black Sea fleet of the defunct Soviet Union.

All this suggests that the republics may continue to devote substantial resources to the military. Not only would this run counter to American and European efforts to shrink military budgets, it would also absorb funds the republics urgently need to stabilize their chaotic economies.

Over the last year, international lenders have grown increasingly impatient with the high military spending of many developing countries. The money spent on the military exceeds the combined spending on health and education in some 20 developing countries. The heads of the World Bank and the International Monetary Fund recently warned that such expenditures are causing them to question whether their funds are being put to the best use.

## Reward restraint, from India to the ex-Soviet Union.

Germany said in September that it would cut aid to India by nearly 25 percent in 1992 unless New Delhi reduced its military budget. Pakistan and China are expected to receive similar warnings. In October, Japan told North Korea that to obtain diplomatic recognition and aid it must halt construction of the Yongbyon plutonium plant. A similar strategy should be applied to the former Soviet republics.

Last month, Secretary of State James Baker outlined security measures the U.S. hopes the republics will adopt. He called on the new states to maintain the unified nuclear command, adhere to the Nuclear Nonproliferation Treaty without creating new nuclear weapons, carry out the conventional forces treaty, limit arms buildups and convert military industries to civilian use.

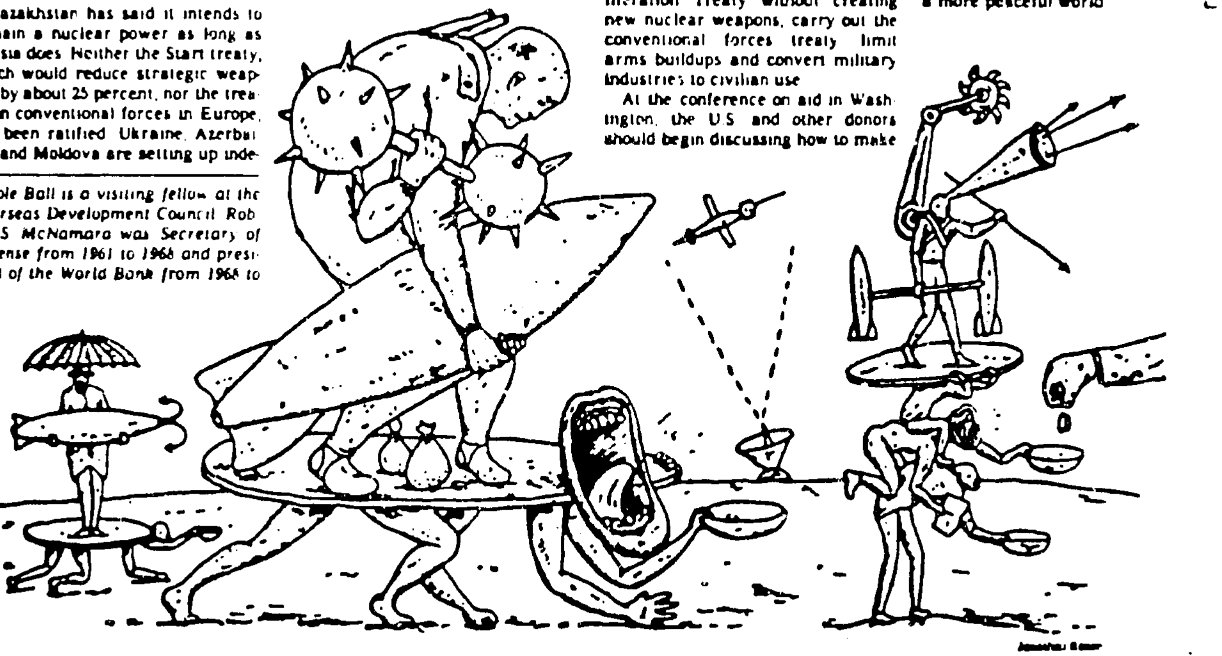
At the conference on aid in Washington, the U.S. and other donors should begin discussing how to make economic and technical assistance contingent on these and similar policies, like ratifying the Start treaty and reducing military expenditures.

Moreover, in line with the mandate received from its board last fall, the I.M.F. should review the republics' military budgets and make its findings available to the World Bank, the European Bank for Reconstruction and Development and the Organization for Economic Cooperation and Development. That way, all aid decisions [illegible] be based on the same information.

Tying economic assistance to limits on military spending is a sensitive issue that has at times led to charges of foreign meddling. Nonetheless, many lenders argue that when military budgets undermine development efforts, aid should be reduced.

By making it clear that the military cannot take precedence over development, the U.S., the other donor countries and the world's lending institutions can insure that the $50 billion to $60 billion they provide annually will help, not hinder, the creation of a more peaceful world. □

*Nicole Ball is a visiting fellow at the Overseas Development Council. Robert S. McNamara was Secretary of Defense from 1961 to 1968 and president of the World Bank from 1968 to 1981.*



# DODGING THE FOREIGN POLICY BULLET

Here we are in the middle of the first presidential campaign of the post-Cold War era. But instead of a Great Debate over the U.S. role in the New World Order, what we are getting is a Great Silence.

Why is foreign policy so conspicuously absent from the 1992 campaign? Is it because the voters aren't interested? Not entirely. It's also because the two Establishment candidates, President Bush and Gov. Bill Clinton, don't really want to hear what the voters have to say. They know that the American public is in an isolationist mood right now. It's not a good time for Establishment candidates to defend their internationalist values.

Bush and Clinton are both being challenged by protest candidates. Republican Patrick J. Buchanan and Democrat Edmund G. (Jerry) Brown Jr. have positioned themselves as anti-Establishment populists. Isolationism is a theme with powerful populist appeal, and both Buchanan and Brown are using it. It's a debate that Bush and Clinton are trying their best to avoid because it's a debate they're afraid they might lose.

**Bush and Clinton are both trying to avoid primary debates on foreign policy for fear they might lose the debates.**

Only one Establishment figure has tried to make foreign policy an issue this year. It was not a presidential candidate or a Member of Congress, but former President Nixon. Nixon described the level of American aid being offered to the former Soviet republics as "pathetically inadequate." He warned of the possibility of a "new despotism" in Russia if the United States does not do more.

The likelihood that Congress will pass a major new aid package seems slim, however, especially without strong pressure from the Administration. President Bush's initial response to Nixon was "There isn't a lot of money around. . . . I don't have a blank check."

Congress echoes that message. "The reason you are not seeing much of a debate," Rep. Stephen J. Solarz, D-N.Y., said, "is that given the manifest unpopularity of foreign aid, there are very few people who see much mileage in publicly calling for it." Mainstream politicians do not want to debate Soviet aid in the political environment of 1992.

Nor is there much mileage in supporting a free-trade agreement with Mexico at a time when American workers are fearful that, as Brown put it, "the corrupt few" will export American jobs "to countries where they can get cheap labor." As a result, Administration officials now say it is unlikely that a deal can be struck for a new North American free-trade agreement in time for congressional ratification this year. Mainstream politicians do not want to debate free trade in the political environment of 1992.

By refusing to engage Buchanan in a full-scale foreign policy debate, Bush has protected himself. Evidence comes from the network exit poll of Republican primary voters in Illinois and Michigan on March 17. Republican voters who endorsed the view that "the U.S. should stop worrying about other countries and put America first" voted for Bush over Buchanan by better than 2-1 in Michigan and by better than 3-1 in Illinois. Lucky for Bush they did, because more than 70 per cent of Republicans in both states agreed with the statement.

Bush is an ardent internationalist. That is one of his few hard-core convictions. Though Bush has condemned Buchanan's isolationism, he has not tried to engage Buchanan on the issues. Instead, he ran an advertisement in Michigan attacking Buchanan for driving a Mercedes-Benz.

Clinton, too, is an internationalist. He calls for a "strategy of American engagement" abroad. But he is careful to defend aid to Russia in terms of America's self-interest. Clinton has said it will "save us billions in lower defense costs forever" and "increase trade opportunities dramatically." He also tries to sound tough on trade. Clinton said in Michigan that he would not approve a free-trade agreement with Mexico without "the elevation of labor and environmental standards on the other side of the Rio Grande."

The outlines of a debate between Bush's internationalism and Clinton's internationalism are beginning to come clear. Bush seems to favor a hegemonic role for the United States, along the lines of the Persian Gulf war, with America the ultimate guarantor of world order and stability. The nation's aim, according to a Pentagon document, will be "to discourage [other countries] from challenging our leadership or seeking to overturn the established political and economic order." We'll supply the muscle. They'll supply the money. It's hegemony on the cheap.

Clinton's internationalism is more multilateral. He envisions a "United Nations rapid-deployment force" to deal with threats to the peace. It is also more concerned with economic development, environmental protection and human rights. But his ideas for a "Democracy Corps" and "America Houses" would involve very little money. It's democracy on the cheap.

The debate so far has not been between Bush and Clinton, however. It has been the two front-runners trying to fend off isolationist challenges. Both Brown and Buchanan opposed the Gulf war. Both have attacked the free-trade agreement with Mexico. Both want to cut American troop strength in Europe (Brown to a token 1,000 troops). Both oppose foreign aid. Brown said he "wouldn't give a penny" to foreign aid "until every small farmer, businessman and family" in the United States is taken care of. It will be interesting to see whether pro-Israel groups pick up on this issue in the New York primary campaign.

Sentiments like that are not respectable. Americans are better informed and more sophisticated about the world than they were in the 1930s. They know that it is not in America's best interest to withdraw from the world. Which is why candidates such as Brown and Buchanan this year, Richard A. Gephardt in 1988 and John B. Connally in 1980 have found that they can get only so far but no farther on isolationism. It keeps them going for a while, but sooner or later they run up against the consensus of informed opinion. ■

# Toward a Policy That's No Longer Foreign

By Roger Morris

SANTA FE, N.M.

As is the case with all triumphs, America's cold war victory brings with it new difficulties. None is more troubling than the gathering irrelevance of U.S. foreign policy.

Militarily, America has emerged unrivaled, yet much of our arsenal is destabilizing, unusable and irrelevant to new tasks of national security. Economically, the Soviet defeat is complete, yet the cold war era also devoured our own productivity, real income and competitiveness, leaving a malignant gap between rich and poor and disgraceful and dangerous social conditions. Politically, we led a successful anti-Soviet alliance, yet the victors now bicker, with no collective security against a threatening depletion of environment and resources.

Not least are the moral costs: abroad, a bitter legacy of our many interventions; at home, a democracy diminished by national security demagogy and extra-constitutional acts, still governed by garrison-state conformity and myopia. America is neither the power nor the ideal that

## The real global revolution is just beginning.

began the cold war 45 years ago.

Ominously, the real global revolution of our epoch is only beginning. We now face simultaneous upheavals that are far more momentous than the Communist challenge: in technology, weapons proliferation, population growth and migration, economic and political aspiration, national disintegration, resource scarcity and environmental decay — all culminations of the old imperial, industrial orders that symbolically climaxed in the fall of the Soviet Union. It is indeed a new world, yet without its own order — or an American policy for living securely within it.

Our victory at least releases us from a Faustian choice between ideals and interests, principle and pragmatism. In the cold war, we often sacrificed what was right for what was expedient. A redeeming irony of this new era is that its realities make principles pragmatic and ideals not only affordable but essential. National security in the post-cold war period comes with policy that is no longer foreign.

In a properly enlightened Washington, that policy would rest on a new trinity of military, economic and political-scientific security.

Militarily, the U.S. would forge ahead of the post-Soviet commonwealth in reducing strategic and conventional arms. To hoard a vast nuclear advantage amid Russian decline would be a Versailles-like peace, provoking eventual revision. To prevent that tragedy, we would go well beyond current negotiations that leave America's preponderance unredressed. America would initiate sweeping cuts in strategic weapons, sponsor dismantling of superpower and allied arsenals and set a timetable for verified demilitarization of the cold war victor as well as vanquished.

We would spur a new coalition for similar elimination of the nuclear Saturday Night Specials, the existing or would-be arsenals of South Africa, Syria, Israel, China, India, Pakistan, Argentina, Brazil, the two Koreas and Iran as well as Iraq. Nothing so threatens peace as these anachronistic, apocalyptic weapons, relics of a vanished era.

We would recognize that conventional arms also consume our common future. The U.S. would cease trafficking in 40 percent of the world's munitions, stop giving or loaning $100 billion for military purchases, press Russia to embargo its share of the two-thirds of the arms trade we conduct together. On a planet where poor nations squander $50 billion a year on weapons, we would shed old military clients and quarantine arms merchants as we once checked fascist and Communist aggressors. And with billions of dollars saved by that new containment, America would invest in equally essential commercial security.

Economically, we would respond to a multipolar world with international trade and domestic industrial policies as concerned as was our commitment in the cold war. Gauging the mercantilist policies of our partner-competitors, their discipline of capital and labor, we would mount a comprehensive public investment strategy, promoting a new preparedness economically, educationally and fiscally.

America would continue its devotion to free trade, yet would strategically manage domestic markets and international businesses, preventing the exploitation of people and the environment at home and abroad as a matter of national interest. We would understand that security depends not only on a dynamic domestic economy but on the well-being of all nations.

We would see clearly that we cannot live safely in a world where four billion to five billion people are excluded from economic opportunity, where there persists an immense transfer of wealth from poor countries to rich, where third world babies are grown on farms to provide organ transplants for first world customers, where 11 million children die every year and there are 200 new corpses each minute in what the World Health Organization calls a "silent genocide" of preventable famine and disease, where the smoking shantytowns of the forgotten surround shrinking enclaves of affluence.

Washington would promote worldwide reinvestment in human capital in education, jobs and land reform in the poorer nations. Using the billions now spent on third world arms, it would be a bargain, high dividend purchase of new security: international economic justice and the resulting stability would create vast new markets for U.S. goods and services.

As a third principle, the U.S. would organize a collective body to oversee environmental action, with planetary management of resources and technology. This world alliance would mobilize scientific and managerial talent to confront crises of climate and conservation, population and pollution. It would address dangerous imbalances of technology and resources, mass population migrations and the spurting growth of sovereignties.

Like cold war alliances, such a collective would be integral to U.S. security. It would epitomize international cooperation amid exploding nationalism and open new avenues for U.S. science, technology and business.

World revolutions now surround a Washington that is paying lip service to change, yet mired in spent missions — bureaucracies defying the death of their raison d'être. A stagnant Foreign Service was crudely politicized in the Reagan-Bush years. Exposed by recent hearings, the C.I.A. stands derelict in insight and integrity. For senior officialdom, Republicans draw on stock-option bureaucrats revolving between public office and consulting for the highest bidder, and the Democrats from a similarly dubious if dogged regime-in-waiting.

Intellectually, our security needs in the 1990's are plain — new sensibility to the cultural, demographic, economic and environmental waves breaking over us, a fresh conceptualization of diversity and globalism. That creativity makes obsolete a vested national establishment. Above all, national security requires a more open, representative foreign policy, a new generation of thinkers and doers.

We may continue to have a divided, poisoned planet, to remain a debt and caste ridden America for a while at least. Or we may choose an era of secure diversity, equitable endowment, true community.

Policy no longer foreign would fulfill that poignant promise of George Washington, of an America not safe or prosperous by what it possessed but in what it was — "a nation," he hoped, "which would have a meliorating influence on all mankind." □

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CONGRESSIONAL QUARTERLY
Weekly Report

**FOREIGN AID**

# Bush's Plan To Help Ex-Soviets Gets Good Reception on Hill

*Leaders support proposals that they had long sought, but members' mood could swing against assistance*

Revealing a break in clouds that have hung heavily over foreign aid since last year, lawmakers generally welcomed President Bush's proposal to assist Russia and the other former Soviet republics.

But legislative weather patterns on foreign aid are difficult to predict. Those promoting the assistance say enactment will require strong guidance from Bush and congressional leaders if they hope to avoid potentially disruptive election-year turbulence.

"It will take the best skills of enlightened leadership," said Rep. Henry J. Hyde, R-Ill. "Some people are sure to look at this as money going to St. Petersburg, Russia, rather than St. Petersburg, Fla."

Bush announced April 1 that the United States would participate in a $24 billion multilateral assistance initiative aimed at stabilizing Russia's economy and would provide additional U.S. assistance, including increased food credits, to Russia and the other former Soviet republics. *(Package, p. 884, economic aid, p. 886; food credits, p. 889)*

In his announcement, Bush signaled the strategy that he likely will use to sell the aid to American voters and nervous lawmakers.

As senior members of Congress had encouraged him to do for months in urging such a package, he presented the assistance as insurance for the United States against the re-emergence of an unfriendly regime rather than as a handout to the former Soviet people.

"The stakes are as high for us now as any that we have faced in this century," Bush said at a televised White House news conference. "If this democratic revolution is defeated, it could plunge us into a world more dangerous in some respects than the dark years of the Cold War." *(Text, p. 907)*

While emphasizing that the United States must lead, Bush made clear

***By Pamela Fessler***

PATT CHISHOLM

**"If this democratic revolution is defeated, it could plunge us into a world more dangerous in some respects than the dark years of the Cold War. America must meet this challenge."**

**—President Bush**

that the financial effort would be international. While emphasizing the depth of assistance required, he and White House officials downplayed the cost to American taxpayers.

"It's not a tremendous amount of money," Bush said. "Our commitment is very, very substantial."

Much of the president's proposal requires no legislative action. However congressional endorsement is crucial, both to provide some of the bilateral aid and to put a bipartisan imprimatur on the overall effort.

When a much smaller assistance plan was enacted late last year, the White House refused to take a public position. Bush was under attack from Democrats and his party's right wing for devoting too much energy to foreign issues and not enough to domestic ones. *(1991 Weekly Report, p. 3536)*

He has since been widely criticized by Democrats and Republicans alike for not more aggressively helping the former Soviet states. The criticism came to a head last month with former President Richard M. Nixon's description of U.S. support for the region as "pathetically inadequate." *(Weekly Report, p. 625)*

Lawmakers said at the time that they would support the administration in seeking congressional approval of a comprehensive aid proposal if Bush would take the lead, a message reiterated the day of his announcement. "We do have to stop the politics on this one," said House Majority Leader Richard A. Gephardt, D-Mo. "It's got to be bipartisan."

The administration appeared ready to take Congress up on the offer Secretary of State James A. Baker III said on April 1 that he was "ready to go up there tomorrow and start fighting for this legislation." In a letter to Congress on April 3, Bush wrote, "This is an issue that transcends any election ... I urge all members of Congress to set aside partisan and parochial interests."

But there were also early signs of potential resistance that could mushroom. While Gephardt and House Speaker Thomas S. Foley, D-Wash., expressed support for aid, House Majority Whip David E. Bonior, D-Mich., threatened to organize a move against assistance to Russia until the administration supports legislation to extend unemployment benefits and to create jobs.

"No way should the president get a dime — and I mean not a single dime — until he's signed off on help for Americans," Bonior said April 2.

And even the talk of bipartisanship had enough partisan overtones to



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## Bush's Plan

- Join in creating a $6 billion international currency stabilization fund for Russia, with a $1.5 billion U.S. share. Further efforts could be undertaken if the other republics issue their own currencies.
- Participate in a seven-nation effort to provide $18 billion in financial support to Russia in 1992 to cover balance-of-payments deficits. This would involve $2.5 billion in deferred debt payments; $4.5 billion in loans from international financial institutions, with a U.S. share of about $1 billion; and $11 billion in bilateral aid, with a U.S. share of $2 billion.
- Provide about $1.5 billion in humanitarian, technical and other assistance over the next two years.
- Increase credit guarantees for the purchase of U.S. agricultural goods by $1.1 billion, with $600 million available to Russia and $500 million for other former Soviet republics.
- Increase the U.S. contribution to the International Monetary Fund by $12.3 billion, some of which would back aid to Russia and the other republics.
- Broaden the use of $500 million approved last year to help dismantle the Soviet nuclear arsenal and transport humanitarian aid. The funds could be used to support nuclear plant safety, defense conversion and employment of former Soviet weapons experts.
- Remove or nullify Cold War restrictions that prohibit or limit grants of credit from the U.S. government, such as guarantees by the Overseas Private Investment Corporation, and private investments by U.S. citizens in the former Soviet republics. The plan would encourage U.S. investment and trade through existing programs.
- Encourage more "people to people" contact with the republics through exchange programs, a Citizens Democracy Corps and the Peace Corps.

make lawmakers wary of predicting success for the plan. Democrats applauded Bush for his aid initiatives and then went on to criticize him for offering them too late.

Within minutes of Bush's announcement, Arkansas Gov. Bill Clinton, campaigning for the Democratic presidential nomination, gave a foreign policy speech in New York that largely mirrored the president's proposals for helping the former Soviet empire. But he too criticized the president for delay. *(Box, p. 885)*

Some Democrats also chided the president for making his announcement only minutes before Clinton's long-scheduled speech. "You have to wonder if that's a sign that this is really going to be political," said Sen. Patrick J. Leahy, D-Vt.

In an effort to explain his timing, Bush said that the administration had been pulling together the components of a package for months and had just been able to work out the details with allies. Administration officials also noted that the Russian government of President Boris N. Yeltsin had only recently implemented credible economic reforms on which the administration has conditioned U.S. assistance.

"This isn't any Johnny-come-lately thing, and this isn't driven by election-year pressures," Bush said. "It's what's right for the United States."

### Vague on Details

Leahy, who heads the Foreign Operations Appropriations Subcommittee, was also critical of the administration's vagueness about the price tag for the aid. Honesty about the cost would be "the real test of leadership," he said.

Administration officials said it was difficult to pinpoint the exact amount because much of the proposed assistance was already in the pipeline or in the form of guarantees or loans that would not involve direct U.S. outlays. And the amounts needed to be appropriated were, for the most part, requested earlier by the administration — including $470 million for humanitarian, technical and other assistance in fiscal 1993 and a $12.3 billion increase in U.S. backing for the International Monetary Fund.

The actual legislation was not sent to Capitol Hill until week's end, making it difficult for members and aides to determine what was required.

Congressional leaders and administration lobbyists have yet to decide how to go about enacting the aid legislation, but they know it will have to be artfully done.

There is talk in both chambers of putting together bipartisan leadership groups that would try informally to work out differences between the many committees with jurisdiction over the aid proposals. Such bipartisan groups in the past have solidified support for legislation to block opposition and ease passage on the floor.

The administration is seeking to begin action on an authorization bill, with any required appropriations to come before final enactment. This would allow legislative action to begin in the Senate; appropriations bills must originate in the House.

Prospects for the legislation look best in the Senate, where a bipartisan group — led by Sam Nunn, D-Ga., and Richard G. Lugar, R-Ind. — has been pushing for a U.S. aid initiative since last year.

Senate Majority Leader George J. Mitchell, D-Maine, said he thought that the Senate would take some action on Russian aid. But he said he wanted to review details of the president's package before making a final judgment about what, if any, changes would be sought.

Both the chairman and the ranking minority member of Foreign Relations — Claiborne Pell, D-R.I., and Jesse Helms, R-N.C. — said they were prepared to introduce the administration's proposal as a starting point for the debate.

Prospects in the House are less certain partly because opposition to foreign aid is stronger there and because the banking scandal has made members more skittish than usual. *(Story, p. 856)*

"To the degree that political survival is the driving force around here, the national interest may be in jeopardy," said Jim Leach, R-Iowa

But Leach and many others think that if the administration and congressional leaders are forceful enough in explaining the need for aid, the House will go along.

"Many of the constituencies against foreign aid are against foreign aid in general," said John Miller, R-Wash. "If members are given a good reason, they'll vote for it."

Deputy Minority Whip Steve Gunderson, R-Wis., added that the inclusion in Bush's plan of credits for the purchase of U.S. agricultural goods had won support from those in farm districts who might otherwise be opposed.

Others cautioned, however, that there were numerous potential pitfalls.

Details of the package are certain to be controversial. While much of the Bush plan is aimed at Russia, which he said is in the best position to use financial aid, many members think more aid should go to the other republics.

Rep. Lee H. Hamilton, D-Ind., chairman of the Foreign Affairs Subcommittee on Europe and the Middle East, said drawing up the conditions that aid recipients would have to meet would also be crucial. "No one wants to pump money into a vast hole," he said.

House Armed Services Committee Chairman Les Aspin, D-Wis., warned that leaders would also have to be careful not to oversell the aid program, which he said still carried with it a great risk that reform efforts in the former Soviet Union would fail.

### The Fundamentals

Bush's package includes three parts: the multilateral initiative of seven industrialized nations, the extension of additional food credits and a legislative package that provides authorization for several additional assistance proposals.

The multilateral initiative calls for $24 billion in aid in 1992, much of it as loans and guarantees, rather than direct assistance. Of that amount, $18 billion would be in bilateral and multilateral assistance aimed at bolstering Russia's balance of payments. The package also includes a $6 billion multilateral fund to stabilize the Russian currency.

Bush also announced that he would increase by $1.1 billion the export credits available for purchase of U.S. agricultural goods by the former republics. Of this amount, $600 million will be targeted to Russia (and counted as part of the U.S. contribution to the $18 billion portion of the multilateral initiative). The remaining $500 million is available for the other former Soviet republics.

The third component is the legislative package, which would provide congressional endorsement for the president's proposals and allow waivers of Cold War-era laws that limit U.S. assistance for, and private business activities in, the former republics.

In addition, the bill would:

- Expand the uses of $500 million authorized last year by Congress to help Russia and the other republics dismantle the former Soviet nuclear arsenal and transport food and medical aid to the republics. The legislation would allow the money, most of which has not yet been spent, to be used for nuclear plant safety, to help relocate former Soviet military forces, to convert defense-related industry and equipment for civilian purposes, and to re-employ defense workers.
- Authorize extension of programs under the Support for East European Democracy Act (SEED) of 1989 to the former Soviet republics. The SEED program includes a wide range of assistance programs and measures to boost the development of private enterprise in Hungary and Poland.
- Encourage exchange and other programs with the republics to assist them in their transition to democracies and free-market economies. These could include educational, cultural and military exchange programs, as well as a Citizens Democracy Corps, through which individual U.S. citizens with legal, economic and other skills would serve as advisers to the republics. Others steps would be taken to encourage private U.S. investment.
- Endorse creation of a science and technology center in Ukraine, similar to one that has been proposed for Russia, to employ former Soviet weapons experts in peaceful research. ■

## Clinton Chides Bush

No sooner had President Bush outlined his package to aid the former Soviet republics than Bill Clinton presented a long-planned foreign policy speech in New York City that included many of the same proposals.

But Arkansas Gov. Clinton, the front-running but beleaguered Democratic presidential candidate, chided Bush for waiting so long and gave himself some credit for pressuring the president into action.

"The present administration has been overly cautious on the issue of aid to Russia, not for policy considerations, but out of political calculation," Clinton said. "Now, prodded by Democrats in Congress, rebuked by [former President Richard M.] Nixon and realizing that I have been raising this issue in the campaign since December, the president is finally, even now as we meet here, putting forward a plan of assistance to Russia and the other new republics. . . . I'd really like it if I could have as much influence on his domestic policy."

Clinton's Democratic opponent, former California Gov. Edmund G. "Jerry" Brown Jr., also endorsed Bush's aid package, although less volubly. "I think it's good, and obviously we have to be a part of the international family," Brown said on the MacNeil/Lehrer NewsHour on April 1. "But still they can't seem to get it right that we must be strong here at home, and we have to make that our primary commitment."

In a broad, thematic foreign policy address, Clinton ticked off a laundry list of criticisms of Bush, saying that the president had left Iraqi President "Saddam Hussein with enough military force to remain in power," continues to "browbeat Israel," chooses "to coddle aging rulers" in China and "still has not recognized Croatia and Slovenia despite prodding from our own European allies."

But Clinton offered a strikingly centrist message overall. Although he has promised to cut defense spending deeper than Bush plans to, Clinton said, "The commander in chief must be prepared to act with force if necessary when our nation's interests and values are threatened, as they were in the gulf war. I will not shrink from using that force responsibly. And equally important, I will see that we maintain the forces that we need to win and win decisively should that necessity arise."

## EDITORIAL/OPINION

# Why We Should Help the CIS

By JOSEPH I. LIEBERMAN

Thanks in part to statesmanlike pressure from former President Nixon, President Bush has finally announced a program of assistance to the Commonwealth of Independent States (CIS). The challenge now for those of us who support such assistance is to gain the backing of the American people. We must convince them that by helping the CIS, we can help ourselves.

Our security self-interest is obvious. If the commonwealth's journey toward democracy fails, and a dictatorship returns, we would once again find ourselves engaged in a Cold War with a nuclear-armed enemy in the Kremlin.

But in the current domestic climate, the recession is foremost among the concerns of the American people. They will be more convinced of the need to aid Russia and the republics if we can demonstrate that it is also in our country's economic interest to do so.

It is an easy argument to make because it is true. Aiding the CIS can help stabilize and liberate a huge new market for American goods and services. The resulting American investments and trade will pay off here at home in profits for business and jobs for people.

The potential is enormous. There are close to 300 million consumers in the CIS, and their pent-up demand is as vast as the land mass they occupy. The long lines at the Moscow McDonald's are a visible symbol of what awaits American products and services, from the simplest commodities to major investments.

We can best help CIS nations and ourselves by targeting key sectors of their economies, such as energy, telecommunications, agribusiness, and aerospace, where the republics have the demand for modernization and the United States has the supply.

The oil industry is a prime example. The CIS republics (primarily Russia and Kazakstan) are the world's largest producers of oil, but since 1989 oil production has been in a free-fall. If the CIS becomes a net importer of oil, as some energy experts predict, global oil markets would be disrupted and oil prices would climb higher — even here in the United States. To prevent the deterioration of the CIS oil industry, American oil companies should be encouraged to invest in the republics' oil fields, as some are beginning to do now. They will profit directly, global oil prices will not rise and the CIS will build up its hard currency reserves which, in turn, can pay for the purchase of other American-made goods and services.

In the telecommunications sector, the market potential in the former Soviet Union is estimated to be about $25 billion a year by the end of the decade. Agriculture is also in desperate need of modernization. Food processing, storage and transportation are all areas in which American agribusiness can take advantage of the CIS market potential. And the republics offer real opportunities for the U.S. aerospace industry to expand. Fairchild Aircraft is poised to sell airplanes in the former Soviet Union and the Baltic nations. Pratt & Whitney, a leading manufacturer of aircraft engines, is also dealing with the Russians.

Trade with the CIS need not be a one-way street. As former President Reagan has suggested, the United States should also take advantage of Soviet expertise in military and space science technology. For the moment, former Soviet scientists are willing to work for rock-bottom prices, as the recent deal 50 of them signed with America's Sun Microsystems illustrates.

American companies, nonetheless, face stiff competition from foreign firms. We have not kept pace with the Europeans, who trade and invest more in the CIS than we do. In 1990, calculating trade relative to GNP among industrialized nations, America was the Soviet Union's smallest trading partner.

The Europeans and even the Japanese are getting involved in the CIS oil industry. Aerospatiale, the French aerospace company, is reported to be considering asking the Russians to collaborate in the development of a new jumbo jet as part of the Airbus consortium. We can expect similar competition in the telecommunications and agriculture sectors, as well as bidding wars over CIS scientific talent.

The problem for American companies is that their foreign competitors are being aided by their respective governments. In contrast, our government provides little in the way of support for American companies wishing to invest in the republics, and Cold War era export controls remain in force. U.S. companies have already lost contracts to their European competitors as a result of such controls. We can't afford to cede the huge CIS market to European and Japanese companies for reasons of bureaucratic inertia. By updating our export control laws (which won't cost taxpayers a penny), expanding official export credits and political risk insurance through the Export-Import Bank and the Overseas Private Investment Corp. (which will cost little), and by promoting joint ventures between CIS scientists and American entrepreneurs, the federal government can help American companies meet the competition on even terms.

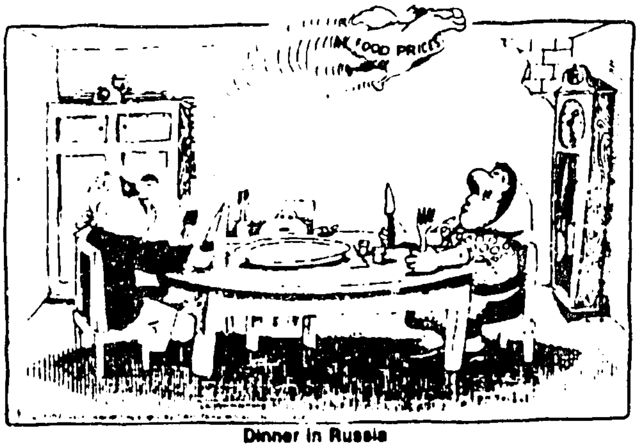
And if that happens, Americans will enjoy an ironic advantage, which officials of the CIS and American business people have confirmed to me. The Russians and other CIS citizens want to deal with us — their Cold War antagonists — rather than have their economy dominated by their European neighbors, if only we give them the same assistance to make such deals possible.

Why? Because we do not border their lands and have never launched a major invasion against them. And because, after looking each other in the eye through decades of nuclear-fueled tension, the people of the CIS have come to respect us.

We would all do well to remember the words of former President John F. Kennedy, who, in speaking about the need for America to remain involved in global markets, said, "The United States did not rise to greatness by waiting for others to lead. Economic isolation and political leadership are wholly incompatible."

I believe a bipartisan consensus on the need for a program of aid to the CIS is emerging in Washington, and I hope we can successfully demonstrate to the American people that the end result will be greater peace and freedom in the world and greater opportunities for economic growth here at home.

*Joseph I. Lieberman, a Democrat, is a U.S. senator from Connecticut.*



Dinner in Russia

THE NEW YORK TIMES, February 25, 1992

# Life or Death for Russian Children

By Arthur Hartman

## The ex-Soviet Union desperately needs medical aid.

WASHINGTON

No aspect of the cataclysmic economic breakdown afflicting the former Soviet people cries out for help as poignantly as the probable fate of millions of children should the West not give them emergency medical aid.

Americans can trust that U.S. medical professionals who administer vaccinations and medications are competent, that hospitals and clinics are sanitary, the needles sterile, the drugs safe.

Parents in the former Soviet Union do not have this assurance. The new commonwealth can produce only 15 to 20 percent of the medical supplies it needs, and it does not have enough hard currency to import them. In addition, a frighteningly large proportion of medical personnel are not well trained. Most hospitals are filthy, dark and cold. Equipment breaks down and cannot be replaced.

Aid is forthcoming but the need is so great that more is required. America is joining other industrialized democracies in helping at governmental and private levels. Through the U.S. Provide Hope project, planes are taking supplies to the new commonwealth. Now, through the privately run Russian Winter Campaign, American governors are mobilizing to send at least one planeload each (about 100 tons per trip) of medicine and food in the next 60 to 90 days.

Beginning next week, Soviet and U.S. military cargo planes will transport some supplies, with the U.S. Government supporting the effort by covering fuel and transportation costs. When all is said and done, the private sector will probably end up delivering twice the amount of needed relief as the U.S. Government.

At stake is not just saving human lives but strengthening democracy in the new commonwealth. The medical conditions, and the critical need they reflect, indicate a deeper political healing process that must take place.

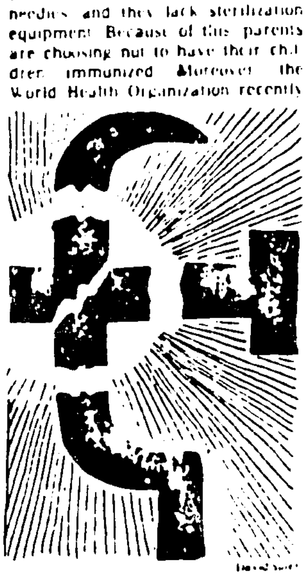
Health care facilities are contributing to the spread of hepatitis B and H.I.V., the virus that causes AIDS. Because of shortages, medical workers are forced to re-use syringes and needles, and they lack sterilization equipment. Because of this, parents are choosing not to have their children immunized. Moreover, the World Health Organization recently tested the 40 vaccines produced in the commonwealth and found 27 of them to be "unfit for human or animal use." Vaccines are often stored past their effective dates and without refrigeration.

According to Murray Feshbach, professor of population studies at Georgetown University, 95 percent of a population must be vaccinated against a disease to prevent an epidemic. Soviet children, many already suffering from vitamin deficiencies and the effects of environmental degradation, are vulnerable to the spread of infectious disease. We know that in 1989 one-quarter of Soviet children who should have been vaccinated against polio were not; one-fifth were not immunized against diphtheria and one-third did not get a whooping cough vaccination.

The incidence of infectious diseases in the former Soviet Union is already much higher than in the West. Some 120,000 new cases of tuberculosis have been reported annually in the Soviet Union. In 1990, [illegible] people were reported to have developed polio, a disease virtually wiped out in the U.S. Seven hundred cases of diphtheria were reported in Moscow alone in 1990, compared with one to three cases a year in the entire United States. A breakdown in sanitation may be responsible for more deaths related to paratyphoid, typhoid and hepatitis A.

The people of the former Soviet Union have inspired the world with their courage in struggling to create a stable democracy out of the ruins of Communism. These same people need our assistance now to help them keep their children alive and healthy.

To balk at providing assistance at a time of desperate need could doom the fragile democracy and the peaceful world order. The children of the former Soviet Union, to whom we can give the gift of life, and our own children, to whom we can give the gift of peace, deserve no less.



*Arthur Hartman, U.S. Ambassador to the Soviet Union from 1981 to 1987, is a member of the Russian Winter Campaign international committee.*

E WASHINGTON TIMES, January 22, 1992

# What manner of aid for the new nations?

## STEVE HANKE

## Sachs vs. Baker

Nations and institutions with a role to play in aid to the members of the Commonwealth of Independent States (C.I.S.) are gathering in Washington, D.C., today and tomorrow. The U.S. State Department has called the conference to coordinate the distribution of aid for the new nations.

Even though the State Department has indicated that the conference will be restricted to discussions about so-called humanitarian aid and self-help programs, it may be politically difficult for Secretary of State James A. Baker III to hold off demands for more aid by the foreign aid lobby. Led by Mr. Boris Yeltsin's adviser, Professor Jeffrey Sachs of Harvard University, the aid lobby is in full swing. Mr. Sachs claims that the transition from socialism to capitalism in the member states of the C.I.S. will be impossible without significant amounts of foreign aid.

*Contrary to Mr. Sachs' claims, foreign aid is clearly not necessary for a successful economic transformation and restructuring.*

In making his case to limit the scope of the conference, Mr Baker should recall that Mr Sachs is employing smoke and mirrors rather than economic analysis, to make his case. Just consider the magnitude of the professor's aid request. After careful study, Mr. Sachs concludes that the C.I.S. needs $20 billion in foreign aid this year. That requirement is calculated as follows. Poland, where Mr Sachs is also an adviser, is going through a painful transition shock therapy. To ease the pain, Poland is receiving almost $3 billion per annum from Western governments. Since the population of the C.I.S. is about 7.25 times greater than Poland's, the C.I.S. should receive 7.25 times more aid than Poland, or $20 billion per annum. Numbers of such magnitude numb the mind. As the late Sen. Everett McKinley Dirksen would say, "A billion here, a billion there, and soon it adds up to real money." Well, $20 billion is real money. Indeed, an additional $20 billion would increase the world's foreign aid disbursements by about 60 percent.

Let's go beyond the complex calculations required to arrive at the $20 billion figure, and examine Mr. Sachs' general argument. The most notable cases of successful transformations from socialism to capitalism are Chile and China's Guangzhou region, which is located directly north of Hong Kong. In 1973, Gen. Augusto Pinochet inherited a socialist economy that was collapsing and suffering from hyperinflation. Today, after a Pinochet-directed transformation, Chile's economy receives high marks. For example, according to a recent report on Third World economies issued by the secretariat of the General Agreement on Tariffs and Trade (GATT) in Geneva, "Chile emerges as a Third World superstar." As for the Guangzhou region of China, it transformed itself from communism into a vigorous market economy over the past 12 years, with a real growth rate of about 12 percent per annum.

In both cases, foreign aid was not required. During the Pinochet years most countries withdrew aid to Chile. As a result, Chile realized a net outflow, rather than a net inflow, of aid. In the 1980s, China, as a whole, received less aid on a per capita basis than any Third World nation. These facts explain why Mr Sachs and other aid lobbyists refrain from playing the Chile and China cards.

One card that Mr Sachs and his associates play with great regularity, however, is the Marshall Plan card. The folk image painted by biographers of statesmen and historians of international relations is one in which Western Europe was little more than a corpse, incapable of economic recovery without U.S. foreign aid. Hence, the image makers conclude that the rapid recovery of Western Europe's economies resulted from the Marshall Plan, which committed the United States to $13.2 billion in aid from 1948 to 1951, with 25 percent of that going to the United Kingdom.

Serious analysis has all but destroyed the widely held folk image of the Marshall Plan, however. By 1948, when the Marshall Plan began, the reconstruction of devastated public infrastructure was largely complete, and Western Europe's economies were already bouncing back. For example, by the last quarter of 1946 almost as much freight was loaded on the railways of Western Europe as had been transported in large enough to stimulate Western European growth by accelerating the replacement and expansion of its capital stock. Indeed, calculations show that, after four years of the Marshall Plan, Western European national income levels were, at best, only 2 percent higher than would have been the case otherwise. While this was a welcome addition, it is hardly the sort of dramatic change trumpeted by the Marshall Plan's image makers and Mr Sachs.

Indeed, the Marshall Plan was simply not a decisive factor in Western Europe's post-World War II boom.

Contrary to Mr. Sachs' claims, foreign aid is clearly not a necessary condition for a successful economic transformation and restructuring. But, perhaps more importantly, there is considerable evidence to suggest that aid impedes the transformation process. For example, Israel and Egypt are the two largest recipients of U.S. aid largesse, and both have been unable to transform their largely socialist economies. In "Toward Growth: A Blueprint for Economic Rebirth in Israel," Alvin Rabushka and I document that, in the case of Israel, aid has done nothing more than fuel Israel's war against capitalism.

In resisting the aid lobby, Mr Baker is holding all the high cards. It's time for him to call Mr Sachs' bluff.

*Steve H. Hanke is a professor of*

## GEORGIE ANNE GEYER

## Window in Moscow

MOSCOW

If anyone thought Russia would change Bob Strauss, he was mistaken. I knew Strauss was his same old charming, irreverent self when he leaned back in the chair in his simple office in the American Embassy here and said:

"This is a tough sonofa----. It's the toughest job I've ever had."

Was he glad he took the job of American ambassador to Moscow at this time of potentially apocalyptic economic collapse?

He smiled the rakish Texas smile that has endeared him to both Democrats (his party) and Republicans (President Bush appointed him). "I think yes," he answered. "I have shortcomings, but I think I also have some strengths."

Those strengths are certainly now evident. When Robert Strauss was appointed to the embassy post only last summer, even many of his devoted friends wondered whether he was too political a creature for a disintegrating empire. And perhaps too humorous.

But a funny thing happened on the way to history. As the Soviet Russian empire breaks down into the present struggle for new political systems, Bob Strauss, American political operative par excellence from Texas, is probably the best man in American politics to understand and interpret what is the most basic of political fights.

"The economists tell me — the

*The Bush administration has been woefully slow in doing anything in Russia.*

figure given to me — is that the value of the whole ruble market today is $10 billion," he said at one point, pinpointing the core of the collapse. "You could buy that whole market.

"Then I talked to high government officials and they told me they're out of wheat.

"Then a European businessman came in. He told me, 'I've been working here for years, but suddenly strange things are going on. I owe different Russians $20 million, but they don't want me to pay them. Then suddenly they'll call and say they need $1 million in medical supplies or $1 million of so-and-so; please pay us!'

"I thought immediately they wanted to put it in an offshore bank — but no, that's our type of story. This isn't Central America or Miami. What's happening here is they're using this man as their barter bank. Why? Because that way they don't have to pay any taxes on the money.

"And this ... is what's being done all over. This is just one sonofa---- to deal with," he summed up in words that describe all too well the incredible situation here.

Still, despite the seeming hopelessness of the moment, Bob Strauss is upbeat about the government of Boris Yeltsin. "Every one of the efforts that Yeltsin is trying and that [his economic team] is trying ... is an honest effort," he went on. "They need support because they're trying to do the right thing — but they don't have the people to do it, and they don't have the support."

The ambassador — thinking about the international meeting to be held this week in Washington to coordinate Western aid to Russia — gives the impression that it is time for the United States in particular finally to give some aid to this stricken country that is trying so desperately to come out of communism.

"I think the U.S. has to decide what it should do," he went on. "I know rushing out here with money is not the prudent thing to do, but we should give them sufficient humanitarian aid to give them a chance."

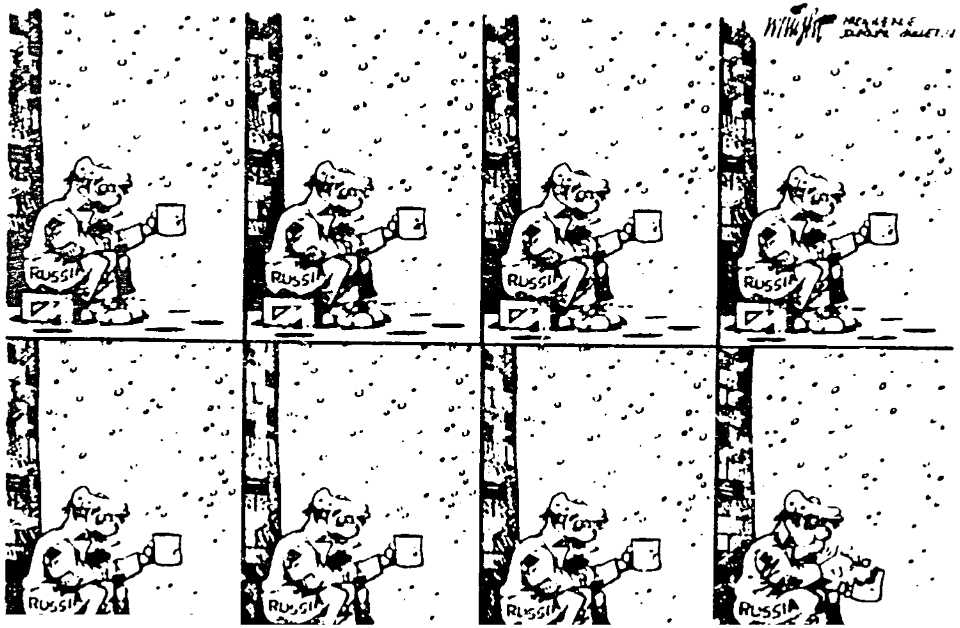
He insists that, contrary to many of the stories, the food sent here has been handled well. "You can deliver food here," he said forcefully. "You do it through the agencies or the European Community system.

"Almost every city has a crude commodity exchange and auction under sealed bids. You put the food in the stream and get the market functioning and use the proceeds for social benefits. I'm coming to the conclusion that's the way to go."

The Bush administration has been woefully slow in doing anything in Russia. Outside of the ambassador's, there is hardly an American voice heard here at this crucial moment for changing communism over to some freer type of society. This is becoming an additional tragedy.

President Bush put Robert

*Georgie Anne Geyer is a nationally syndicated columnist.*



THE JOURNAL OF COMMERCE, March 23, 1992

# Maquiladoras in the Caucasus

**By GERALD ROBBINS**

Ethnic strife in the Caucasus, a serious threat to the former Soviet republics, is receiving insufficient official attention in Washington. The U.S. policy — offering agricultural credits, humanitarian airlifts and large-scale conferences — will not do enough to restore order and a measure of prosperity.

A better approach was suggested this month by former President Richard Nixon: providing U.S. technical and managerial help through a "free enterprise corps." A related and promising idea is to establish twinned "maquiladora" plants, in which parts made in Turkey are assembled across the border in the Caucasus.

The collapse of communism in the Caucasus created conditions that foster extremism. The systems that replaced communist dogma are ethnic or religious identity. Muslim Turks and Christian Caucasians advocate extremism with increasing frequency.

Besides Armenia and Azerbaijan, there are several pressure points in the former Soviet Union. The patchwork of tiny autonomous republics on the Russian side are breeding grounds for turmoil.

Consider the dilemma of Dagestan. With a population of less than 2 million, this republic recognizes 10 indigenous ethnic groups as full-fledged nationalities. In northern Dagestan there are the Nogais who wish to unite with their brethren in the Russian province of Stavropol and the neighboring Chechen-Ingush Autonomous Republic. In the south, the Lezghins want unification with their brothers in neighboring Azerbaijan.

Along the Caspian Sea there is the Avar-Kumyk rivalry. The Avars are resettled mountain people crowding out the plains-oriented Kumyks. Fearing Avar domination, the Kumyks demand control of their historic territories and association with Russia, while the Avar Popular Front asks for a single unitary republic within a North Caucasus confederation.

This scenario is invariably repeated throughout the Caucasus. Chechens, Abkhazians, Cherkess, Dargins, Ingush, Kurds, Kaktsy and Ossetians are just some of the ethnic groups wanting redrawn borders or independence. Joseph Stalin's World War II policy of deportation and forced resettlement, combined with Moscow's subsequent attempts to integrate cultures, explains the quagmire of the Caucasus.

Today's Russian Republic has its own problems and prefers to disengage from the situation. Its newspapers and leaders are calling for an end to two centuries of Moscow's presence in the region. "There is a sovereign Azerbaijan, sovereign Armenia and sovereign Georgia," Russia's Vice President Alexander Rutskoi declared recently. "Let them work it out among themselves."

One initiative, recently launched by Turkey, offers some promise that this may happen. The recently established Black Sea Economic Cooperation Scheme offers a model for economic cooperation. The program tries to forge economic ties among Turkey, Bulgaria, Romania and the former Soviet republics of Armenia, Azerbaijan, Georgia, Moldova, Russia and Ukraine.

The basic idea is to integrate this collection of states and republics into the world economy by pursuing "mutual confidence building projects." The pact's founding declaration calls for "free enterprise," "economic liberty" and "bilateral cooperation." Although it states those goals without making specific suggestions, the program provides a blueprint worth expanding.

Washington can promote innovative programs under the auspices of the Black Sea pact. A particularly useful idea, used in the United States and Mexico, is the concept of twinned "maquiladora" plants across a common border.

Under the maquiladora program, U.S. factories produce parts for assembly in Mexico, allowing them to remain cost effective and internationally competitive. South of the border, maquiladora operations are a valuable revenue source and major employer.

Geographical proximity and cultural similarities make Turkey's relations with the Caucasus analogous to U.S. ties with Mexico. Turkey has the strongest economic infrastructure of the Black Sea states and is therefore in a position to influence the economic future of the region.

A maquiladora program would enable Turkish companies to produce low-cost products such as electronic components and automotive parts for export or for domestic consumption. Administered by the Black Sea pact, perhaps with U.S. advisers and financial help, the program could be expanded to other troubled areas that share a border with Turkey.

This type of project is suitable for sponsorship by the U.S. Agency for International Development. For example, the agency could form a consultant corps to help start a maquiladora program.

Cross-border plants are a means to ensuring peace in the Caucasus. It is shortsighted for President Bush to respond to Mr. Nixon's criticisms by saying Washington does "not have a blank check for all that." As the former president said, "The communists have lost the Cold War, but the West has not yet won it."

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*Gerald Robbins is a New York writer and consultant specializing in Middle East trade issues.*

# Why Is the US Ignoring the World's Children?

**By Bill Bradley**

IN the past two years, the world community has made important strides in defining international priorities. Whether it is the environment, endangered species, or democratic principles, people everywhere have begun to decide what resources and values must be protected.

But while the world undergoes dramatic changes, the United States has fallen behind in a crucial area of international responsibility: the protection of the world's children. At a time when the US must increasingly lead by its moral example, the Bush administration has ignored the United Nations Convention on the Rights of the Child, the treaty that strives to assure the basic needs of children around the world.

Two years ago last November, the UN General Assembly adopted a historic treaty designed to serve as the standard of international law in the area of children's rights. Generated with substantial US involvement, the accord establishes minimum international standards for the survival, development, and protection of children. For the first time, the world community put into writing its commitment to a better future for those who will take us there.

But after putting the finishing touches on the treaty, the US virtually abandoned it. Though more than 100 nations have ratified the Convention since November 1989, President George Bush has refused to forward it to the Senate.

Administration lawyers claim they want to ensure that the convention fits into our legal system. But similar concerns in other treaties have always been successfully addressed. The haggling over the peripheral legalisms really stems from a fear that the convention will oblige the US to actually live up to its goals. But while administration lawyers deliberate, children suffer and die.


The Bush administration's failure to give the convention higher priority has left the US, historically a leader on children's issues, behind the great majority of the world.

While all of our Western allies have either ratified or signed the convention, the US stands instead with such non-signatories as Iraq, Libya, and Cambodia – reprehensible company at a time when democracy and human rights are sweeping the world.

The convention is not simply a lofty collection of heartfelt beliefs. In many ways, it mirrors our own Constitution, asserting the rights of free expression and religion, nationality and family ties, and the highest attainable standards of health and basic education. The treaty also establishes international standards for protecting children from sexual abuse and exploitation, neglect, and illegal narcotics trade.

We don't like to think that children are vulnerable to such horrors. But they are. More than 1 million children in developing countries die each month from causes such as vaccine-preventable diseases and diarrheal dehydration. Poverty and mistreatment kill millions more.

Nor are children at risk only in third-world countries. Almost 40,000 American babies die before their first birthday each year, and one in five children lives in poverty in the US. Just in the last two years, children in my state of New Jersey have suffered through a major measles epidemic. The US needs this treaty as well.

Those nations that have signed the convention know that its mandates are necessary. Whether it is stopping a preventable disease like measles, or ending child labor abuses, poverty, and illiteracy, we need to meet our obligations to the next generation.

The Convention on the Rights of the Child is a long-overdue human-rights treaty. It ascended to acceptance as international law in a mere 10 months. The convention has high principles and a strong legal foundation. That it does not have the support of the US is a shame President Bush should erase immediately.

■ *Sen. Bill Bradley (D) of New Jersey is the co-chairman of the Advisory Council on the Rights of the Child.*

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*Jessica Mathews*

# Life and Death: U.S. Population Policy

George Bush's hypocritical and cowardly intransigence on world population growth is keeping the United States from offering a choice of life over death to millions of women in developing countries. Recently released population projections shed a new light on the future costs of this harsh policy.

There is no blinking at one devastating fact: Children born less than two years after their next older sibling are almost twice as likely to die as those born more than two years apart. Spacing is the single most important contributor to infant death. Providing the means of spacing births can therefore prevent huge numbers—perhaps one-fifth—of these deaths, and a considerable portion of maternal mortality as well.

This is not a matter of imposing someone else's culturally alien notion of the right number of children on a Kenyan, Indonesian or Saudi couple. It is about providing the means for couples who want to space or limit the number of their children to do so. Demographers call this "unmet demand" for family planning services. They peg it today at 120 million women or couples. They know that to be a gross underestimate, because experience has shown that well-designed family planning programs create demand as word spreads from satisfied users to family, friends and neighbors. The real number lies somewhere between 120 million and the 300 million couples who do not now have access to contraceptives.

The new United Nations projections reveal that it will matter enormously to our grandchildren whether contraceptive use spreads quickly or slowly. They show that the future is far more uncertain, and either much more threatening or a lot more hopeful, than we have been led to think.

Until now, official population projections have been built on the assumption that fertility will eventually reach replacement levels (in which each couple reproductively replaces itself by having, on average, 2.1 children) and stay there. After some decades at replacement fertility, populations stabilize. Depending on how fast replacement level fertility is reached, global population has been projected to stabilize at 9 billion to 14 billion people, approximately double to triple today's 5.3 billion.

The new U.N. figures expose what has been demographers' dirty little secret. Constant replacement fertility is an assumption adopted for reasons of statistical convenience. There are no grounds for believing that human behavior will actually follow that pattern. Most developed countries are 10 percent to 20 percent below replacement fertility today and may not increase. Other countries may never reach replacement.

Here's how much it matters. Sticking with the old assumption and using the most up-to-date data on birth rates, socioeconomic trends and the like, the United Nations now projects global stabilization in 2150 at 11.5 billion (up, incidentally, from its previous estimate of 10.1 billion). If, however, fertility is assumed to be 5 percent higher than replacement, global population in that year would be 20.8 billion and climbing. If fertility is just 5 percent lower, population would be 5.6 billion. (This is not a typo. Those who want to know more about these astonishing numbers can consult a clear, short explanation by the Population Reference Bureau.)

Since 1984, the United States has withheld funds from the principal providers of international family planning services, the U.N. Population Fund and private agencies—the former with the concocted excuse that the money might otherwise support forced programs in China, the latter on the grounds that no U.S. money should go to any agency that directly or indirectly provides abortion services, even counseling or referral. The fact that fewer contraceptives means more abortions and more deaths does not seem to trouble those who support these policies.

*In developing countries, birth spacing is the most important factor in infant death.*

For three years, the president has vetoed or threatened to veto every congressional attempt to overturn these policies and repulsed every effort at compromise. Yet before Bush became Ronald Reagan's vice-president, he was a leading advocate of international family planning, criticizing the "timidity" of agencies that could not understand how "desperately" these services are needed.

Politicians have the right to change their minds, but when they do they have to explain why. Bush has never done so. I don't believe that he can. All of the reasons he once cited for making population control a top international priority are far more urgent today than they were 20 years ago.

In a recent speech to the United Nations, former World Bank president Robert S. McNamara outlined an aggressive program to slow global population growth, one pillar of which would be the provision of comprehensive family planning. He estimated the cost in 2000 at $8 billion (in 1990 dollars) most of which would be borne by developing countries. International assistance would need to grow fourfold to $3.5 billion, about 5 percent of all development assistance. That is a pittance.

Whether the motivation is altruistic or selfish, principally to relieve needless human suffering or to ensure the future habitability of the planet, the U.N. numbers make clear that there are urgent reasons—of both fear and hope—for the United States to do its part in providing the means for family planning. Congress is ready to act. This is the president's choice—between reason and conscience or politics as usual.

*The writer, vice president of World Resources Institute, writes this column independently for The Post.*

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# Ethiopia's Shift to Democracy Depends on US Aid

By Peter Shirus

AFTER 30 years of war, an uneasy peace has broken out in Ethiopia. With it comes an opportunity to eak the deadly cycle of war and famine. do so, however, Ethiopia will need the lp of Western nations, led by the United tes, which responded so generously ring past famines. The donors must now ovide critical support to foster the tran- on to democracy and to finance recon- uction.

The problems facing the new rulers of iopia, dominated by the Tigrean Peo- 's Liberation Force (TPLF), are enor- us. The most fundamental issue is the ure of Ethiopia as a nation as demands ethnic self-determination escalate. The government has already accepted the sibility that Eritrea will become inde- ident. This will be decided in a UN-su- vised referendum two years hence.

Having come to power through an ap- l to their own ethnic nationalism, the reans must show that they can govern country as a whole and bridge ethnic sions. The government's willingness to ntenance an independent Eritrea is thema to many Ethiopians. That com- ed with the demise of an authoritarian ator and the new freedoms of expres- and association, could be an explosive ture in a country with long-repressed strongly felt ethnic loyalties.

Despite sporadic fighting in the south of

the country, the government has so far done a credible job of preventing a return to civil war. Soon after taking power, the TPLF convened a national conference and formed a coalition government incorporating a range of political and ethnic forces. The government has redrawn provincial boundaries to reflect linguistic and ethnic groupings.

On the economic front the government is caught in a bind. Foreign donors are looking for major economic policy reforms while the government maintains that it cannot implement reforms until the government gets an injection of cash to jump-start the economy. In fact, the country has been cash-starved since the new government took over because of low export levels and little foreign aid.

The agricultural sector, backbone of the Ethiopian economy, suffered incalculable damage from former dictator Mengistu Haile Mariam's policies of forced resettlement, price controls, and insecure land tenure. The new government is reversing these policies. Nonetheless, relief needs remain critical in regions where rains have failed and fields are barren.

ADDING to Ethiopia's burdens, an estimated 250,000 soldiers from Mengistu's army have been demobilized and are returning to their homes or to the cities. They must be reintegrated into civil society, or they will drain the economy and potentially pose a political or military threat. The government is also looking at ways to reintegrate up to 500,000 refugees returning from neighboring countries.

The United States played a pivotal role last year in facilitating a smooth transfer of power in Ethiopia when the rebels took over. The US should now support a nascent democratic government willing to address the root causes of famine. Under restrictions imposed by the congressionally mandated Brooke Amendment, however, aid to Ethiopia is restricted to emergency relief because of the approximately $6 million owed the US by the previous regime. Outrageously, the $6 million debt is for storage costs charged to Ethiopia for goods the country never received.

Congressional action to waive the Brooke Amendment has been stymied by the inability of Congress to pass any foreign-aid bill. The executive branch also has the authority to waive the Brooke Amendment, but that process is bogged down in bureaucratic delays.

To Ethiopians, it makes no difference how the waiver is obtained. What is important is that the US demonstrate its commitment to support their fragile transition to democracy.

Given the current political climate against foreign aid in an election year, neither Congress nor the executive branch is exerting leadership on this issue. But let's be realistic. We are talking about a very small amount of funds for the poorest country in the world. That much is not beyond our means.

■ *Peter Shirus, senior director of the Africa region for Catholic Relief Services, recently returned from a two-week trip to Ethiopia and Eritrea.*

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MONDAY DEVELOPMENTS

A biweekly publication of InterAction

February 3, 1992; Volume 10, Number 2

# Bush Budget Brings Good News For PVOs On Tax Issue

The President's budget request for next year endorses the US charitable community's position on a proposed Internal Revenue Service regulation that would severely limit donations to non-profits working overseas. InterAction and its members have been waging a vigorous fight against this IRS proposal for the past nine months.

Bush's request to the Congress for Fiscal Year 1993 contains an item requesting that the Congress make full domestic allocation of charitable contributions the law in a tax bill this year. The request is as follows: "(T)he Administration proposes to treat all charitable contributions deductible under current law as sourced to domestic income for purposes of computing the foreign tax credit and related computations. These changes would be effective for *(please turn to page 4)*

**Tax** *(Continued from page 1)* Contributions made in calendar years ending on or after December 31, 1992."

This item must be included in a tax bill which still must be passed by the House and Senate and then signed by the President. The coalition of non-profit organizations working on this issue, in which InterAction has played a central role, must intensify its efforts to make sure that this provision remains part of any major tax package enacted this year. Our goals haven't changed; but the President's support certainly makes the task easier!

Under current budget rules, any item that costs revenue must be accompanied by a provision which raises an equal amount of revenue. For this provision and one other matter of interest to the charitable community relating to the tax treatment of gifts of appreciated property, the President proposes the following revenue-raiser: "The changes would be financed by requiring charitable organizations to file with the Internal Revenue Service annual information returns reporting charitable contributions in excess of $500 from any one donor during the preceding calendar year. The reporting proposal would be effective for contributions made on or after July 1, 1992."

InterAction members are urged to examine the implications of this new reporting requirement. If you have any comments, please contact Tony Gambino at InterAction **no later than February 15**. If the IRS reporting requirement will cause serious problems at your organization, we need to know that as soon as possible.

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CRS Issue Brief by Johnathan E. Sanford

**Multilateral Development Banks: Issues for Congress** 03-13-92


## SUMMARY

The United States belongs to five multilateral development banks (MDBs): the World Bank and four regional (Africa, Asia, Europe, and Latin America) banks. The MDBs are the largest source of official development assistance to developing countries. In 1989, their total loan authorizations exceeded $30 billion, about three quarters of it on market-rate terms and the rest on concessional (low cost) terms. The United States is the largest single stockholder in all but one of the MDBs, though a majority of MDB stock is held by other countries. In 1991, the Administration is seeking an appropriation of $1.785 billion to fund the paid-in portion of new U.S. contributions or subscriptions to MDBs. The Administration is also asking Congress to authorize new multi-year subscriptions or contributions to the Asian Development Bank (ADB), the African Development Fund (AFDF), the International Finance Corporation (IFC), and (possibly later in the year) the Asian Development Fund (ADF). The Administration is also seeking congressional approval of a $12 billion increase in the U.S. quota at the International Monetary Fund (IMF).

This issue brief discusses the organization and operations of the MDBs, current MDB legislation before Congress, the level of U.S. spending on MDB programs compared to other U.S. international assistance expenditures, some policy issues arising from the IFC negotiations and Soviet application for membership in the World Bank and IMF. Then it focuses on 3 specific issues. First, how much emphasis have the MDBs put and how much should they put on poverty alleviation? By most measures, the MDBs are placing more emphasis on poverty alleviation programs than ever before. However, their increased emphasis on adjustment lending and economic reform has raised concern. Supporters argue that economic reform is a precondition to any real effort at poverty alleviation. Critics worry that the economic policy reforms pressed by the MDBs may put a heavy burden on the poor and cause them serious injury.

Second, critics have also voiced concern about the possible negative environmental impact of MDB lending. The MDBs have expanded their emphasis on environmental issues in recent years. Critics argue, however, that adequate weight is still not being given to these issues. They also complain that the Bank is hampering oversight by not providing broad public access to information on its procedures and operations.

Third, critics and officials within the MDBs and their member country governments have asked that the borrower countries' level of military spending be taken into account by the multilateral agencies in their loan decisions. The IMF and the World Bank have given more attention to this issue in the past year but they have not made their lending contingent on borrowers' reducing their military expenditures to any set level.

The issue brief reviews the issues and recent congressional action in these areas. Pending legislation affecting U.S. participation in the multilateral agencies is contained in the conference report to H.R. 2508, the FY1992 foreign operations appropriations bill (H.R. 2621), and the FY1993 foreign operations appropriation bill (unnumbered). For discussion of other issues involving the multilateral agencies, see also CRS Report 91-847 F, *World Bank: Answers to 26 Frequent Questions*.


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# United Nations: Debt crisis persists

Boutros Boutros-Ghali.

In his acceptance speech before the General Assembly on 3 December, secretary-general-designate Boutros Boutros-Ghali declared that "tackling the crippling problem of international debt" will be a priority in his efforts to "narrow the gap between the rich North and the poor South", as well as achieving a healthy world economy.

Ghali was voicing the alarm felt throughout much of the United Nations system that, while lenders no longer see the debt as a threat to the international banking system, the $1.3 trillion developing country foreign debt continues to bleed many low- and lower-income countries of their ability to sustain social and economic progress. For over a decade now, debt payments to the North exceeded most of the poor countries' earning capacity, causing most of the indebted nations to "adjust" by making cuts in food subsidies, education and health spending.

In fact, several United Nations organizations that closely monitor developing country debt have all called for stepped-up negotiations for more aggressive debt reduction and other relief measures. Speaking at the release of the annual World Debt Tables 1991-1992, World Bank chief economist Lawrence Summers said that getting many of these countries out of crisis would "require exceptional measures which go

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# Debt crisis persists

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beyond the bilateral debt relief covered by the existing Toronto Terms (1988) offered by the Paris Club of official creditors".

In his final report to the General Assembly on the external debt crisis, secretary-general Javier Pérez de Cuéllar pointed out that, although long-term relief had gradually become an accepted component of the international debt-management strategy, it had not led to a significant reduction of the debt burden.

He noted that, since about two thirds of the debt of the poorest countries (and 35 per cent of their debt service) were related to official development assistance loans, official debt write-offs could contribute significantly to easing the debt burden of these countries.

Antoine Blanca, the United Nations director-general for development and international economic co-operation, highlighted this ongoing concern in his recent address before the General Assembly's Economic and Social Committee, arguing that "the required amount of debt reduction is large enough, and the need is urgent enough, to merit political decisions at the highest levels of governments".

While noting that some progress had been registered during the past two years in relieving the foreign debt of developing countries, Blanca cited the fact that the debt burden of most developing and many countries in transition continued to be extremely heavy and that debt servicing also continued to be a drain on domestic savings, utilizing a large part of their foreign exchange earnings.

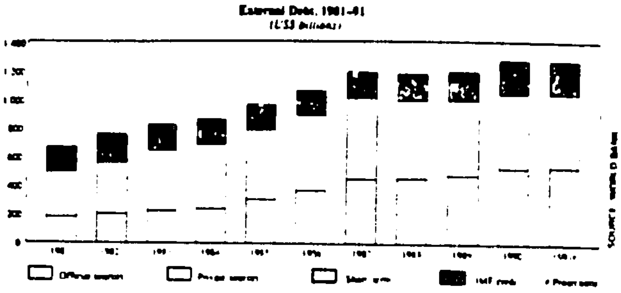
In spite of a slight decline in the debt to GDP ratio and debt service ratio, particularly in the 15 heavily indebted countries, of the six countries that have successfully completed debt renegotiations, only three have gradually established voluntary access to capital markets.

The information presented by the Bretton Woods institutions—the World Bank and the International Monetary Fund—during their annual meetings in Bangkok in October, albeit optimistic on possible future developments, was bleak on the short term. Indeed, the net long-term resource flows into the severely indebted low-income countries has declined since 1986. In the case of the severely indebted middle-income countries, these flows continue to be negative by a considerable amount.

Blanca specifically cited the need for the industrialized countries to adopt appropriate fiscal, monetary and trade policies and achieve greater co-ordination among themselves so that the reform and restructuring efforts of developing countries could be matched with adequate external financing and an open trading system that would allow these countries to adjust with growth.

Failing that, said Blanca, many countries would continue to be marginalized from international trade and financial markets under the heavy weight of debt.

Thus, if more meaningful debt reduction packages are to be undertaken, the governments of the creditor countries and the multilateral institutions, despite the very real budgetary restraints some of them now feel, will have to make a significantly greater effort to promote such packages.



## Africa

Nowhere is the debt burden more onerous than in Africa. Africa's total debt is virtually equal to the continent's entire annual economic output. The $25 billion debt service bill in 1990 was greater than the total aid received by Africa in the previous year—$21 billion. The World Bank has warned that debt payments will rise steeply in the 1990s in the absence of significant cancellations.

Several initiatives have been taken towards alleviating this debt burden. Specifically, the Group of Seven most industrialized countries has, since its 1987 Venice summit, and more so since its Toronto summit in 1988, written off or reduced certain categories of African debt. Up to 1990, the cancellations totalled some $7.6 billion, and such creditors as France and Italy have announced further measures.

However, as pointed out in the secretary-general's report for the final review and appraisal of the United Nations Programme of Action for African Economic Recovery and Development 1986-1990 (UNPAAERD), the benefits of such initiatives have been limited, not only because of the small number of beneficiary countries but also because of the magnitude of the debt burden.

Some creditor countries have recognized this problem, hence the scheme—known as the Trinidad terms—proposed by the United Kingdom which would improve on the Toronto package by reducing in one stroke the stock of eligible debt by two thirds instead of one third, with repayments on the remaining debt spread over 25 years.

Because external debt is hampering Africa's capacity to engineer economic recovery, Pérez de Cuéllar proposed the cancellation of all official bilateral debt and stepped-up efforts to substantially reduce multilateral debt. He also called for the writing down of commercial debts, which were already highly discounted on the financial markets, at commensurate rates and the buying back of the remainder through donor-supported initiatives, including various swap options. These measures received the support of the Organization of African Unity.

According to Gert Rosenthal, executive secretary of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), over-indebtedness persists throughout the region and efforts to reduce official and private debt have been "slow and inadequate". ECLAC estimated that the accumulation of arrears in the servicing of the external debt would reach $25 billion by the end of 1991.

## Latin America

A small group of middle-income countries in Latin America—notably, Chile, Mexico and Venezuela—are emerging from their debt crisis by negotiating commercial bank debt reduction, often with official support, and are gaining access once again to commercial credit markets.

But according to the United Nations Department of International Economic and Social Affairs (DIESA) in its year-end global economic update, this return to the capital markets, while indicating new confidence among lenders and borrowers alike, is very limited. In fact, according to DIESA, Asian borrowers accounted for almost 80 per cent of developing country bank loans and bond issues while African nations remain isolated. Because most countries will have to rely on financing by the multilateral financial institutions, DIESA recommends that capital funds such as the International Monetary Fund and the International Finance Corporation step up the expansion of their lending resources available to developing countries.

The United Nations Conference on Trade and Development (UNCTAD), which has urged an overall debt reduction of 30 per cent as the centrepiece of the international debt strategy, sees present efforts such as the Brady Plan as falling far short of the needs of developing countries. In anticipation of the upcoming UNCTAD VIII conference in February, Kenneth K. S. Dadzie, its secretary-general, calls for a much stronger Brady plan in which "the negotiation process between debtor countries and commercial banks would be anchored on the estimate of a country's actual debt reduction and cash-flow needs rather than the balance of negotiating strength." He cited that the recent decisions to reduce the official bilateral debt of Egypt and Poland by at least 50 per cent would provide the guidelines for negotiations with other countries. ■

## UNCTAD ready for February conference

The United Nations Conference on Trade and Development (UNCTAD) will be holding its eighth session in Cartagena de Indias, Colombia, from 8 to 25 February. The conference, entitled "Accelerating the Development Process: Challenges for National and International Development Policies in the 1990s", will focus on five agenda items including resources for development, international trade, technology, services and commodities.

The institutional role of UNCTAD, which seeks to make the international trading system more responsive to the developing countries, will also be reviewed in light of the changing international economic and political environment. The Group of 77, the group of 128 developing countries, has met several times in recent months preparing the working document for UNCTAD VIII. The Geneva-based intergovernmental body holds these meetings every four years.

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# Sustainability requires new economic concepts

By Winifred Armstrong

Many people now recognize that, for the first time in history, we are using up more of the earth's resources than the earth can regenerate. This unprecedented situation requires us to rethink how we organize production in order to find an equilibrium between what we use and existing resources.

Both capitalist and socialist models have been predicated on assumptions of continued growth. Both measure prosperity by growth and growth by consumption. We now recognize that increasing the world's consumption of resources may soon result in less growth, less wealth and ultimately less consumption.

*We have shown more capacity than will to bring environmental and social costs and benefits into our economic equations.*

As I see it, we are moving, albeit too slowly, toward alternative concepts that will take us beyond existing economic models to increasingly emphasize development instead of growth, and integrate concepts of environment into development as well. The obsolescence and replacement that characterize current modes of production must shift to a system which provides incentives to reduce the resources required for production inputs and also the amount of waste generated. More goods can be designed to be repaired, recycled, reutilized—with a consequent reorganization of jobs as well as materials. Access to transportation, for example, may become more important than the number of cars per capita as both planning goal and prosperity measure.

The aim is an integrated system that will balance the use and the replenishment of resources. In mining or logging, for example, we can calculate the using up of a resource with the need to replace its value. When a production process causes environmental damage, we can estimate the cost and include it in the pricing of the product.

The theoreticians of capitalist and socialist economic frameworks did not anticipate these needs. But the alternative theory and tools to achieve these ends are well under way, the products of years of work and workshops drawing together diverse ideas and people. They are ready for application—at the Earth Summit, in commercial and non-profit projects, in how we all think about and go about our business.

## If you don't count it . . .

A second arena for alternative conceptualizing deals with what economists do and don't count in the equations underlying policy formulation.

We economists don't count subsistence agriculture or informal economic activities. Yet in Africa, 50 to 90 per cent of people (depending on the country) gain most of their livelihood from what they grow and eat or make and barter. In countries as diverse as Peru and Italy, some 50 per cent or more of their people may be engaged in the informal sectors.

But if goods and services don't enter the cash economy, we economists don't count them. "And if you don't count it, it doesn't count," remarked one observer. It is increasingly clear that disregarding what half or more of people do to sustain themselves seriously skews economic policy.

Much current economic analysis does not count access to education or effects on health in the gain or loss to a project—these are called "externalities". We don't count the number of people engaged in the productive process as a goal—and so don't include it as an indicator. Thus when Ghana is proclaimed a success after undertaking eight years of the World Bank's structural adjustment programme (SAP), the fact that the majority of Ghanaians are living at a standard of living far lower than they were 15 years ago is not "counted" or even mentioned.

Policies based on economic models that leave out such key factors skew both economic reality and potential. In a number of African countries, for example, SAPs require people to replace the food they produce with imported food on the grounds that the imported food is cheaper. This policy, however, does not take into consideration what people eat from what they grow (that's subsistence), or what they barter for other goods and services (that's informal activity) or what the education and health services they can no longer afford may mean to their productive life (that's an externality).

The World Bank's SAPs now in effect in more than 20 African countries address many genuine problems. But the overall policy posits a limited model based on comparative advantage in a single global free market system—by which restricted criteria I believe most people in Africa (and many elsewhere) cannot succeed and many may not survive.

One World Bank official long experienced in African affairs commented ruefully that the majority of Africans in the countries which have adopted SAPs are getting poorer. The majority of Africans I talked with on a recent trip through 17 countries shared that observation—and yet most felt their countries could be viable, that is, under another framework could balance their production and consumption from their own resources with a sustainable lifestyle engaged in by their people.

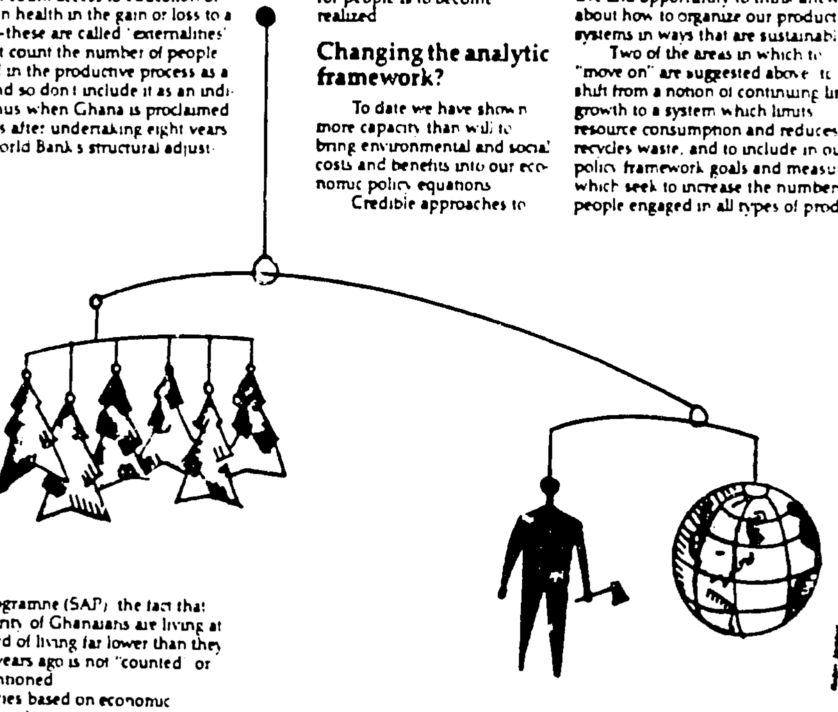
Prevailing models do not aim for or achieve sustainability by people. Multiple policies which encourage economic initiative and participation by all groups—subsistence, informal, local, communal, and not just the private cash market sectors—may be more in order if sustainability by and for people is to become realized.

## Changing the analytic framework?

To date we have shown more capacity than will to bring environmental and social costs and benefits into our economic policy equations.

Credible approaches to broaden the frame of reference of development are in the works. The United Nations Development Programme's (UNDP) *Human Development Report* is one such effort. The United Nations Statistical Office, in cooperation with other United Nations organizations, has over the past decade developed indicators of informal economic activities, particularly as related to putting a value on women's work. The World Bank has developed an environmental accounting framework. None of these has yet to be effectively applied in practice, however.

Still, thousands of community, non-governmental and local government undertakings from New York to Nairobi work to improve survival and development possibilities for their participants in ways that go beyond our current models. It is only recently that these efforts are becoming linked to a wider intellectual and political framework.



## Are North and South sustainable?

As I see it, neither the North nor the South is sustainable under the present economic framework. Northern countries representing approximately 25 per cent of the world's people consume roughly 75 per cent of the world's production and are overrun with waste products which further damage the resource base from which future production must come. Yet the United States Congressional Budget Office reports that the standard of living for 80 per cent of Americans is lower than it was 10 years ago. Poverty seems increasingly widespread in Eastern Europe and other regions as well. Meanwhile, the 75 per cent of the world's people who are using 25 per cent of the world's production need to increase their share both relatively and absolutely.

Trying harder using current economic premises is clearly not working. Faced with the possibility of collective impoverishment—the earth's comfort, with our own—we are given both incentive and opportunity to think anew about how to organize our productive systems in ways that are sustainable.

Two of the areas in which to "move on" are suggested above: to shift from a notion of continuing linear growth to a system which limits resource consumption and reduces and recycles waste, and to include in our policy framework goals and measures which seek to increase the numbers of people engaged in all types of productive activities—not just the cash economy.

Decisions to organize projects, programmes and institutions in alternative ways do not need to wait for a mandate from elsewhere. We can begin wherever we are to set out sustainable objectives and apply the growing body of new concepts while contributing through application to evolving them. And we can assist and insist that the governmental and international bodies that represent us go beyond the current restrictive framework that so clearly no longer meets our needs. ■

*Winifred Armstrong, an international economist and a principal organizer of The Other Economic Summit (TOES) in Houston '90 and Toronto '88, recently returned from a [illegible] trip in East and Southern Africa. She is working on a book on Getting to An Economics that will Work for People: Something New Out of Africa, and would welcome further thoughts on the points raised in this article from DF readers.*

# Technology transfer from developed to developing countries

*Transfer of technology is one way to promote both environmental quality and economic welfare. Robert W. Fri, president of Resources for the Future (RFF), and Chester L. Cooper, coordinator of RFF's international programs, have considered how assistance from the developed world could be usefully applied to environmental and developmental problems in the developing world through technology transfer based on specific guidelines.*

Sustainable international development involves environmental protection at both the local and global levels. Such protection depends on close cooperation among industrialized and developing nations in regard to technology. The recommendations below focus on how available international resources could be applied more usefully to local economic development and to environmental problems in the former USSR, Eastern Europe, Asia, Africa, and Latin America. The emphasis in these suggestions is on the near term and rests on a belief that the problems to be addressed cannot wait for the emergence of new technologies, institutions, and international frameworks, and on a conviction that the lessons gained by acting now will prove essential to the success of the long-term programs and enterprises that presumably will emerge from UNCED. Five guidelines are offered here for a near-term program of international environmental technology transfer.

First, both the public and private sectors of donor nations should encourage technology transfers that meet not only local environmental concerns, but also serve existing national economic development needs. Any process or product that reduces resource inputs and minimizes the production of harmful residuals is of interest in this regard. Since such processes and products are already the stuff of commerce, the transfer of technologies that benefit both economic well-being and environmental quality can be stimulated without delay.

Second, the unique advantages the public sector can exercise to facilitate technology transfers to meet both economic and environmental needs should be utilized. Specialized government staffs could "broker" contacts between potential suppliers and recipients and identify technology demands. Information clearinghouses could help developing countries find private-sector technology to meet their demands. In some cases, government-business partnerships could facilitate the transfer of technology. Finally, governments could set minimum environmental standards for technology sales to discourage exportation of environmentally hazardous technologies.

Third, the capacity of developing nations to plan, acquire, operate, maintain, and manage the technologies they need should be expanded. Governments, academia, nongovernment organizations (NGOs), and business could all contribute in this regard.

Fourth, financing on a bilateral basis should be encouraged. This might be accomplished with respect to reducing carbon dioxide ($CO_2$) emissions along the following lines: since a country committed to invest in $CO_2$ reductions will want to do so as cost-effectively as possible, it might pay another country the extra cost of a solar-electric power plant and take credit at home for an equivalent $CO_2$ reduction. Such arrangements could enlarge the flow of technology aimed at mitigating greenhouse gas emissions well before there is international agreement on limiting these emissions.

Finally, steps should be taken to reduce commercial obstacles to technology transfer. Progress is being made in this regard, but for some nations and some technologies such obstacles remain significant.

For some individual technology transfer initiatives, national or multinational institutions should provide international leadership. Some initiatives have merit aside from global environmental protection. These include the promotion of increased energy efficiency, especially in the larger, coal-rich countries; reforestation, especially in tropical regions; population stabilization, especially in the Third World; faster development of nonfossil energy systems; and the movement of fossil energy systems down the $CO_2$ emissions ladder—from coal to oil to natural gas.

Other initiatives may also be worth pursuing. An enterprise for organizing and coordinating technology transfers could be sponsored and managed by the U.S. Environmental Protection Agency on behalf of the international community. Japan's RITE laboratory for studying global change issues could evolve into an international venture for the development of new environmental technologies. An energy efficiency research and development program primarily directed toward Eastern Europe could be established through a cooperative arrangement between the Budapest Environment Center and either the European Coummunity or the Organization for Economic Cooperation and Development. A global program for addressing $CO_2$ emissions through economic incentives and disincentives could be developed by a task force of international economists. The United States, Canada, and Japan could collaborate on a technical assistance program. (The U.S. Agency for International Development has significant funding, expertise, and well-established field stations. Canada's International Development Research Center has impressive credentials and much experience. Japan has large funds but lacks adequate overseas assistance establishments and field experience.) Innovative debt-for-environmental protection exchanges between creditor and debtor countries could be created. With NGOs and private foundations, regional development banks could identify and meet the need for building indigenous technological capacity. Finally, a consortium of nations such as Brazil, China, and India could provide assistance with respect to low-tech agriculture and conservation techniques to other developing countries and the industrialized world. ■

Robert W. Fri
Chester L. Cooper



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# The ZPG Reporter

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# Bearing the Burden

## *Women's Status Linked to Stopping Overpopulation*

Today, 1.3 billion women—fully one-half of the world's women—are in their childbearing years. Most of these women grew up in developing countries where they had little or no access to adequate health care, schooling, or nutrition.

As a result, their adult lives are often besieged by multiple reproductive health problems, including high rates of unintended pregnancies, reproductive tract infections and maternal mortality.

The rapid pace of population growth continues to push these women to the margins of society. Combined with their low political, economic and social status, nearly one out of every three women in their reproductive years lacks access to reliable contraceptive methods and family planning information. Predictably, pregnancies are often too close and too numerous at too young or too old an age.

In fact, Family Health International reports that more births, maternal deaths, abortions, and infant deaths were recorded worldwide from 1970 to 1990 than in any other 20-year period of history. During this same period, world population increased by 50 percent.

Enhancing the status of women is now widely recognized as key to saving women's lives, paving the way for greater contraceptive acceptance, and stopping population growth. Wider opportunities for women are also seen as essential in order to achieve greater environmental protection and sustainable development.

### The World of Women

The girl who lives in a poor country will most likely subsist on a diet that does not meet her nutritional requirements. Female infants and children are particularly vulnerable to infection and illness, as many cultures place less value upon their survival. A strong preference for sons may be expressed in the number of visits to a doctor during illness. For example, a study of ten Indian villages found that only 22 percent of ill girls were taken to a health care facility in comparison to 80 percent of ill boys.

This young girl has numerous household responsibilities, ranging from the care of her siblings to daily water and fuelwood collection. She often helps her mother manage food production by herding small animals and weeding the family garden plot.

These duties will usually take top priority and, consequently, she will receive little or no formal education. Over one-half of Third World women are illiterate; in several African and South Asian countries, as many as 80 percent of women over 25 years of age have never entered a classroom.

Her parents will most likely choose a prospective spouse for her while she is still in her teens. According to the World Fertility Survey, approximately 50 percent of African women, 40 percent of Asian women, and 30 percent of Latin American women are married by age 18.

Her primary duty will be to have as many children as her husband desires. In cultures where a woman's value often depends upon her fertility, she is subject to violence and abandonment if she does not "produce" the expected number of children, particularly sons. For many women, married life becomes a daily struggle to balance family expectations with personal security. Oftentimes, without her husband's approval, she cannot use contraceptives without fearing for her safety.

Women bear not only children and the attendant responsibilities of childcare, but also the burden of growing food. In Third World countries, the bulk of a woman's daily activities revolves around the production of food both for her family and for trading or selling in local markets.

According to U.N. estimates, women grow at least 50 percent of the world's food and as much as 80 percent in some African countries. One-third to one-half of all agricultural laborers in the Third World are women. With their extensive knowledge of seed varieties, tubers, trees and crop systems, women carry on the tradition of ecologically sound methods of food production.

As population growth continues to accelerate, these women must contend with escalating environmental degradation in the forms of soil erosion, deforestation and water

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Women participate in a political meeting in a public schoolhouse in the African country of Benin.

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## Women and UNCED

This June, an estimated 25,000 to 40,000 people will gather in Rio de Janeiro for the United Nations Conference on Environment and Development (UNCED). The proposed inclusion of population issues in one of the key documents to be presented at UNCED has been hotly contested at various preparatory meetings.

During the World Women's Congress for a Healthy Planet, held in Miami this past November, there was particularly vocal criticism of the *Women's Action Agenda 21*, which was viewed by some participants as an attack on Third World women. During one population workshop, several women repeated their concern that remedies for stopping population growth will be placed upon the shoulders of Third World women without an accompanying look at wasteful consumers in affluent countries.

For example, the initial draft of the *Women's Action Agenda 21* listed "raising the economic, health, education and social status of women and their children" as key to resolving the population growth issue and ending the maldistribution of global resources. It also called for further expansion of family planning programs that would be neither coercive nor compulsory in their approach.

But the final draft dramatically altered the intent of the original text by the insertion of a new paragraph: "We know that the major causes of environmental degradation are economic systems that exploit and misuse nature and people, pollutants and waste of industry, and military technologies. We are outraged by the suggestion that women's fertility rates (euphemistically called population pressures) are to blame." Strong emphasis was also placed upon the consumption and waste patterns of the industrialized nations.

Organizations which participated at the World Women's Congress were asked to comment on the changes made to the final draft. ZPG submitted new language which sought to defuse the North/South conflict by concentrating upon the *I=PAT (Impact = Population x Affluence x Technology)* formula and by focusing on the links between women's health, population growth, consumption and the environment. The ZPG document stressed that population growth is an issue for everyone, not just for poor countries.

For the complete text of the *Women's Action Agenda 21*, you may request copies from the Women's Environment and Development Organization, 845 Third Avenue, 15th Floor, New York, NY 10022.

### Correction

In the December issue of *The ZPG Reporter*, the feature article on biodiversity included a chart that listed incorrect figures for population growth over the past 30 years. Please contact ZPG for a free copy of the article, entitled "Unraveling the Tapestry of Life" along with the revised chart.

# Women's Status

*Continued from page 1*

pollution. These ecological shortfalls force women to spend more time each day in search of basic necessities. In rural areas where women already spend several hours each day seeking sufficient fuelwood and water supplies, the depletion of woodlands or water sources will eventually force them to walk farther in search of new supplies. Soil erosion caused by intensive agriculture on fragile soils will ultimately reduce the amount of food they can provide for their families.

According to a report from the U.N. Development Fund for Women, "an often destructive quest for survival is fueled by high rates of population growth and the failure of policymakers to recognize an obvious truth: that as long as women remain poor and powerless, fragile ecosystems will remain at risk." The report concludes that women who are poor, hungry and desperate have little time to ponder the long-term consequences of their actions upon the planet. They do whatever is necessary to feed their families and survive one more day.

### Contraceptive Barriers

The debilitating effects of poverty can be offset by programs that offer women some degree of control over their lives. Increasing the availability of family planning programs is one way to enhance a woman's sense of autonomy and improve her health as well as ensure the survival of her children.

Today, complications of pregnancy, childbirth, and unsafe abortion are the leading killers of women of reproductive age throughout the Third World. Every year 500,000 women die during pregnancy or childbirth. Included in this annual total are abortions performed without adequate medical supervision, which take the lives of up to 200,000 women.

According to the U.N. Population Fund, family planning information and modern contraceptive methods could decrease maternal deaths by 50,000 to 70,000 each year and ensure healthier babies. In addition, a greater investment in family planning programs could help prevent unintended pregnancies which result in an estimated 50 to 60 million abortions—both legal and illegal—every year.

But unless more thorough health care and examinations are included, family planning programs can be met with fear and resistance. Rani Bang, co-director of India's Society for Education, Action and Research in Community Health, examined the use of modern contraceptives among village women in India. Her studies of two Indian villages revealed that 92 percent of the women had some type of gynecological disease. Ms. Bang found that contraceptives were often provided to these women without first testing for the presence of gynecological diseases. She believes this practice aggravates any existing health conditions, fosters the perception that "contraception leads to suffering," and often prompts affected women to discontinue their use.

In addition to incomplete gynecological exams, inaccurate information about certain contraceptive methods abounds. For example, one survey of Mexican women found that two-thirds believed that oral contraceptives caused birth defects. In Chile, one-third of surveyed women thought the pill accumulated in the stomach and caused stomach cancer. Nearly half the women in a Philippines survey thought it caused sterility. Better follow-up counseling could increase awareness and put to rest certain myths about contraception.

### Success Stories

While cultural and familial barriers often prevent women from getting complete family planning information, there have been successful efforts to improve women's health and enable them to decide on family size. What makes these programs work and why do they work?

The International Union for the Conservation of Nature and Natural Resources (IUCN) has attempted to unite family planning information with a thriving environmental program. One pilot program in Pakistan has met with encouraging results.

More than one million people reside in the Orangi community of Karachi, Pakistan, one of Asia's largest squatter settlements. Over a ten-year period, the IUCN program organized the construction of a sanitation system as well as the distribution of tree plants and vegetable seeds. Project facilitators found that people who live there are well aware that this conservation program would be even more beneficial if population pressures on land and water resources could be reduced. nearly 90 percent of Orangi inhabitants recognized the benefits of family planning for their community and their health. Family planning information had become part of a health program at the request of the women involved. In addition, the contraceptive prevalence rate among Orangi couples was almost three times higher than the national rate.

In Bangladesh, the Women's Health Coalition (BWHC) provides comprehensive maternal and child health services at low cost. For example, women pay the equivalent of only 10 cents for general family planning services; 31 cents for a pelvic exam, and 78 cents for an early abortion. The costs of these reproductive health services amount to ten percent or less of an unskilled worker's weekly income. In 1990, BWHC clinics provided over 145,000 reproductive health services.

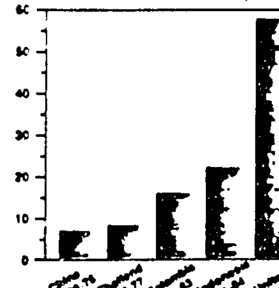
These two projects are good examples of efforts on the local level to improve women's lives. More comprehensive programs are also flourishing. In 1987, the World Health Organization and the World Bank organized the Safe Motherhood Initiative. Every day, an estimated 500 women die while attempting to end an unwanted pregnancy. The sponsors of the Safe Motherhood Initiative want to provide women with more low-cost maternal and child health services within walking distance of their homes. This maternal and child health program aims to halve maternal deaths in poor countries by the year 2000.

These services could be provided with a per capita investment of just $1.50 per year. This amount would enable most countries to adopt more comprehensive family planning services as well as support "one-stop" health and family planning services. Similar programs in Nicaragua, Botswana and Sri Lanka have led to both higher contraceptive prevalence rates and more medically supervised births.

Some family planning programs have been very successful in a relatively short period of time. In the United States, it took 58 years for the total fertility rate—average number of children born to a woman during her reproductive lifetime—to drop from 6.0 to 3.5. In countries such as Thailand, Colombia, South Korea, Sri Lanka, and Indonesia, families achieved this same fertility drop two to four times more rapidly—15 years in Colombia and only 8 years in Thailand. (See chart.)

One of the most reliable predictors of women's contraceptive use, family size and ultimately population growth rates is the level of education attained. According to the World Fertility Survey, educated women have been found to have fewer children. In Brazil, for instance, uneducated women have an average of 6.5 children while those with a secondary education only have 2.5 children. In four other Latin American countries, education was responsible for fertility declines between 40 percent and 60 percent in the last decade alone.

**Time Taken for Total Rate of Fertility to Decline from 6 to 3.5 Births per Woman**




But today, there are still more than 600 million illiterate women who desperately need education for themselves and their families. Jodi Jacobson at the Worldwatch Institute believes that "policymakers need to realize that if they directed attention to women, they could save two generations at once."

And according to environmental author and film producer Paula DiPerna, "the need for women's involvement is nowhere more evident than in attempting to stem overpopulation. Without control over their reproductive destiny, empowerment, and fair access to education and income, women will continue, willingly and unwillingly, to bring children into the world the environment cannot support, rendering null the concept of sustainable development."

—*Rebecca Stutsman*

Population Crisis Committee

# PRESS RELEASE

**HOLD FOR RELEASE**
**UNTIL MONDAY, FEBRUARY 3, 1992—A.M.**

## *POPULATION PICKS & PANS*
## For 1991

India, Thailand, Colombia, Morocco and Kenya have made significant progress toward providing universal access to family planning and lowering average family size, according to the Population Crisis Committee's 1991 *Population Picks & Pans.*

Five other countries—the United States, the Philippines, Saudi Arabia, Malawi and Haiti—are criticized by the Population Crisis Committee for their lack of progress (or backsliding) on these issues.

Together, these 10 countries contribute more than a quarter of the current annual increase in world population—about 24 million of the more than 90 million people added each year.

According to *Picks & Pans*, family size in the United States has actually increased over the last few years, from 1.8 children to 2.1, and the U.S. population is expected to grow by 2.7 million people in 1992—significantly more than the 2 million added each year over the course of the 1980s. In contrast, family size in Thailand continued its rapid decline during the 1980s—from 4.5 children in 1980 to just 2.2 in 1991.

"Not only has the U.S. government abdicated its leadership role in family planning internationally, it has also effectively reduced access to family planning services here at home," says Sharon L. Camp, Ph.D.,

—Continued—

senior vice president of the Population Crisis Committee (PCC). "Thailand's achievements and those of PCC's other 1991 picks provide a stark contrast to the dismal record of the U.S. federal government on family planning over the last decade and its active support of those who seek to limit women's reproductive choices worldwide."

Strong government support for family planning and effective public-private cooperation in providing services have been crucial to success in all but one of the five countries praised by PCC.

"Political commitment is a key factor in nearly all these countries," says Dr. Camp. "We can see its importance by looking at the countries making little progress. Despite large amounts of foreign aid to the Philippines, for example, access to family planning services has barely increased over the past decade. And it's the absence of political leadership that has impeded progress—not any lack of demand for fertility control."

PCC selected the 10 winners and losers in consultation with a wide range of experts on international family planning. The achievement of each winner was judged relative to its own starting point and recent history, rather than on the basis of absolute levels of achievement. Thus while fertility is still very high in Kenya—an average of 6.7 children per woman—it is significantly lower than in the early 1980s when women had, on average, more than 8 children. The most rapid progress has been made very recently.

*Population Picks & Pans* is part of PCC's effort to track world progress towards population stabilization through the coming decade. The 1990s were first identified as the "critical decade" for success or failure on this front in PCC's world progress report for 1990.

The Population Crisis Committee is a private, non-profit organization that advocates population stabilization through universal access to quality voluntary family planning services.



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**The Picks:**
**Countries Making the Most Progress in Family Planning**

**India: The states of Maharashtra, Punjab, Gujarat, Kerala and Tamil Nadu.**

❑ As many as 50 percent of couples use a contraceptive method in the five states cited by PCC and the average number of children born to a woman (total fertility) has fallen by one-third to one-half.

❑ Strong leadership by these state-level governments is largely credited for the achievements and is compared negatively with leadership by other state governments in recent years.

**Thailand:**

❑ In less than 20 years, the level of contraceptive use among couples in Thailand has risen from less than 10 percent to more than 67 percent and average family size has fallen to just 2.2 children.

❑ Creative marketing and effective public-private cooperation are important reasons for Thailand's family planning successes, according to PCC.

**Colombia:**

❑ Total fertility has dropped by 60 percent since 1965, from an average of seven children per woman to less than three today.

❑ PCC credits the government's consistent political and financial support and its partnership with the national family planning association, PROFAMILIA, for continuing program successes.

**Morocco:**

❑ More than 40 percent of couples are estimated to use a contraceptive method in Morocco and fertility has fallen by more than 25 percent over the decade of the 1980s.

❑ The many innovative approaches of Morocco's family planning program—including housecalls—have resulted in a near universal knowledge of contraceptive methods among women and rapidly increasing contraceptive use.



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**Kenya:**

❐ After many years of little progress on family planning in Kenya, contraceptive use has almost doubled in the past few years, to 27 percent of couples.

❐ A new emphasis on quality family planning services in the Kenyan program, along with a higher level of political commitment, have helped Kenya turn the corner, according to PCC.

## The Pans:
## Countries Making the Least Progress in Family Planning

**United States of America:**

❐ After years of near-constant fertility, family size in the United States has been increasing since 1988, important given the significant impact of American consumption patterns on the global environment.

❐ Failing federal expenditures (in constant dollars) and the continuing erosion of abortion rights during the 1980s, (including the Reagan-era "gag rule") have hurt access to family planning services, states PCC.

**Philippines:**

❐ Levels of contraceptive use among Filipinos increased little, if at all, in the latter part of the 1980s making the Philippines the fastest growing country in Southeast Asia.

❐ The government's reluctance to support family planning measures is attributed to the great influence of the Catholic church hierarchy in Filipino politics.

**Saudi Arabia:**

❐ Continued high levels of fertility (an average of more than 7 children per woman) and declines in death rates have resulted in a higher rate of population growth in Saudi Arabia at the end of the 1980s than at the beginning. Officially, the government limits access to contraception.

❐ The government's pro-natalist policies are rooted in a desire to reduce the country's reliance on foreign labor, yet less than 5 percent of Saudi women are active in the labor force.

**Malawi:**

❑ Only 1 percent of couples in Malawi use a modern contraceptive method, due to the almost total lack of access to family planning services up until very recently.

❑ President Kamuzu Banda, who has maintained authoritarian rule in Malawi for more than 25 years, resisted the introduction of family planning, despite a 50 percent rate of malnutrition among the country's children and other signs of widespread poverty and suffering.

**Haiti:**

❑ On average, Haitian women still have more than six children—the same as in 1980—and only about 10 percent of couples use a contraceptive method.

❑ In addition to widespread poverty, the corruption and despotism of the Duvalier governments—and most of their successors—have made steady or substantial progress in family planning very difficult.

"Neither religion nor culture are insurmountable obstacles to the acceptance of family planning," says Dr. Camp. "Both Morocco, a predominantly Muslim country, and Colombia, which is overwhelmingly Catholic, demonstrate this. The willingness, on the part of a government, to create a climate supportive of reproductive choice and responsible parenthood is the critical factor."

❖ ❖ ❖

*Population Picks & Pans:*
*The Population Crisis Committee's*
*1991 Selection of the Ten Countries Worldwide*
*Making the Most and Least Progress in Family Planning*
is available for purchase by the public for $3.00 from

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IFPRI Report, International Food Policy Research Institute

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# COMMENTARY: GETTING MACROECONOMIC POLICIES RIGHT IS CRUCIAL FOR RURAL DEVELOPMENT

Agriculture and the rural sector have the dominant weight in the economies of most developing countries. Rural development is part of the process of "structural transformation" characterized by a diversification of the economy away from agriculture. This process is facilitated by rapid agricultural growth, at least initially, but leads ultimately to significant declines in the share of agriculture in total employment and output. For many developing countries rural development is a key element of the overall development process that can provide the basis for a self-sustaining and equitable economic growth.

Recent discussions of development strategy for low-income, labor-surplus countries have emphasized, with good reason, the need to "get agriculture moving." As agriculture develops it generates increased demand for farm inputs and, more important, increases incomes among rural households. As their incomes rise, especially those of low-income households, demand increases for food and labor-intensive industrial consumer goods and services, such as clothing and housing, produced in the local economy. This leads to further increases in labor demand and income in a self-reinforcing growth process. To the contrary, high-income rural households tend to spend income increases on goods produced in urban areas or imported from abroad.

During the 1960s Taiwan and the Philippines had comparable records in agricultural growth. However, Taiwan had smaller landholdings, used less mechanization, and had stronger growth linkages than did the Philippines. Taiwan, unlike the Philippines, had a broad-based pattern of rural employment and output gains that accompanied agricultural growth and provided the demand stimulus for rural-based industrialization.

Beyond the demand effects of agricultural growth, the supply response of rural nonagricultural producers is crucial as well. Supply factors that significantly affect the profitability and competitiveness of rural nonfarm enterprises relate to some aspects of the macroeconomic policy environment, including the foreign trade regime, interest rate and credit policies, and public investment in infrastructure.

Import restrictions have been used extensively in many developing countries to protect domestic industry from foreign competition. Such trade barriers have benefited producers of import-competing consumer goods but effectively penalized export-oriented industries and capital goods producers. Moreover, the induced exchange rate overvaluation, together with low tariff rates on imported capital goods, has promoted excessive mechanization and the growth of capital-intensive industries based in urban areas instead of labor-intensive industries based in rural areas. Restrictive trade regimes that distort domestic prices and limit access of small producers to foreign exchange inhibit the development of rural nonfarm enterprises.

Many developing-country governments have imposed interest rate ceilings or credit controls on the formal banking system, resulting in artificially low interest rates and an allocation of loans biased toward large-scale, urban-based enterprises. In some cases low-cost credit has been directly provided by the government as a means of promoting investment in selected industries, also favoring large producers, while the underpricing of capital has encouraged the adoption of more capital-intensive technologies. Small-scale rural enterprises have been forced to rely heavily on informal credit markets where interest rates tend to be much higher. This has served as another impediment to a strong supply response of nonagricultural production to the demand stimulus arising from agricultural growth.

The supply response is also a function of the rural infrastructure, defined here as including both social and physical infrastructure in the rural sector. Public investment in

(continued on page 4)

COMMENTARY *(continued from page 1)*

education, for instance, helps improve labor skills, managerial capacity, and the work culture. Improved roads and other physical infrastructure reduce marketing costs for producers, increase the access of consumers to marketable products, and generally contribute to market integration as a basis for the development of a wide range of rural nonagricultural activities. Unfortunately, public investment policy in many developing countries has not emphasized the development of infrastructure; or if it has, expenditures were largely made in urban, not rural, areas. The underdevelopment of rural infrastructure in some developing countries has been shown in recent IFPRI studies to represent an important supply-side constraint in the linkage effects of agricultural growth on rural nonagricultural production and overall economic growth.

Thus, rapid agricultural growth does not automatically lead to rural development and rapid overall economic growth that is equitable and sustainable. Constraints induced by macroeconomic policies can inhibit the response of rural nonagricultural producers and reduce the magnitude of the employment and income multiplier effects arising from agricultural growth. It is especially important that the foreign trade regime, interest rate and credit policies, and public investment in infrastructure provide an environment conducive to enhancing the competitiveness of small-scale, rural-based enterprises.

Romeo M. Bautista

# Challenges for Global Agricultural Research

*Searching for sustainable and environmentally safe food production systems to feed the growing population of the world*

Robert O. Blake
*Chairman, Committee on Agricultural Sustainability for Developing Countries*

Twenty years ago, and in the face of growing populations and food shortages in South Asia, the world's spirits were boosted by news of India's and Pakistan's seemingly sudden success in launching the "Green Revolution." Both these countries introduced highly productive varieties of wheat and rice, employing new methods in the use of more and better chemical fertilizers, improved irrigation, and pesticides. As a result, countries that once feared famine began to produce enough to meet their needs, and even export.

As has happened so often, history is now repeating itself. An agricultural crisis is again looming on the horizon. But this time it has a global dimension, and policymakers worldwide must face a potentially explosive conflict of choices. New ways must be found to increase agricultural production by nearly 50 percent in the next two decades. This must be done, however, without depleting the earth's soil and water resources, which will be needed to meet greater demands in the future.

Traditional agriculture may not be able to meet this challenge. This means that once again, international agricultural researchers and their national colleagues are being called on to play a major role in fashioning sustainable and productive agricultural systems for the planet.

Fortunately, this time, there are not 2 but 17 international agricultural research centers—all operating under the leadership of the Consultative Group on International Agricultural Research (CGIAR)—and another dozen centers that are cooperating with them or are in the process of being set up. Even more important, there is a qualitative change of focus in the centers' research. Increasingly, scientists are being asked by their financial backers and by the CGIAR's Technical Advisory Committee (TAC), which coordinates their research, not only to develop sturdier and more productive plants but also cost-effective and labor-effective ways to protect and improve soils and conserve water. They are also giving more attention to environmental concerns by helping small farmers and farmers working on marginally productive lands. This truly represents, as the popular press has said, a "greening of international agricultural research" and of CGIAR.

What has brought all this about? There has been outside pressure, of course. But, principally, this shift has come as a healthy internal response by the international agricultural research community to some very frightening and challenging realities:

- Agricultural productivity and production must continue to accelerate at an unprecedented rate for at least the next four decades particularly to help the poor countries of the tropics feed their rapidly growing populations.
- Chemical inputs (pesticides, herbicides, and fertilizers) may be too expensive, unavailable, and, in the case of misused pesticides, dangerous for the farmers in developing countries. Yet, much of the increased world food production must come from these farmers.
- Very little additional irrigated land can be brought into production, barely making up for the cultivable land being lost to salinity and waterlogging.
- Too many national agricultural research and extension systems in the developing world have become underfunded, overly politicized, and hence, ineffective, over the years. These weakened systems, therefore, are not strong enough partners for the international agricultural research centers. Even some of the best national centers—in Brazil, Mexico, and the Philippines—have deteriorated in the last decade as debt-ridden governments have cut support.
- Developing countries cannot rely on their most fertile lands alone for food and other agricultural produce. They must also sustain production on poorly endowed lands, where farming is often difficult because of various combinations of recurring drought, wetness, cold, steep ground, or infertile soil.

## Meeting these problems

To meet these challenges and to move to sustainable (i.e., productive and environmentally sound) agricultural systems, the centers recognized in the mid-1980s that they would have to make major changes in their research programs. How well have they met the need to develop sustainable agricultural systems?

The short answer is that they are all making important progress, some more than others. Following the lead taken by TAC and the TAC's own Sustainability Committee, all the centers have begun to revise their research gradually. The extent to which these changes are marked by creativity and daring depends on the quality of the leadership of each center and the ability of its scientists to adapt to the changing perceptions about agricultural research. All this represents a big step forward. Prior to making the changes that I have described, most of the centers concentrated on increasing the productivity of the food crops that they were mandated to cover. Relatively little attention was being paid to the protection of natural resources.

Centers working on the problems of a whole region, such as the International Center on Tropical Agriculture (CIAT) in Colombia, the International Center of Agricultural Research in the Dry Areas (ICARDA) in Syria, and the International Institute of Tropical Agriculture (IITA) in Nigeria, appear to be experiencing less difficulty in making the necessary changes in their research strategies than the centers working on specific crops. They, too, will need to be ready to make mid-term corrections.

As yet, none of them has made fully systematic efforts to analyze the sustainability of the agricultural systems in which they are involved taking into consideration not just economic and environmental trends but also key institutional, political, and cultural factors. This is a huge and complex task for the agricultural support services, banks, and funding institutions to undertake in concert with farmers' associations.

The centers cannot do all this alone. For one thing, they do not have the necessary funds. Nor do they yet have the political backing to generate them. But even more important, they should not try: to be effective, the greatest part of such a complex and politically sensitive effort must be carried forward by national governments and national institutions in each country. As for the international centers, they will need partners other than the national centers, which are dedicated to bringing about fundamental changes in farming methods and the way that governments support those efforts. These new partners will fill certain gaps in the centers' arsenal of skills and activities and fit a certain profile:

- They would carry out research that the centers cannot get to or should not undertake. Some of these new partners should be farm-level and nongovernmental organizations (NGOs) that could be technically strengthened to do research at the local level and—equally important—to help get the centers' own successful research to the farmers in their localities.
- They would include those who could help persuade governments to make and implement realistic, financially valid plans to solve national agricultural problems. Possible partners in this effort would be the World Bank, the regional banks, other development agencies, and policy-oriented study institutes, such as the US-based World Resources Institute. To date, however, the banks and development agencies have seldom focused on this type of strategic agricultural planning.
- They would need to be able to help farmers—especially women farmers—adapt the centers' research for use in different ecological and cultural situations. National and regional farmers' groups, international NGOs, and even socially oriented private companies could become new allies for the centers.
- They should include groups outside the usual scientific circles within which the centers operate, while sharing the centers' vision, so that they could help the centers compete for political and financial resources in a resource-scarce world.

## Needed changes

What changes deserve the greatest attention of the centers and their partners?

They should give the highest priority to integrating realistic and cost-effective methods of protecting natural resources at the farm level into more research projects. Protection and improvement of the soil must be at the heart of every project. A good model is the work that IITA of Nigeria has done in introducing soil conservation techniques into many methods of producing cassava, a crop on which 500 million people depend.

The centers must also do more to directly address the broader economic, cultural, and political issues that affect agricultural systems, as well as environmental concerns. This involves collaboration with national partners, for example, in dealing with crucial issues such as land tenure and infrastructure.

The centers must examine—individually and collectively—more closely the agricultural problems of the relatively few regions of high or potentially high productivity that are central to success in radically increasing food production (e.g., India and Pakistan's Punjab and the rice paddy systems in South Asia, South East Asia, and China). CIAT's new strategic plan to examine the overall sustainability of tropical mid-level hill areas in Latin America is a move in the right direction. But that organization should, very soon, go beyond this first step to determine where and how a substantial increase in tropical Latin American food production can be achieved.

The centers should also place a higher priority on developing "farmer-friendly," integrated pest management and integrated nutrient management techniques. The commodity-oriented centers must develop such techniques for whole agricultural systems where the crops on which their research concentrates are the principal—but not the only—crop involved. For example, the Center for Wheat and Maize Improvement, which is now doing important work on disease and insect resistant maize, should expand this to include integrated pest management research for other crops in maize-dominated systems.

The centers need to step up their efforts for protecting traditional crops and related wild varieties, whose genes may prove crucial to achieving sustainability at the high production level required. This effort is urgent and must continue to involve all the centers, not just the International Board for Plant Genetic Resources in Rome, which is specifically charged with coordinating this task.

These relatively new tasks will require the support and cooperation of persons and institutions well beyond the centers and their normal partners. The centers will need to involve themselves progressively as the key scientific players on a new kind of team designed to attack all the dimensions of agricultural sustainability and rural poverty. These efforts will certainly require more money, probably in increasingly large amounts, as this decade proceeds. Some of it will have to be released by scaling back old programs that are now of relatively lower priority. Greater emphasis must be placed on mobilizing additional financial—and political—support for the centers. Innovative techniques may need to be employed to raise additional funds.

## Special role for the Bank

The question is often asked: Why not rely more on the national agricultural research centers rather than the international centers? The answer is important: Increasing the productivity of food plants requires—and will continue to require—a broader global approach, one that is difficult for national centers to achieve. The centers are the research organizations best suited for managing such a global approach.

I do, however, believe efficient national centers that are able to adapt world agricultural advances to local needs must in time be developed in all countries and regions. To a considerable extent, the international centers can contribute, and already are contributing to the strengthening of the national centers through training and joint research. However, we must face facts. Too many national research institutions are far too weak to meet the heavy scientific requirement that their national conditions require. Building adequate scientific research capacity in these countries may take a decade or more. The World Bank, the regional banks, and some of the national aid donors are working hard to strengthen the research organizations in developing countries. The Special African Agricultural Research Fund (SPAAR), supported by the Bank and a number of countries, is an example of such an effort.

There is another special role for the World Bank. It is the only organization that has a strong enough resource base, and potentially enough political and intellectual leverage to take on the job of overall "managing director" of such an effort. It has a strong and vested interest in doing a better job in using broader agricultural planning to achieve its development objectives.

Admittedly, the Bank will have to make some major changes in its policies and operating style if it is to take on such a broad responsibility. But under its new leadership, the Bank looks like it is ready to embark on new paths. As a first step, the Bank could join with the centers and a growing number of willing countries in undertaking a series of country-specific discussions on agricultural sustainability and agriculture's place in national economies.

Despite the daunting task ahead, I am encouraged by the progress that the centers have already made. Indeed, the "greening" of international agricultural research is moving into what one could call "middle gear" and forging ahead. ■

# Managing water for economic, environmental, and human health

Kenneth D. Frederick

*Large-scale water projects have been widely promoted and subsidized as catalysts for economic growth during the twentieth century. Both the economic and environmental costs of developing and diverting additional water supplies for agricultural, industrial, and municipal use have risen markedly in recent decades. This reality and the increasing competition for the economic, environmental, and human health services provided by water suggest that more efficient and sustainable management of existing water supplies is needed. This management must take into account the limits of and ecological processes underlying natural water systems as well as the indigenous knowledge, resources, and supply and demand conditions of individual localities.*

The capacity to control water supplies for human purposes has increased markedly during the twentieth century. But as water development has expanded, the opportunities for adding to water supplies have declined, the economic and environmental costs of new supplies have risen sharply, and the threats to supplies from pollution and groundwater depletion have mounted. Demand for water has continued to grow with increases in population and incomes. Despite this rising demand and the increasing scarcity of supplies, fresh water is commonly treated as a free resource.

Some of the environmental and development goals of the United Nations Conference on Environment and Development will not be achieved without adequate incentives to conserve water and to protect the aquatic ecosystems on which future supplies depend. In the developed countries, where high-quality water is taken for granted, the challenge is to manage and use the resource efficiently and sustainably. Developing countries face the additional task of providing all of their people with the minimum supplies of high-quality water that are essential to good health and important to economic development. This task is formidable—31 percent of the people in the developing world lack access to safe drinking water, and 44 percent lack sanitation facilities. Moreover, in developing countries waterborne diseases and illnesses are responsible for diminished economic prospects as well as high mortality and morbidity rates.

## Water and economic development

Technological and scientific advances in earth moving, dam construction, pumping, and hydrology have greatly increased the capacity to control the flows of surface waters and to utilize groundwater, which is less susceptible to the vagaries of climate. Although the total quantity of water in the global hydrologic system has not been altered, the location and quality of the resource, as well as the timing of its use, have changed in both developed and developing countries.

Water projects have been viewed as catalysts for broader economic growth. In the United States, subsidized irrigation projects encouraged the settlement and development of the West. When the U.S. economy sank into a deep depression during the 1930s, water projects were an important part of the strategy for increasing employment and stimulating overall economic recovery. While the United States has developed the world's most extensive system of water projects, efforts to control and divert water for human uses have occurred worldwide. Some of the largest water projects, such as the Aswan Dam on the Nile River, are in the developing countries.

Large-scale water projects have become the accepted strategy for solving most water problems. The distinguished geographer Gilbert F. White has observed that for several decades ending in the 1960s large multipurpose dams were widely viewed as symbols of farseeing, humane management of natural resources. The rapid growth of such projects reflects this view. The number of reservoirs with a minimum storage capacity of 100 million cubic meters began to grow rapidly during the first half of this century in North America, and after 1950 in the world as a whole. From 1950 to 1985, the number of such reservoirs increased threefold and their storage capacity increased ninefold worldwide. Water diversions also rose sharply. Scientists in the former USSR have estimated that global withdrawals increased nearly fivefold between 1900 and 1980, with three-fourths of this increase occurring just within the last three decades.

While drinking is the most critical use of water for sustaining life, by far the largest use is irrigation, which accounts for about 70 percent of all water withdrawals. Agriculture is particularly sensitive to the availability of water. Reliable

**Rising water costs and high government debt burdens make it unlikely that new irrigation projects will receive the generous subsidies that have fostered the worldwide growth of irrigation to date.**

supplies are essential to the introduction of high-yield farming. Irrigation, which makes farming less susceptible to variability of precipitation, encourages yield-increasing investments and expands the area capable of supporting productive agriculture. Worldwide, the area of land irrigated increased from about 48 million hectares at the start of the twentieth century to 94 million hectares in 1950, and to 250 million hectares currently.

Generous subsidies, and institutions that ignore some of the costs associated with agricultural water use, have fostered the growth of irrigation throughout the world. However, rising water costs, high government debt burdens, increasing competition for scarce water supplies, and growing awareness of environmental problems make it less likely that new irrigation projects will benefit from such government largess and myopia. Moreover, high and rising salinity levels in water, dependence on nonrenewable groundwater stocks, and pressures to reallocate water from agriculture to other uses are forcing some previously irrigated lands out of production. In most areas of the world, further expansion of irrigation will depend largely on improved management of existing water supplies rather than on the development of additional supplies.

All irrigation water contains salts that are left behind when water is transpired by plants and evaporated from fields. If allowed to accumulate in the soil, the salts retard and eventually kill the plants. Sustainable irrigation requires application of enough water to leach the salts out of the root zone and then removal of the drainage water from beneath the field. Poor drainage leads to waterlogging, which also destroys the productivity of the land. Salinity has resulted in the abandonment of irrigation on millions of hectares of land and reduced yields on millions more. For instance, in the Aral Sea basin of the former Soviet Union, waterlogging had forced about 1 million hectares out of production by the mid-1980s, and high salt levels reduced crop yields on about 60 percent of the 7.6 million hectares irrigated in the basin.

In parts of the United States, India, and China, and in many other areas, current water use depends on nonrenewable supplies. Although the extent of groundwater supplies worldwide is unknown, groundwater use exceeds recharge on about 4 million hectares in the United States—20 percent of the total area irrigated in the United States. Depletion of the Ogallala aquifer already has contributed to the termination of irrigation on about 1 million hectares in the U.S. High Plains.

As water becomes increasingly scarce, pressures will mount to develop additional supplies and to transfer water from agriculture to other uses. Transfers are already occurring in the western United States, and the high costs of new supplies will make water marketing increasingly attractive in other places. Rising water costs are inevitable for three reasons. First, because the best sites are developed first, subsequent additions to a basin's water storage capacity are increasingly expensive. Second, storage increases a river basin's safe yield only at a diminishing rate. And at some point evaporation losses can more than offset any gains in safe yield associated with additional surface storage. Finally, the social costs of storing and diverting water for offstream use rise as streamflows are depleted.

## Water development and the environment

Water projects and water use alter the natural environment. The environmental impacts can be good and bad. For example, a reservoir creates a new environment that favors some organisms at the expense of others and replaces the esthetic and recreational benefits of a free-flowing stream with those of a lake. As

**Among other reasons increasing competition for water will make expansion of irrigation largely dependent on improved management of existing water supplies rather than on development of additional supplies.**

water use intensifies, however, the net effects are likely to be negative, particularly when water development and use proceed without adequate regard for ecological processes and for the environmental values provided by natural water systems.

These processes and values often are overlooked in plans designed to use water as a catalyst for economic development. Planners and managers routinely emphasize the positive and ignore or understate the negative impacts of water projects. For instance, reduced flooding and more reliable supplies for offstream use might be viewed as unmitigated benefits of dams and reservoirs, while any adverse impacts on the ecology of downstream areas dependent on annual flooding and silt deposition are ignored. Likewise, the negative impacts on aquatic ecosystems of withdrawing water from and returning contaminated effluents to streams or lakes are often excessively discounted.

The U.S. experience up to the passage of the Clean Water Act in 1972 illustrates how a strong development bias combined with policies that foster an illusion of unlimited supplies of inexpensive fresh water can erode the productive, recreational, and esthetic values of a nation's water resources. In the fifteen years following passage of the act, the nation has spent more than $100 billion to limit and treat industrial and municipal wastes discharged into lakes and streams. Although the act's goal of restoring all navigable water to fishable and swimmable condition has not been reached, the overall quality of these waters has improved markedly since the early 1970s. Changes in public attitudes and policies prompted by environmental concerns have altered water use and development patterns significantly. Water project construction peaked in the late 1960s, per capita water withdrawals peaked in 1975, and total withdrawals peaked in 1980.

Despite the overall improvement in water quality, many lakes and streams remain too polluted to fully support their designated uses. Nonpoint pollutants such as runoff from farms, urban areas, and construction sites are now the primary sources of pollutants reaching the nation's waters. The United States has not developed an effective strategy for curbing these pollutants. Moreover, investments to control municipal and industrial pollutants are yielding diminishing returns.

Large-scale water projects have played a prominent role in development efforts throughout the developing world in recent decades. Unfortunately, disappointing economic benefits and unanticipated environmental costs have characterized many of these projects. Thayer Scudder, an anthropologist with the California Institute of Technology, has documented how the hydroelectric potential of the river basins in tropical Africa has been developed largely for the benefit of the cities at the expense of the ecology and most of the rural people. Even when irrigation has been included as an important project objective, the resulting agricultural benefits often fail to compensate for the negative impacts on the productivity of riverine habitats that previously supported millions of people.

## Drinking water and human health

The differences between the developed and developing countries are many, but few have more impact on human welfare than the access of people to safe drinking water and adequate sanitation. Most residents of the industrialized world take for granted that virtually unlimited supplies of high-quality water can be available at the turn of a tap and that human and household wastes are removed quickly from their homes and neighborhoods. In contrast, more than 1.2 billion people in the developing world do not have access to safe drinking water supplies, and 1.7 billion do not have decent sanitation (see table, p. 24).

> Inadequate drinking water supplies and sanitation facilities can have devastating impacts on mortality and morbidity and can seriously impede economic development

Inadequate drinking water supplies and sanitation facilities can have devastating impacts on mortality, morbidity, and the economy. Water-related diseases and illnesses are responsible for the deaths of most of the 5 million children under five who die annually in Africa. Guinea worm and schistosomiasis, parasitic diseases propagated by poor sanitation and unsafe water supplies, are often painful and debilitating. Guinea worm reportedly afflicts about 20 million people in sub-Saharan Africa, India, and Pakistan. The schistosome parasite is believed to infect more than 200 million people, 20 million of whom suffer from chronic schistosomiasis. Poor sanitation and drinking water are largely responsible for the deadly cholera epidemic currently spreading through several countries in Latin America and Africa.

Economic prospects are seriously impeded by poor health conditions as well as by the countless hours that people in developing areas must spend carrying water. In western Nigeria, for instance, farmers afflicted with Guinea worm typi-

**Water and sanitation services in the developing world (millions of people)**

| | 1980 | | 1990 | |
|---|---|---|---|---|
| | Served | Not served | Served | Not served |
| Urban population | | | | |
| Water | 720 | 213 | 1,089 | 244 |
| Sanitation | 641 | 292 | 955 | 377 |
| Rural population | | | | |
| Water | 690 | 1,613 | 1,670 | 989 |
| Sanitation | 861 | 1,442 | 1,295 | 1,364 |
| Total population | | | | |
| Water | 1,411 | 1,825 | 2,758 | 1,232 |
| Sanitation | 1,502 | 1,734 | 2,250 | 1,740 |

*Source:* Adapted from Daniel A. Okun, "Meeting the Need for Water and Sanitation for Urban Populations," The Abel Wolman Distinguished Lecture, National Research Council, May 1991.



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cally loose 100 work days a year. And in villages lacking water supplies, families may spend many hours each day carrying the minimum quantities of water for drinking and domestic uses from distant and often contaminated sources.

The lack of basic water and sanitation facilities in the developing countries and their importance to human welfare and sustained development prompted the United Nations to designate the 1980s as the International Drinking Water Supply and Sanitation Decade. During that decade, global efforts extended water service to an additional 1.3 billion people and sanitation service to another 748 million in the developing world. While impressive, these results fall well short of the U.N. goal of providing clean drinking water and sanitation for all by 1990. Sanitation facilities failed even to keep pace with population growth, as the number of people lacking these services increased by 6 million during the decade. And the provision of both water and sanitation facilities lagged behind the explosive growth of urban areas, where another 31 million were without adequate water supplies and 85 million were without sanitation (see table, p. 24).

> **Among analysts, there is a growing belief that more efficient water management practices and sounder funding arrangements are required to provide water and sanitation services in the developing world.**

The largest shortfalls were in Africa, where population growth in excess of 3 percent annually and an 80 percent increase in urban population during the "water decade" overwhelmed capacity to provide water and sanitation services. The number of people without safe water rose by 20 million and those with inadequate sanitation increased by 30 million. In May 1990, delegates from 46 African nations met in Ivory Coast to develop a strategy to reverse this trend. The delegates recommended that future investments in water and sanitation be based on effective demand and recovered through user fees—a surprising outcome in view of the extreme poverty that characterizes their countries. Moreover, they supported privatization of these services as a means of promoting greater efficiency. These recommendations run counter to the tradition of providing highly subsidized water through government agencies. But they reflect a growing belief among analysts that more efficient water management practices and sounder funding arrangements are required to provide water and sanitation services to the developing world's rapidly growing population.

### Improving water management

The demands for water and the services it provides will continue to grow. In the developing areas of the world, population growth and economic development efforts suggest that domestic, industrial, and agricultural water demands will grow rapidly. In the developed countries, demands for the environmental services provided by clean streams and lakes may grow more rapidly than the demand for withdrawal uses. In most areas, allocating water for one use—whether it is for irrigating crops or preserving instream flows—will involve tradeoffs. There is no free water. Moreover, the costs of meeting new water demands are generally high relative to the prices people are accustomed to paying for water use. And these costs will rise as the demand for water increases.

Efficient and sustainable water development and use must take into account the limits of and the ecological processes underlying natural water systems. The traditional structural response to increasing water demands has often ignored these limits and processes, resulting in some unfortunate environmental and human consequences. Greater emphasis should be given to improving the management of the existing supplies and infrastructure and to allocating scarce supplies effectively among competing uses.

Two factors are fundamental to improved water management. First, because all the water resources within a basin—precipitation, runoff, water in lakes and streams, and groundwater—are interrelated, evaluation of a water project or water use should take into consideration potential impacts on the entire hydrologic system and on the ecological system of which it is an integral part. Basinwide management is particularly difficult to achieve when rivers and aquifers cross international borders, as they commonly do. Yet it is in such situations that improved management may be needed most to avoid dangerous conflicts over scarce water supplies. Second, local people must be integrated

> **Consideration of the potential impacts of water use on ecological systems, and integration of indigenous knowledge, resources, and demands into water projects are fundamental to improved water management.**

effectively into the planning, management, and maintenance processes. The failure to take adequate account of indigenous knowledge, resources, and demands underlie many of the inefficiencies and adverse environmental impacts that have plagued water projects.

Solutions to water problems can no longer ignore the need to limit use and to reallocate supplies over time in response to changing supply and demand conditions. The underpricing of water for uses such as irrigation or waste disposal reduces the quantity and quality of water available for other uses. It also dissipates an opportunity to provide funding for maintaining and building supply facilities. Similarly, locking water into particular uses regardless of the underlying supply and demand conditions becomes increasingly costly over time. Water markets and efficient pricing policies deserve a more prominent role in future water planning and management than they have been accorded in the past. ■

*Kenneth D. Frederick is a senior fellow in the Energy and Natural Resources Division at RFF.*

# Put Children First

By Jimmy Carter

IN the face of 14 million child deaths a year, at a time when drought and famine threaten the lives of 27 million people in Africa alone, the world's leading children's agency has something hopeful to say.

In a new report issued this month, UNICEF – the United Nations Children's Fund – says there has never been a better opportunity than now exists to reverse the spread of disease and hunger brought on by poverty and war. If that's true, it is important for all of us here and around the world to appreciate just how rare an opportunity that is.

In a divided world that has so long neglected its children, this represents a second chance. And in the labyrinth of international politics and diplomacy, where governments struggle to adjust to rapidly changing attitudes and events, second chances are something history has rarely afforded.

The world's leaders were painfully aware of this in the wake of World War II, when they went about building a world order based on fortifying the ideological chasm between East and West. The bitter conflict in the northern hemisphere spread quickly to the developing countries of the South, where the superpowers found willing partners in need of an economic boost.

When UNICEF changed its postwar mandate to focus on these countries in 1950, it urged the world's governments to remember that the needs of children knew no political boundaries.

Unfortunately, few government leaders listened. In the industrialized countries, humanitarian aid increasingly took a back seat to the arms race. In the developing world, where rapid decolonization led to poverty and power struggles, valuable resources went to equip armies, further slowing or even reversing social development. It may have been a cold war, but the cost of waging it was reminiscent of the bloodiest conflict.

Now, 40 years after UNICEF asked the world to put children above the differences of their parents, the cold war has thawed. Fortunately, we did not destroy each other and we have not destroyed the possibility of a better future for our children. It is once again time to consider a new world order with new priorities. Almost miraculously, we find ourselves with an unprecedented second chance.

IN its annual "State of the World's Children" report, UNICEF says essentially what it said when the Berlin Wall was still freshly painted – that nurturing our children is our best if not our only hope for truly improving our civilization.

The report points out that low-cost technologies like immunization are saving millions of lives and can potentially save millions more. It puts forth 10 propositions for a new world order. Among them: Falling military expenditures in developing countries should be linked to increased international aid, market economies should be accompanied by a commitment to social programs, gender apartheid should be opposed as strongly as the apartheid of race, and the vicious cycle of Africa's debt should finally be broken. UNICEF's report stresses "children first," in good times and in bad.

Will the world listen this time? There is reason to be hopeful. A little over a year ago, 71 heads of state – the largest gathering of world leaders ever – came to the UN for the World Summit for Children.

There they adopted specific goals for the year 2000, including a one-third reduction in children's deaths and universal access to safe water. About 100 countries will soon finalize plans of action for pursuing these goals. UNICEF says – the same number of countries that have now ratified an international treaty known as the UN "Convention on the Rights of the Child." All this activity has come in the last two years, and all of it signals a real commitment at last to make children an international priority.

The ultimate responsibility for making good on these promises, of course, rests largely with all of us as individuals. The United States will play a leadership role in any new world order, and it is time to take that role as seriously in the pursuit of human rights – including the treatment of children – as we have in transforming NATO to meet new challenges.

So far, the US has refused to ratify the "Convention on the Rights of the Child," and commitments to health care for our own children have been getting weaker, not stronger. UNICEF's report also points out that child poverty in the US has risen steadily, increasing 22 percent in the 1980s, despite a sharp drop in poverty among the elderly. The disparity reflects markedly different levels of government commitment.

With an election on the horizon, Americans should read UNICEF's report and understand how fortunate we are to be living at such a time of change, to have an opportunity to reshape global priorities. Then they should ask the candidates: Where do children fit into your vision of a new world order? And are you willing to set the example?

In 1946, these were not the questions of the day. In 1992 – if we care at all about the future of the planet – they must be.

■ *Former President Jimmy Carter is chairman of the Carter Center, Emory University, in Atlanta.*

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Commentary

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# Toward a new international safety net

THOMAS G. WEISS
LARRY MINEAR

"THE PROFOUND political upheavals of the last few years have brought us to a turning point," reports the President of the International Committee of the Red Cross, "between a past which is scarcely behind us and a future in which mankind is trying with fresh enthusiasm to redefine relationships and to rediscover human values."

The tension between the reality of suffering borne of Cold War-related civil strife and the prospect of a more humane future is nowhere more apparent than in Iraq. While last April's dramatic rescue of the Kurds saved countless lives, the death rate of Iraqi children has grown exponentially since then. Aid efforts have taken the worst chill out of an unusually cold winter, but Kurds and Shiites remain vulnerable and the economic situation of the civilian population precarious.

In retrospect, the international response to Saddam Hussein's adventurism seems, from the vantage point of war victims, less the first chapter in a new world order than yet another chapter in the old. The intervention in the Gulf and subsequent developments have, however, helped to bring several key questions into focus.

First, how can international institutions better cope with fast-paced and complex emergencies?

Agencies like the United Nations High Commission for Refugees were created after World War II primarily to help those fleeing communist regimes. But human migration today defies familiar categories. Most of the needy half-million-plus persons who last year fled the former Eastern bloc do not meet the traditional definition of refugees.

Second, how can the world more effectively aid and protect vulnerable people within the borders of countries whose governments impede access? What are the limits of sovereignty in today's interconnected world?

Governments have traditionally taken a dim view of what they consider interference in their internal affairs. Yet most emergencies today involve people who, like the Kurds and Shiites, have not crossed an international border and do not enjoy the full protection of aid agencies.

Third, what should be the role of military force in assuring respect for humane values? Is coercion in the service of humanity a contradiction in terms or a way to safeguard human life?

American and other Western troops played an indispensable role in rescuing the Kurds last year, and are now airlifting supplies to the former Soviet Union. Yet some aid agencies following in their wake in Iraq find their credibility undercut by their association with military force and economic sanctions, and military troops in many situations are hardly humanitarian assets.

The United Nations Charter permits military force in support of UN objectives, a capacity underutilized during the Cold War but revived in the Gulf. The coalition forces mobilized, however, lacked accountability to the UN. Moreover, UN soldiers must normally wait in the wings until belligerents in places like Yugoslavia and Somalia agree to stop fighting.

Complex though such questions be, they are beginning to receive overdue attention. Late last year, governments agreed that the United Nations requires better humanitarian machinery. The new Secretary-General has moved with dispatch to appoint an energetic Swedish diplomat, Jan Eliasson, to take charge. The new coordinator will seek to mobilize the financial, material, and diplomatic resources of UN headquarters and in world capitals in the service of people in peril.

Sovereignty is now understood to embody humanitarian obligations. The General Assembly has encouraged international action even without a host government's request. States have given their blessing to such creative but hitherto controversial strategies as cross-border operations. Capitalizing on this more assertive humanitarian spirit, ground rules are needed to assure so that major emergencies wherever they occur receive prompt and sympathetic review.

The Security Council has belatedly agreed that the human carnage in Somalia, like last year's suffering in Iraq, threatens international peace and security. In Yugoslavia, the Secretary-General has proposed abandoning the normal practice of deploying UN soldiers only with the consent of the warring parties. The willingness of the High Commissioner for Refugees to stretch her agency's mandate to assist the million internally displaced within Yugoslavia represents another encouraging step.

Fresh thought is also being given to enhancing the military wherewithal of the United Nations. Suggestions include reinvigorating the Military Staff Committee, creating stand-by troops for rapid deployment in crises, and providing a military component for humanitarian operations.

To be sure, widespread human suffering continues unstanched in the wake of the Cold War. The world's humanitarian machinery in places like Somalia and Yugoslavia, Haiti and Liberia, often seems overwhelmed. Nevertheless, the world is beginning to get its humanitarian act together. The time is ripe to move with new vision and vigor toward a more responsive international safety net for the victims of war.

*Thomas G. Weiss and Larry Minear are codirectors of the Humanitarianism and War Project, sponsored by the Thomas J. Watson Jr. Institute for International Studies, and the Refugee Policy Group, at ...*

# An Open Letter To Mr. Boutros-Ghali

By John C. Whitehead and Edward C. Luck

AS you take the reins as United Nations secretary-general both congratulations and sympathies are in order. You face an awesome mix of opportunities and problems, none made easier by those who expect you to be a miracle worker.

Your predecessor, Javier Perez de Cuéllar, took office when the UN was at a low point and gradually rebuilt its stature. Now with the UN on an unprecedented winning streak, you carry the burden of high expectations. With the end of the cold war and the collapse of the old bipolar system, people are looking to the UN to insure a peaceful transition to a more humane world order.

Your first 100 days will set a tone and direction for your five-year tenure. You will have few military, economic, or financial resources at your disposal. But you will have the power to propose, to preach, and to persuade – powerful tools when combined with integrity, independence, and intellect. But first you must decide to be a leader as well as a mediator, to be both a Dag Hammarskjold and a Javier Perez de Cuéllar.

A good place to start would be to deliver a "state of the world" speech at the time of the unprecedented Jan. 30 Security Council meeting at the summit level. Present to the world's leaders a vision of a world in which global norms take precedence over nationalism and protectionism, based on the realities of interdependence. Challenge notions of sovereignty as inadequate to a world in which national leaders can no longer guarantee the welfare, rights, or security of their citizens, nor protect the environment without the cooperation of other countries. Assert the centrality of the UN peacemaking and peacekeeping efforts to national security in an era when no one wants to play world policeman and everyone wants others to share the burden. Ask for the resources to get the job done. Explain why in a global economy neither regional trade blocs nor a growing gap between rich and poor are in our long-term interests. Speak to the peoples of the world, not just to nations and governments, which may be as much a part of the problem as of the solution. Use the UN as your rostrum and the worldwide media as your partner.

UNTIL the UN gets its house in order, mere words will ring hollow. You have spoken of the need to restructure the organization, and key member states have called for reforms, but the momentum could be lost if you do not act quickly and decisively. There are lots of sensible proposals, but the key elements should be to (1) appoint a top manager to whom you can delegate administrative, personnel, and financial matters, (2) centralize authority and dramatically reduce the number of officials reporting to you, (3) appoint the best professionals to key posts regardless of the patronage demands of member states, and (4) shift people and resources from less important to more important tasks. Member states should consider amending the Charter to shake up the UN's ineffective economic and social structure and to broaden Security Council membership.

Along with reform, you should not shy from pressing those countries – about two-thirds of the UN's members – that are chronically negligent in paying their dues. The US, which owes about as much as everyone else combined, should be first on your list. Charging interest on late payments should get the point across. It is ironic that the UN should be on the verge of bankruptcy, with no reserves for peacekeeping or humanitarian emergencies, at the height of its effectiveness.

Your toughest job may be deciding when to say no. The UN's resources are already spread too thin. Regional organizations should be asked to carry more of the burden.

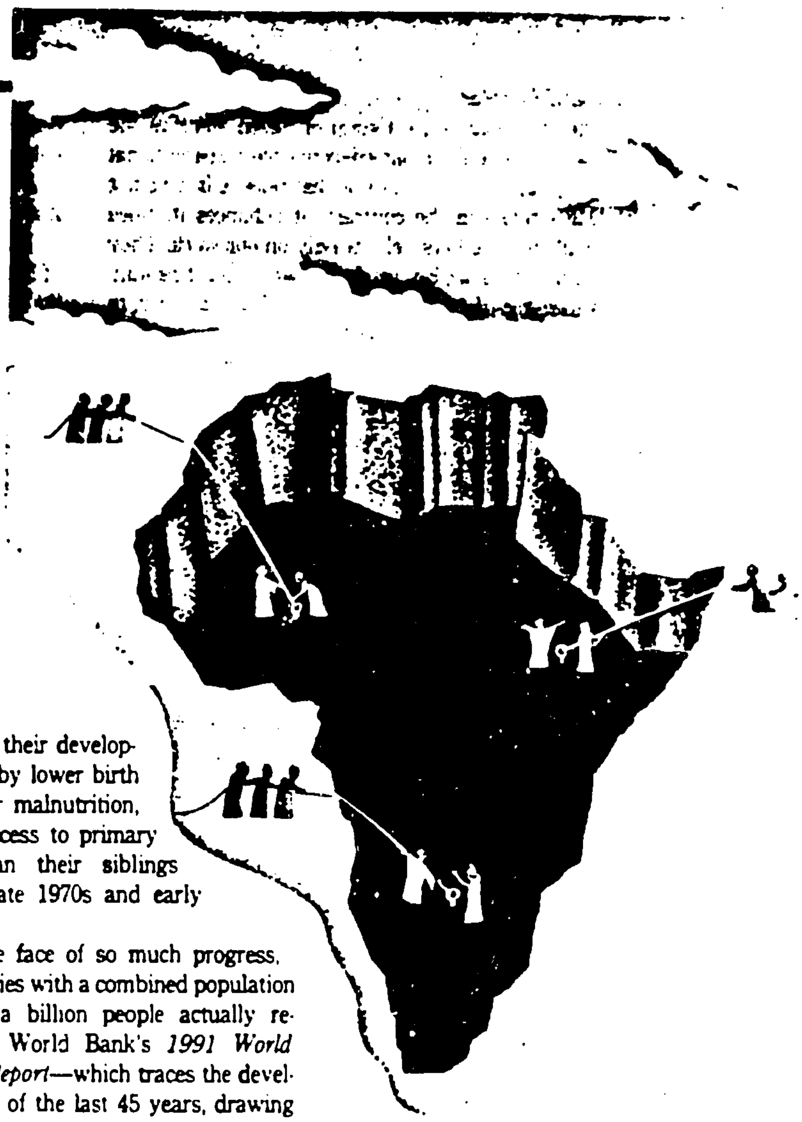
Never before has a secretary-general had so many choices. As you enunciate your priorities and vision, you can build a global constituency that cuts across national boundaries. People everywhere are ready for a far-sighted, coherent message about the changes under way in the world. You can be the messenger pointing the way to a better world order.

■ *John C. Whitehead, former Deputy Secretary of State, is chairman of the United Nations Association of the USA (UNA-USA); Edward C. Luck is president of UNA-USA.*

# The Challenges of Development

*Some lessons of history for Sub-Saharan Africa*

Lawrence H. Summers



For the developing world as a whole, the past 25 years have seen unprecedented progress:

- Per-capita income in low-income countries has nearly doubled over the last generation—growing faster than the United Kingdom during the Industrial Revolution, faster than the United States in its period of rapid growth as it came to economic maturity, and faster than Japan during its prewar growth spurt;
- Life expectancy has increased by ten years—twice the gain the United States could achieve by eliminating both cancer and heart disease; and
- Infant mortality rates have been nearly halved, child death rates have plummeted, and immunization rates have skyrocketed

But this impressive overall performance conceals an extremely uneven pattern of progress. While some countries in East Asia have seen their incomes double and then double again, 36 nations are poorer today than they were a generation ago (see table)—19 of them in Sub-Saharan Africa. One in every two Africans lives in a nation that has lost ground over the last 25 years, compared with only one in 20 Asians or one in four Latin Americans (see chart), meaning social development has stagnated or even suffered reversals. In many African countries today, children are more likely to have their development stunted by lower birth weight, higher malnutrition, and poorer access to primary education than their siblings born in the late 1970s and early 1980s

Why, in the face of so much progress, have 36 countries with a combined population of over half a billion people actually regressed? The World Bank's *1991 World Development Report*—which traces the development record of the last 45 years, drawing on a wealth of Bank research and institutional experience, including the *Long-Term Perspective Study of Sub-Saharan Africa*—provides two explanations:

- First, national development failures are the fault of national policies—they cannot be blamed on a hostile international environment, or physical limits to growth; and
- Second, national policies have failed when governments thwarted progress, supplanting markets rather than supporting them.

**Countries whose constant dollar GNP per capita was lower in 1989 than in 1965**

| AFRICA | LATIN AMERICA | ASIA |
|---|---|---|
| Benin | Argentina | Bangladesh |
| Burundi | Bolivia | Nepal |
| Chad | Chile | Pakistan |
| Ethiopia | Dominican Republic | Sri Lanka |
| Gambia | Guatemala | Syria |
| Ghana | Guyana | |
| Madagascar | Honduras | |
| Malawi | Jamaica | |
| Mauritania | Panama | |
| Niger | Peru | |
| Nigeria | Venezuela | |
| Senegal | Uruguay | |
| Somalia | | |
| Tanzania | | |
| Togo | | |
| Uganda | | |
| Zaire | | |
| Zambia | | |
| Zimbabwe | | |

Source: The World Bank.
Note: The constant dollar GNP per capita is based upon World Bank Atlas GNP per capita in dollars deflated by a US GDP deflator into 1989 dollars (1965=[illegible]). Growth rates of constant price local currency GNP per capita may differ substantially due to exchange rate changes.

## Why has development failed?

In searching for an answer to this difficult question, several reasons are often cited that seem to absolve national governments of responsibility. Perhaps the least plausible is a lack of foreign aid. Just look across continents—Africa received 8 percent of its income in foreign aid in 1989, much higher than the 1.7 percent for South Asia, 0.7 percent for East Asia, and 0.4 percent for Latin America. Eastern Europe dreams of, but does not expect to receive, 2 percent of its income in foreign assistance. True, Africa is poor so its aid share in income looks big. But Africa received four times as much assistance per person as Asia in 1989, and Africa's share of world aid has risen even as it has fallen further behind.

What about terms of trade? Terms of trade have turned against some commodity exporters in recent years, and many are on the list of countries that have regressed. But this can hardly explain why some countries succeeded while others failed. A comparison is telling. In 1965, Thailand was poorer than Ghana, Uganda, and Niger, and even as late as 1970, was more dependent on commodity exports than Kenya or Côte d'Ivoire. Yet today, Thailand is emerging as a newly industrialized economy, with manufactures accounting for more than half of exports.

Despite all the complaints about declining terms of trade, African countries have not fared well in maintaining their share of the market. From 1970 to 1986, Ghana's share of cocoa exports slipped from 29 percent to 8 percent, Uganda's share of coffee exports fell by almost 50 percent, and Sudan's share of cotton exports dropped by more than half. If Africa had simply managed to maintain its share, it would have enjoyed an additional $10 billion in export revenues—a figure approaching its total foreign aid receipts.

What about debt? Africa's debt burden is crushing, and there is no realistic prospect of the debts being repaid. But those burdens are a consequence, not a cause, of the miserable return that has been earned on the investments that debt financed. In 1980, the ratio of debt to GNP was 49 percent in South Korea and 28 percent in Indonesia, compared to 9 percent in Nigeria, 29 percent in Ghana, 33 percent in Zaire and 50 percent in Tanzania and Kenya. Debt did not stop these two Asian countries from prospering, and it need not have stopped any African nation. Of course, what is past is past, and as shall be indicated later on, there is a compelling case for debt reduction when and if countries undertake serious reforms in their policy environment.

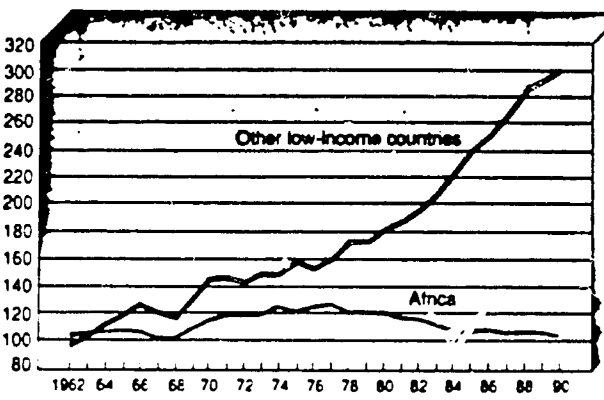
Finally, what about inherent absolute physical limitations on nations' ability to provide for growth? In some cases of regress, Argentina for example, this clearly does not apply. Nor is it very persuasive in Africa. Agricultural yields per hectare have more than doubled over the last 30 years in the developing world, but they have risen by less than 30 percent in Africa. There is no question that with proper incentives for farmers and adequate infrastructures, Africa could greatly expand its food output.

## Policies that work

Where then can we turn for guidance? Certainly, there is one simple but often neglected lesson: War stops development. Almost all of the 36 countries that have lost ground over the last 25 years have been involved in a substantial military conflict. The Middle East is often thought of as the world's tinderbox; yet relative to population, Africans have three times as high a war fatality rate. In the last 30 years, wars have claimed nearly seven million victims, either directly or indirectly, by making the provision of food and basic social services difficult or impossible. Today, post-Cold War, the threat of "hot" war in Africa persists. Sub-Saharan African governments spend four times as much on the military as on health, and equal amounts on the military and education. By contrast, in East Asia, spending on both health and education far exceeds military outlays.

But what else does the development record have to offer? A review of the successes and failures suggests four key lessons about government policies. In essence governments that fail do too much and do it badly; successful governments do less and do it better.

Africa left behind
GNP per capita
(1960=100)



Source: The World Bank

***Sound macroeconomic policies with sustainable fiscal deficits and realistic exchange rates are a prerequisite to progress.*** Large government budget deficits absorb domestic saving and foreign funds that could otherwise be channeled to the private sector. They crowd out more productive investments, frequently placing the financial system under great strain. Often they induce rapid inflation, which exacerbates the deficit, creating a vicious cycle. Deficits also lead to overvalued exchange rates, thereby stifling exports, damaging domestic producers, and creating pressures for protectionism. Look at Zaire and Thailand in the late 1980s. Thailand enjoyed stable rapid growth with low deficits, while Zaire suffered large deficits and bore the consequences in terms of lost export competitiveness, reduced private investment, and slow growth.

If persistent government budget deficits are the surest route to economic failure, an artificially overvalued exchange rate must be the runner up. Overvaluation leads to the rationing of foreign exchange, which historically means that those in government and their friends skim off large rents. It creates pressure for layer after layer of controls on imports, capital flows, and even travel. It also destroys emerging export industries, perhaps the most important foundation for growth.

There is an easy and reliable way to identify unrealistic exchange rate policies: compare the official rate with the parallel market rate. Studies demonstrate that when the spread is wide, growth slows, returns on investment decline, and the prospect of financial crisis and capital flight increases. That a strong currency makes for a strong economy is a particularly damaging myth. The Asian success stories were all built around the export growth created by low, realistic, real exchange rates. In 1970, Indonesia's manufactured exports in 1970 were less than Nigeria's and are now 36 times as large, and Malaysia's were three and a half times Kenya's and are now 52 times bigger.

***A permissive rather than a prohibitive policy environment is essential for the private sector.*** The great debate over economic systems is now over. Almost no one disagrees that communism is the longest way from capitalism to capitalism. For all their faults, competitive markets are the best way man has yet found to get goods and services produced efficiently.

What does creating a permissive environment for the private sector entail? One thing it means is avoiding government monopolies or punitive regulations. The tremendous success of the Nigerians in abolishing agricultural marketing boards and moving toward a realistic exchange rate is clear. Output of a number of key export crops, including cocoa, has increased by more than 50 percent since low points reached in the mid-1980s. Indeed, the production of both rubber and cotton has quadrupled since 1986; soybean production and processing has risen even more.

A permissive environment also means allowing market forces to determine prices without price controls or large subsidies. Fertilizer policies in many African countries exemplify what is wrong with price controls—the resulting rationing implies that some well-connected farmers secure large amounts of fertilizer at low cost, while those less well-connected find fertilizer less available and more expensive.

Finally, a permissive environment is one where government seeks to reduce rather than increase the cost of doing business. That means lowering tariffs and quotas on crucial intermediate and capital goods. According to a recent study, investment costs are 50 percent higher in Africa than in South Asia, and this is just the cost of capital goods, with no account taken of the additional costs caused by the inefficient provision of infrastructure. The need for business to maintain their own capacity for generating electricity is an example.

***Government has no business attempting to directly manage the production of private goods and services.*** Around the world, the record of public enterprise management is one of disaster. While it may be true in theory that a properly managed public enterprise can be as productive and efficient as a private one, the reality is that politics, usually of a virulent nature, intrudes, and efficiency is sacrificed. Public enterprise managers are rarely permitted to shed labor to produce at minimum cost. Moreover, procurement is often treated as a way of enriching contractors and procurement officers.

Nigeria appears to provide almost a textbook example of what can go wrong when the government gets directly into the business of producing goods and services. Between 1973 and 1990, the Nigerian public sector invested $115 billion, just about $1,000 for every citizen. Yet there is no growth to show for this investment. Why? Most of the investment was greatly overpriced for "non-commercial" reasons. In addition, most public sector assets are operating at capacity utilization of less than 40 percent. This is not to mention the $3 billion Ajaokuta Steel complex, which, after another $1 billion to complete, will then lose money even on a sunk cost basis.

It does not have to be this way. Look at the difference between oil refineries run by private firms and those that are public. Look at the difference between hotels maintained privately and publicly. Relying on the private sector to undertake major investments, Nigeria could have achieved the same output with up to $80 billion less investment over the last 18 years since the oil boom.

***No country has ever developed without adequate provision of basic investment in infrastructure and in people.*** Governments that spread themselves too thin inevitably find themselves neglecting the tasks that only they can perform. Experience suggests that governments that stay out of the production business, as did many in East Asia, provide more effectively for schooling and health care and create better infrastructure foundations for private business.

Small amounts of public investment in key sectors, such as agriculture, can make a huge difference. For example, small-scale, relatively cheap irrigation schemes and the basic tasks of agricultural research and extension are neglected, while large outlays are allocated for fertilizer subsidies in many countries. Similarly, a classic pattern is overinvestment in new physical facilities and underinvestment in repair and maintenance.

Human investments are especially important. The two greatest threats to Africa's future are the investments that are being neglected in primary education and in food security. A child born in Mali, Niger, or Burkina Faso today is more likely to be malnourished while under five than to go to primary school on reaching six, and in at least 16 African countries, a child is more likely to die before the age of five than to attend secondary school. Ironically, the public sector workforce is often neglected even as employment expands. Teachers' real wages fell by two thirds over the last 15 years in Nigeria and by 13 percent in eastern and southern Africa from 1980 to 1985. It is hardly surprising that education deteriorates. In nations where the quality of education and health care are rising, the salaries of teachers and nurses are increasing as well.

*The two greatest threats to Africa's future are the investments that are being neglected in primary education and in food security.*

## The case for adjustment

These four principles underlie the adjustment programs that the Bank now supports—and has supported—in many African countries. They reject the heavy-handed government policies of the past, instead looking to governments to provide necessary basic services and positive support to the market. Tanzania's plight in the 1980s had as much to do with a decline in the provision of public services as with the mess policies had made of resource allocation in the production of private goods. Reform of public sector management and expansion of physical and social infrastructure will be essential to success. This can only occur, however, if growth takes off in goods production, which depends in turn upon an enabling environment for the private sector—a tough recipe to fill.

As a Ghanaian official recently put it: "We need two legs to walk on—a strong and effective state and a strong private sector; we have neither and are not likely to have either any time soon. We are like a cripple I saw recently with no legs, pushing himself around on a crude board with wheels, surviving only by begging and trying to look sympathetic to the potential alms giver."

Some critics allege, however, that the adjustment programs lack a human face. There is no question that Africa's crisis has produced welfare declines—incomes have fallen and amongst African countries forced to cut overall spending, real social spending per head decreased 26 percent between 1980 and 1985. But this reduction was largely forced by the overall drop in national income and the necessity to deal with unsustainable budget deficits. Governments actually went some way to protect social spending, which rose from 23 to 26 percent of total non-interest spending for this group. Yet undoubtedly, more needs to be done.

In the course of the 1980s, the Bank has paid increasing attention to this issue, emphasizing improved social service delivery and the protection of education and health spending, especially at the primary levels. A third of adjustment loans involved conditional social sector spending in 1989-90, up sharply from only 7 percent in the first half of the decade. Yet social sector improvement is only possible if governments have the political courage to come down on weak programs rather than weak claimants.

Some critics also assert that devaluation or the elimination of subsidies further impoverishes the poor. This is a misconception. Subsidies and exchange controls redistribute purchasing power—they do not create it. Prior to reform, the poor in countries like Mozambique or Tanzania often received the worst of both worlds, purchasing goods at high parallel market prices, while selling their own produce at depressed official prices. When markets were (partially) liberalized in Tanzania, rural welfare improved immensely, simply because goods became available again. While it is true that urban wages have declined drastically in many countries, the primary reason was the collapse of urban labor demand as attempts to pursue inefficiently capital-intensive and public sector-led growth fell apart. Where adjustment has been consistently pursued and growth is coming back, as in Ghana, urban wages have begun to recover as well.

Finally, some critics assert that trade liberalization does not work, because either local producers will not respond or foreign markets will be closed. At least in the case of Africa, the idea that closed foreign markets inhibit exports is not tenable. Africa's share in worldwide exports has plummeted over the last two decades, while East Asian countries have increased their share in commodity and non-commodity markets. In the 1980s, even large developing countries such as China and Mexico sharply boosted their shares of world markets. Because of poor infrastructure and weaker market institutions, supply responses will sometimes be slower in Africa, but evidence demonstrates that producers do respond when given the proper incentives and the tools to work with. Indeed, Tanzania's urban informal sector is estimated to have tripled in size since the mid-1980s.

## Some final thoughts . . .

Nations control their own economic destiny. But this is not to deny that the developed world has a continuing obligation to Africa. At a minimum, it is high time that as African governments act to provide a sensible framework for private production and cut wasteful spending, major creditors respond by negotiating substantial reductions in debt service.

For most of the 1980s, both private and official creditors pretended that African countries could service their debt and rescheduling was the order of the day. With low-income African nations only making 42 percent of their scheduled payments this year and Côte d'Ivoire's private debt trading at 5 percent of its face value, this is clearly untenable. Even with export-promoting policies, the only good chance most African countries have of achieving a sustainable balance of payments position in the 1990s is through a large reduction in private and official debt (the latter, on Trinidad terms, for example) and higher aid flows. This only makes sense, however, if the resources are likely to be used wisely, not squandered on inappropriate industries, unnecessary public spending, or in support of overvalued exchange rates.

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There are widespread fears that with the focus of foreign aid donors' attention turning to the former Soviet bloc, Africa will be marginalized. But these fears are overdone. For instance, the Bank is lending less as an institution than it could be. Much greater is the risk that an impatient world will stop aid to help those who are not seen to help themselves. Foreign private capital is unlikely to flow to countries that cannot even succeed in attracting their own citizen's capital. Moreover, government aid to Africa is threatened by the perception that too many African governments are "kleptocracies."

Can the next two decades be better than the last two? If African nations learn from worldwide experience and put into action the above-mentioned principles, there is no reason why living standards in Africa cannot double over the next generation. But there is one lesson to keep in mind. Takeoff takes longer than one expects but then happens faster than one expects. Who could have expected even five years ago that Mexico would today be wrestling with the problem of how to manage capital inflows from the United States?

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Five years after the adoption of the UN's ambitious Programme of Action for African Economic Recovery and Development, the result is a worsening of economic and social conditions and a gloomy outlook for the future. While the continent made progress toward democratization, it did not do enough to liberalize its economies. The Africans, for their part, maintain that the donor community reneged on its commitment to increase aid, with net inflows actually declining 5 percent from 1986 to 1990.

By ANNE SHEPHERD

If the last decade proved rough on African countries, the present might be even worse. That, at any rate, is the gloomy message that permeated the recent review of the United Nations Programme of Action for African Economic Recovery and Development (UNPAAERD) in New York.

The program—unique in UN history for its focus on just one region of the world—was adopted at a special session of the General Assembly in 1986 to find ways of overcoming the severe crisis facing most African countries.

But, according to the UN secretary general's final review and appraisal of the implementation of UNPAAERD, "Despite Africa's broad range of initiatives and notable progress toward democratization, economic and social conditions actually worsened" during the five year period. Overcoming the "persistent, decade long crisis in Africa" presents "the greatest development challenge of our time," the report declared.

Yet, during a two week debate by an ad hoc committee in the General Assembly on Africa's plight on September 3-13, donors rejected specific targets suggested by the secretary general for increased aid, debt relief, and a fund to diversify Africa's commodity exports. Even the watered down version of the somewhat inappropriately named "New Agenda for the Development of Africa in the 1990s" met resistance in the General Assembly with the US insisting on a rewording of key sections.

"Western governments have hardened themselves vis à vis the specific problems of Africa," charged one African negotiator. "We are up against a brick wall."

"Africa has got to get used to two things," added a UN Africa specialist. "First, resources will be hard to come by in the next decade. Second, they will have to give a lot in return for whatever resources they get." At a time when the continent needs help more than ever before, he noted, "Africa will increasingly have to rely on itself."

According to the secretary general's report, during the UNPAAERD period GDP growth averaged a mere 2.3 percent, well below the rate of population growth. As a result, GDP per capita fell by an average of 0.5



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# THE LOST DECADE

debate on the draft "new agenda" for Africa."

"While the Nordic countries had achieved the [illegible] percent target for development cooperation, the Swedish delegate noted that external assistance was of limited value without correlated changes on the African domestic scene.

Despite economic reform measures being taken by African governments, he maintained, greater efforts needed to be made to liberalize economies, open up free trade, remove general subsidies that were not focused on the poorest parts of the population, and encourage the development of a thriving private sector. Trade with and investment in Africa, he charged, continue to be impeded by a "plethora of red tape and bureaucratic fences."

"It has not been a lost decade for others, so why should it be a lost decade for Africa?" asked a senior U.S. official who has been involved in the negotiations. "We are willing to accept our obligations, to accept the necessity for more assistance, in fact all they want, but within the context that African countries have the prime responsibility for their own development."

The same official conceded, however, that developments in Eastern Europe—or the "prodigal son phenomenon," as he put it—have had a profound effect on Western attitudes toward Africa and explained in part the West's tough line. Asked recently by an African diplomat when Africa would become fashionable in the West, the U.S. official responded: "Africa had its chance in the 1960s, but they threw it away."

That the West is hardly likely to come to Africa's rescue in its greatest hour of need is underscored by the outturn of the UNPAAERD review. In his report, the UN secretary-general put it to donors that to double the continent's annual per capita income to the modest sum of $700, Africa would have to achieve a GDP growth rate of 6 percent per annum over the next 21 years.

This, the report said, would require a [illegible] of the historic "[illegible]" between [illegible] countries [illegible] of specific targets with regard to aid, debt, and commodity prices.

Rejecting the [illegible] "[illegible] pact" approach, the U.S. and more conservative donors, not wishing to cede the political leverage associated with aid, argued for a case-by-case approach. Agreement on the new agenda in the General Assembly was further held up by U.S. insistence that wording in the original ad hoc committee document, which refers to the continent's commitment to democratization, be made more specific by referring to the link between improved governance and accountability and successful long-term development.

In his report, the UN secretary-general estimated that to achieve a 6 percent growth rate, Africa would require $30 billion in net official development assistance by 1992, to increase on a cumulative basis at 4 percent per annum to the year 2000.

In the new agenda, external partners committed themselves to "provide additional resource flows to Africa that will complement domestic efforts and financial resources," without putting a figure to this support.

"Even more important than aid flows," the report went on to say, "is the need for a bold attempt to tackle Africa's debt problem." Citing the recent cancellation by the U.S. of $[illegible] billion of Egypt's debt and forgiveness of 70 percent of Poland's debt as examples of measures that can be taken given the political will, the secretary-general proposed a cancellation of all official bilateral debt and semi-official exports credits, substantial reduction through donor financing of debt owed to multilateral institutions (which accounts for 40 percent of the continent's debt servicing obligations), and writing down of private commercial debt through donor-funded equity and environment swaps.

The draft new agenda presented by the ad hoc committee to the General Assembly, citing the Group of 7 London summit in July, made reference to [illegible] debt [illegible] going well beyond the relief granted under Toronto terms" (which involve a one-third [illegible] of official debt).

Yet [illegible] the U.S. was arguing that this paragraph be [illegible] the [illegible] W[illegible] regard to debt [illegible] "on the need for adding [illegible] debt relief measures, on a case-by-case basis for the poorest, most indebted countries, going well beyond the relief granted under the Toronto terms."

Whatever wording is finally agreed, the unlikelihood that the targets set by the secretary-general will become a reality is underscored by the difficulties being faced by British Prime Minister John Major in selling his "Trinidad terms" (which involve a once-off two-thirds cancellation of official debt) to other industrialized countries. After failing to get a concrete response during the G7 summit in London in July, Major announced at the Commonwealth heads of government summit in Harare recently that if he can't carry others with him, Britain will move alone.

The new agenda is similarly vague on the other debt proposals, promising, for example, no more than "serious consideration" to reducing the burden of debt owed to multilateral financial institutions. It also goes no further than to authorize a feasibility study on an African Diversification Fund, postponing one of the report's most original and pressing suggestions.

For beleaguered African governments, the clear message is that, as Nigeria's ambassador to the U.N., Ibrahim Gambari, put it in a speech on behalf of the Organization of African Unity, "our salvation is fully in our hands."

Yet even more so than the countries of Eastern Europe, argues the U.S. expert who has been closely associated with UNPAAERD, Africa needs a [illegible]. Right now, he says, the outlook is grim. My worst fear is that a lot of the new democracies [illegible] will find themselves [illegible] to [illegible].

**Economic Policies for a New South Africa**

**Edited by Desmond Lachman and Kenneth Bercuson with a staff team comprising Daudi Ballali, Robert Corker, Charalambos Christofides, and James Wein**

IMF, January 1992

# I Overview and Summary

This study focuses primarily on the redistributive and growth policies that will be needed in a new South Africa, on the budget options available to effect such policies, and on the opportunities for outward-looking policies in the external sector that would result from the eventual elimination of trade and financial sanctions. The remainder of this introductory chapter provides a brief overview of the ensuing chapters and indicates the main conclusions that are to be drawn.

The *poverty profile* of South Africa (Chapter II) highlights the contrast between the first-world living standards enjoyed overwhelmingly by the white minority and the third-world conditions of poverty in which the majority of the black population lives. It also illustrates how the reduction of economic growth in the 1980s, which accompanied international financial sanctions and increased domestic uncertainty, resulted in a slowing of the earlier trend toward a more equal distribution of income and led to a sharp rise in the proportion of the black labor force outside the formal sector of the economy, to its present level of over 40 percent. The main conclusion to be drawn is that poverty in South Africa is so severe that redistribution policies, which alone will not be adequate to counter it, must be supported by policies designed to place the economy on a higher growth path. Only then could the economy be expected to generate the resources necessary to satisfy the needs of the least privileged sectors of society on a sustained basis.

The *production function analysis of the effects of apartheid on income distribution* (Chapter III) concludes that the narrowing in the "wedge" between white and nonwhite wages for jobs in similar skill categories was largely responsible for the improvement of the nonwhite income share over the past two decades. For purposes of policymaking, this finding suggests that future improvements in income distribution between races will need to derive mainly from better training and better employment opportunities for nonwhites rather than from a further compression of the wedge between wages for different racial groups.

The *medium-term economic scenarios* (Chapter IV) aim at determining which macroeconomic policies would be needed to foster rapid growth of output and employment. These scenarios, which were based on the estimation of a production function and the use of a savings and investment framework, suggest that if economic growth were to be raised to about 3½ percent a year—or to the minimum rate that would be required to reduce the level of unemployment given the rapid prospective growth of the labor force—the investment-to-GDP ratio would need to rise to about 27 percent from its present level of 19 percent. Such an increase in investment would need to be supported by a major domestic savings effort, particularly in public savings, even if South Africa were to again become a significant net user of external savings. The basic implication for budget policy is that if South Africa were to attain a higher growth path, the effort to redress social backlogs would need to focus on reorienting spending priorities rather than on resorting to deficit financing.

The analysis of *recent trends in budget spending* (Chapter V) in South Africa reveals that over the past several years there has been a basic shift in spending priorities toward social ends. Moreover, a comparison of South Africa's overall level of social spending with that of other countries at a similar stage of development suggests that it is relatively high by international standards, both as a percentage of GDP and as a proportion of total budget outlays. This comparison also suggests that the scope for further compressing nonsocial spending in South Africa is limited and therefore implies that social expenditures will need to be reordered if the budget is to attend to the needs of the least privileged groups of society without significant resort to deficit financing or to higher taxes.

The examination of *the per capita level of social spending by different racial groups* (Chapter V) indicates that, despite some progress in recent years, South Africa's budget still reflects very marked differences between the races. The estimates clearly suggest that equalizing spending levels at the present white level would result in an overall level of social spending dramatically beyond the capacity of the budget. Moreover, these estimates show that equalizing such spending rates at levels consistent with maintaining budget discipline would result in a substantial decline in benefit rates for nonblacks but only limited increases, from relatively low levels, in benefits for blacks. The corollary to this finding is that redistribution policies will need to be firmly supported by growth-oriented policies if the social spending gap is to be effectively bridged.

The *comparative analysis of the tax system* (Chapter VI) suggests that the overall South African tax burden and its marginal tax rates cannot be judged to be low by international standards; indeed, the tax burden on the white community appears to be relatively high even by industrial country standards. This would argue against raising tax rates in South Africa and running the risk of heightening disincentive effects. Revenue would be more effectively raised through substantially reducing tax expenditures, broadening the tax base, and changing the mix between direct and indirect taxes.

The *review of external policies* (Chapter VII), instituted since 1985 in response to the application of trade and financial sanctions, highlights South Africa's increased reliance on exchange rate and demand-management policies to effect the needed shift in its external current account balance. Moreover, the review brings out the increased impetus that sanctions have given to such inward-looking policies in South Africa as the introduction of an import surcharge, the reintroduction of a dual exchange rate, and the negotiation of a "standstill" arrangement on commercial debt. The review examines the scope for a shift toward more liberal trade and payment policies as international sanctions are eliminated.



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# Zimbabwe

## Financing Health Services

### A WORLD BANK COUNTRY STUDY

1992

**EXECUTIVE SUMMARY**

**Introduction**

i. During the nine years that have passed since independence in 1980, Zimbabwe has made impressive progress in providing health care to its population. Millions of people have for the first time gained access to basic care, and a range of cost-effective preventive health programs have been launched. The service delivery and health status figures given below attest to this rapid progress, much of it financed through an expansion of Government spending for health.

ii. But, as Zimbabwean officials widely recognize, the country is now facing a mounting crisis in the financing of health services. In the prevailing environment of severe overall fiscal constraints, there is a danger that the Government may not be able to meet fully its existing financial commitments to the health sector (salaries, medical equipment and drugs, transport, manpower development, etc.). Yet not only will all of these commitments need to be met, but Zimbabwe will have to make a number of additional investments in preventive and curative care, if the country's health objectives for the 1990s and the beginning of the next century are to be achieved. The issue of how to pay for existing and expanded future health services is therefore a real and pressing one.

iii. To deal successfully with these growing difficulties in the financing of health care, Zimbabweans generally agree that ways must be found to mobilize additional resources for use in the sector, and to obtain more 'good health' from existing expenditures. At the same time, the Government's ongoing efforts to achieve greater equity in health - both in access to care and in paying for this care - must be maintained, and even reinforced.

iv. This will require that Zimbabweans develop bold and imaginative policies and programs, and enhance their analytical and management skills in the financing of health care. It will also require a concerted and coordinated effort between the public and private sectors, including central, local, and municipal government, church missions and other NGOs, private modern and traditional practitioners, and industry.

v. This report offers a number of policy and program options that could help to resolve the crisis in financing health services in Zimbabwe. The recommended measures which are summarized below are organized into three main groupings: measures to inject additional money into the health sector (Resource Mobilization - including selective increases in user charges, greater cost-sharing between central and local government and NGOs, expansion of private insurance, and creation of a National Health Development Fund); measures to help Zimbabwe get more 'value for money' in health (Allocative and Technical Efficiency - increased budget shares for primary and preventive health care, stronger management of hospital expenditures and patient stay, etc.); and measures to develop the systems and skills needed to support stronger health financing (Management of Health Expenditures - revised budget and expenditure procedures, improved facility-based accounting skills/systems, decentralized procurement of goods and privatization of hospital services, etc.).

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# Alarm Bell for Third-World Democracies

By John A. Peeler

THE recent abortive coup in Venezuela highlights a critical challenge for world economic policy if the recent resurgence of democracy in the world is to be durable. Not only in Latin America, but in Eastern Europe and the former Soviet Union, nascent democracies have had to endure the excruciating strains of conventional austerity policies, usually under the direction of the International Monetary Fund (IMF). The misery caused by those policies is a major contributor to political instability. But this is defended as necessary to the long-run economic health of the countries involved.

There are kernels of truth in this claim. Populism, a policy of redistribution of resources in favor of the poor majority without adequate regard for the conditions for expanding production, has failed repeatedly in Latin America, bringing hyperinflation and stagnation. Stalinist central planning sought to direct the national economy from the center. But its collapse in the former communist states has been even more complete than the failure of populism in Latin America. What is left is a world in which mainstream capitalist economic policy seems the only game in town.

But this triumphal economics has its own myths that have pernicious effects. The most pervasive is the myth of "the long run" – the idea that a market unfettered by political interference will, "in the long run," work to the benefit of all. It is assumed that those who suffer from competition will catch up in the long run. But there is no way to confirm or deny this since the long run never seems to come.

A second myth is that economics is a "science." Few economists believe this. But there is still a priestly aura about consultations with economists. In today's complicated and rapidly changing world economy, economics is not a science with known, immutable laws; it is an arena for debate about choices.

A related myth is that the best economic policy is one not contaminated by politics. If economics were a science with immutable laws, it would be best to let those who understand those laws carry them out – minus ignorant politicians and citizens. This is the basic assumption of the IMF in the third world – that its economists know best what is good for a country and that any political interference with the economic prescription is harmful.

In reality IMF prescriptions, like other economic policies, are inherently political. They represent choices about the distribution of resources. To minimize barriers to trade and government intervention is just as political as

**The warning signals were evident in Venezuela since the government adopted the IMF austerity policy.**

the idea of central planning.

The free-trade, free-market, pro-privatization policies of the IMF are politically dominant in today's world. Third-world governments have no realistic choice but to adopt such policies, because not only the IMF, but the World Bank and the governments of the major economic powers demand them as signs of creditworthiness. Yet the short-term result is an impoverishment of third-world populations.

It is difficult for a democratic regime to sustain a massive deterioration in its standard of living. If people really have power over their government, as they should in a democracy, they won't sit back and take it. The warning signals were evident in Venezuela for two years, since the newly inaugurated Pérez government adopted the IMF policy. Riots and repression are daily occurrences. The attempted coup itself was popular in the poor barrios because it seemed to offer a way out of an untenable situation.

Yes, in the present international environment, President Carlos Andres Perez adopted the only response that has international support – a free-trade, free-market policy coupled with political repression of the majority. The only conceivable political justification for a democratic government acting that way would be that it is really acting in the interests of the majority. But again, that is a myth. There is no assurance that they will be better off in the long run.

Populism and revolution are alternatives to this economic crisis. But they are unviable without international economic support. If the Venezuelan plotters had come to power, they would have come to grief. They planned a nationalist, populist program rejecting the IMF model and channeling resources to the poor in order to cement a political base. In the context of the current international power structure, such a strategy would be doomed to isolation and failure. Similarly, a true social revolution that sought to eliminate capitalism entirely would be strangled. No one would support it. Witness the fate of the moderate Nicaraguan revolution.

Third-world democracies cannot escape this dilemma on their own. They can only be released by a change in the conventional global economic wisdom – mainly the economic policymakers and elites in New York, Washington, Zurich, Frankfurt, and Tokyo. There must be a recognition that if the economic risks of populism and social revolution are to be avoided, the world's economic leaders must make a political choice to promote the redistribution of resources in favor of the poor.

■ *John A. Peeler, professor of political science at Bucknell University, is author of "Latin American Democracies: Colombia, Costa Rica, Venezuela."*

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# Shock Therapy and Its Victims

. By Valtr Komarek

PRAGUE

A grave error is being made in Eastern Europe and now the former Soviet Union, one that will have enormous and dire consequences for millions of people. I am eaking of the "shock therapy" ap- oach to economic conversion that is ighly similar to the program start- last week in Russia.

Shock therapy, as defined by doz- s of Western armchair economists, lls for a thorough change-over m a command to a market econ- y in a relatively short time, gener- y two to three years. This speeded- process typically involves making currency convertible, eliminating sidies, decontrolling prices, priva- ng industry and eliminating re- ictions on imports. These steps, it believed, will set the stage for ire growth and renewal based on nd market principles after a brief ustment period.

Infortunately, shock therapy is out ouch with reality. It ignores the act of such an approach on the t educated, skilled classes of East- Europe. In Czechoslovakia, re radical reforms have been in e for a year, the outcome in 1991 a 22 percent fall-off in industrial ut, an increase in the unemploy- t rate from 2½ to 8½ percent, an tion rate of 58 percent, a 33 per- decline in domestic demand and percent shrinkage in the gross estic product. Although these ds are the consequence of 40 rs of Communist mismanage- t, their sudden intensity results n shock therapy.

urthermore, no available evi- e, statistical or anecdotal, dem- rates that these negative trends reversing. In fact, a strong case be made that they are accelerat- and are more the result of shock apy than of structural deficien- in the economy as a whole. Po- .. which began shock therapy t six months earlier than Czecho- akia, has suffered an even great- terioration.

e issue is one of time, not intent. ern European economists agree e need to establish market econ- s. The question is whether it ld be done over two years or 10.

put matters in perspective, con- that it has taken Britain more 12 years to make the transition its brand of socialism to capitalism, even under the spirited leadership of Margaret Thatcher. The privatization started in 1978 has yet to come to full fruition, major British public companies, including British Telecom, are not yet fully privatized.

Can the democracies of Eastern Europe be expected to proceed any faster? Can public enterprises be expected to withstand the rigors of international competition without the same degree of preparation Western European institutions have enjoyed?

Moreover, shock therapy ignores the basic concept of division of labor in an advanced industrialized society. Most of the people of Czechoslovakia, Poland and Russia have committed their lives to developing highly specialized skills for heavy industries. Vast numbers of these people are being asked to abandon their training and experience, and, without an adequate adjustment phase, take part in an amorphous "market" building itself up from scratch.

In Hungary, this plunge was not as painful as elsewhere in the former Soviet bloc because its economy was more geared toward agriculture and commerce. But in Czechoslovakia, whose economy is oriented toward heavy industries, this means beginning anew, without the mainstays like capital goods and steel that stabilize all modern economies. The results tear at the country's social fabric.

**It took Thatcher 12 years to privatize Britain. Eastern Europe gets two years.**

Instead, Eastern Europeans need to draw on their strengths in key manufacturing sectors, like precision instruments in Czechoslovakia, in order to join the world economy. Major industries — electronics, for example — need to be protected until they have been prepared, with the help of Western technical aid, to compete. Governments need to make sure their citizens are not cast adrift.

This approach would allow the industries time to stabilize. It would provide breathing space for the creation of a banking system able to channel domestic savings to support corporate growth based on market principles. Tax revenues could be funneled into infrastructure projects to build a hospitable environment for foreign and domestic investment, while creating jobs and tickling domestic demand in much the same way that public works like building a highway system or putting a man on the moon do in the West.

In spite of the gross inefficiencies of Communism, domestic demand in Czechoslovakia was sufficient to sustain a modicum of economic well-being in 1989. Why was it insufficient to do so in 1991? The excessive and needless damage of shock therapy is largely to blame.

Because of the plunge in buying power as newly freed prices rose and the value of the currency fell, domestic demand has dropped nearly 50 percent in real terms in the past two years. In addition, Czechoslovak trade, which had been directed toward its former Soviet bloc partners, was given no time to reorient itself westward. Finally, existing mechanisms for capital investment, mainly the various state ministries, were eliminated, resulting in a decline in investment of more than one-third.

**Crash capitalism is failing in Czechoslovakia and Poland. Is Russia next?**

Not all elements of shock therapy are misguided. For example, allowing the currency to "float" against Western currencies, as prescribed by the International Monetary Fund, is certainly a crucial early step. But taken as a whole, the radical approach largely eliminates the role of government in the economy virtually overnight. I know of no country that could withstand such a shock.

To quote Samuel Johnson, "The chief differences among men are over means, not ends." Shock therapy is untested beyond the economic laboratories of Cambridge, Mass. Its vision of the market has never been completely realized in any industrialized nation in this century, including the United States. It is a means that could bring about an awful end, particularly when one considers its current application in Russia and ex-Soviet republics, where conditions are more complicated and serious than in Eastern Europe. There, mere social implications could have geopolitical and even military overtones.

The time is at hand to rethink shock therapy. We should expand the discussions now under way with the West to address critical long-term social implications. □

Mirko Ilic

*Komarek, former Deputy e Minister of Czechoslovakia, is tor of the Forecasting Institute he Academy of Sciences in ue.*

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THE GLOBAL ECONOMY

# Venezuela: Reform Not the Culprit

By Richard Feinberg and Peter Hakim

SHOCK waves spread rapidly across Latin America when Venezuela troops stormed the presidential palace on Feb. 4 in a very nearly successful attempt to assassinate President Carlos Andres Perez. Venezuela, after all, could boast uninterrupted democratic rule since 1958, the longest stretch of any country in South America.

For the past two years, Venezuela had also enjoyed the highest rates of economic growth of any country in the Americas. Moreover, almost everyone had thought that Venezuela's Army, which spearheaded the attempted takeover of power, was securely under civilian authority. If democracy was under siege in Venezuela, it could hardly be considered safe anywhere in Latin America.

Blame for Venezuela's troubles was quickly placed on the country's economic reform program supported by the International Monetary Fund. It called for sharp cutbacks in government subsidies, for market-determined prices, and for relaxed import restrictions. Such adjustments, in the absence of strong social safety nets, worsened inequities and imposed new hardships on much of the middle class and poor. Many analysts quickly concluded that the resulting widespread anger and desperation emboldened an already restive military, unhappy with continuing cuts in its own budgets.

The argument appeared to be at least partially confirmed last week when President Perez, while pledging to sustain his economic reform program, also announced sizable reductions in petroleum and food prices, among other measures intended to ease the pain of reform.

This explanation of the Venezuela coup attempt, if it is correct, would suggest that governments cannot easily build democracy at the same time they are turning to market-based economics. It would further suggest that fragile democracies – not only in Latin America but also in Eastern Europe and the republics of the former Soviet Union – may have to choose between free politics and free markets.

But the world is not that simple – nor is Venezuela. Declining living standards and rising inequality were certainly part – but not the most important part – of the explanation for the attempted overthrow.

The fact is, every Latin American country has had to confront painful economic adjustments and harsh austerity in the past decade (in most, far more severe and prolonged than in Venezuela). Yet civilian rule has not been seriously challenged at least so far in any other of the region's major countries.

MARKET economic reforms and accompanying austerity do not automatically lead to political trouble. What is critical is the skill and sensitivity with which such programs are carried out – whether they are managed credibly and fairly and whether they inspire confidence in a nation's institutions and leaders. Politics, not economics, is the key – and in Venezuela the political leadership fell short. Pérez neglected to use his impressive leadership talents to mobilize support for his programs. He did not build broad-based coalitions among those who stood to benefit, nor was enough done to cushion the blow among those who would be adversely affected. Compounding the problem, his government appeared unwilling or unable to deal with the corruption that plagues Venezuelan politics and society.

The wrong lesson to draw from recent events in Venezuela is that democratic practice is incompatible with tough economic reform or free-market development. The right lessons, however, may be even more sobering.

First, democratic rule is not fully secure in any Latin American country. The trend toward democracy in the region and worldwide is encouraging, but it is too early to celebrate its "triumph." By themselves, elections do not guarantee democratic stability; elected governments must become more accessible, accountable, and efficient.

Second, it is also too early to celebrate the "triumph" of free markets. There is a growing consensus among economists, business leaders, and many politicians in Latin America and worldwide that market-oriented, trade-emphasizing development strategies work best to produce economic growth. To convince the wider public, economic policies must be perceived as fairly designed and fairly implemented.

Third, it must be understood that economics is not [illegible] a technical science. Economic decisions are at the heart of politics everywhere, and those [illegible] must reflect and balance [illegible] interests – material and [illegible] – of many groups. [illegible] reform [illegible] managed politically.

The bitter truth is that democratic governance and economic reforms will suffer reversals not only in Venezuela but [illegible] developing and formerly socialist nations. But that is no good reason to give up on either market economics or democratic politics – or blame the failure of one on the other.

■ *Richard Feinberg and Peter Hakim of the Inter-American Dialogue [illegible] the Monitor.*

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JOURNAL OF COMMERCE, March 27, 1992

# A Latin American Renaissance

By DOUGLAS CAMPBELL

On his first visit to Canada 30 years ago, John F. Kennedy said, "Geography has made us neighbors. History has made us friends. Economics has made us partners. And necessity has made us allies. Those whom nature has joined together let no man put asunder."

President Kennedy's words could well be applied today to Mexico, as the pending North American Free Trade Agreement could indeed create a unique partnership.

The proposed agreement, which is being negotiated by the United States, Mexico and Canada, has run into serious difficulties. The uncertainty underlying a potential agreement adds a new dimension to the evaluation of investment opportunities in Mexico.

Until 1982, Mexico pursued a protectionist, inward-oriented economic development strategy. With the exception of maquiladoras, or "twin plants," along the U.S.-Mexican border, no foreign company could own more than 49% of a Mexican company. Tariff protection created a highly inefficient industrial base. The Mexican government owned, controlled, regulated or subsidized nearly every business.

The profits from these oligopolies worsened the unequal distribution of income, with the poorest 20% of the population earning only 2% of income. The governing party, which has controlled Mexico since the 1920s, began to subsidize food, housing and health care to prevent revolution and loss of power.

Huge deficits were supported by the 1978 discovery of 61 billion barrels of oil. When the price of oil collapsed in 1982, foreign reserves were depleted and Mexico faced crisis.

Into this picture came Miguel de la Madrid, elected president of Mexico in 1982. He decided Mexico could not remain a closed society. In short order, Mexico joined the General Agreement on Tariffs and Trade, sold off 40% of government-owned corporations and reduced food, housing and health care subsidies.

Businesses became more competitive. Foreign companies were allowed to own 100% of their Mexican operations. By 1988, earnings from oil, which had accounted for 78% of the country's exports in 1982, declined to 35% of exports. A devalued peso stimulated manufacturing, which became 40% of the total gross national product. Wages and prices were frozen and inflation dropped from 160% to 24%.

Carlos Salinas de Gortari, Mr. de la Madrid's chosen successor, took office in December 1988. In May 1989, revised policy permitted direct investment by foreigners of up to $100 million with 100% foreign ownership, and without government authorization. Ford, Nissan, Volkswagen, Hewlett-Packard, Nestle and many other companies have taken advantage of this policy.

In July 1989, the Salinas administration reached a debt settlement with some 440 banks. As a result, Mexico's overall debt is down from $50 billion to about $40 billion.

Finally, privatization was accelerated. Leading companies put on the block included Cannanea, which produces 6% of the world's copper, Mexicana and Aeromexico, the two national airlines, and Telmex, the Mexican telephone company.

These and other liberalizing actions paid almost immediate dividends. The Bolsa de Valores, the best performing stock market in the world, was up 100% in 1988, 71% in 1989, 37% in 1990 and 120% in 1991. A dollar invested in the Mexican market in 1986 was equal to $16.31 on Dec. 31, 1991.

Other Latin American countries are following the Mexican model. In the early 1930s, Argentina was one of the world's seven richest countries. With 2.8 million square kilometers of fertile land, ample natural resources and a highly educated population, Argentina had all the ingredients of a developed country.

Under the Peron regime, standards of living fell more than 50%. President Carlos Menem and his finance minister, Domingo Cavallo, are now trying to compress several of the stages Mexico went through to revitalize Argentina.

In a vital move, the Argentine austral was tied to the American dollar in March 1991. This effectively eliminated inflation, which had been at a 4000% annual rate in 1989.

Mr. Menem's post-election deregulation decree abolished the detailed rules that caused Argentine inflation, spawned inefficient industry and allowed cronies to carve industry into personal cartels.

For example, most import-export regulations and taxes have been rescinded, ports must stay open 24 hours a day and custom officials may not block trade. The government proposes to privatize energy, oil, ports, roads, defense industries and petrochemicals by the end of this year. The dramatic turnaround has not been missed by the Argentine stock market, which more than tripled last year.

Unlike Mexico and Argentina, the Brazilian administration has little power in the highly fragmented Brazilian Congress. To halt the inflation they created, the nation's leaders staged sudden interventions in the economy, featuring new currencies, asset confiscations, indexation, deindexation, price freezes and exchange devaluations. Not until 1991 did leaders suspect the old formula might be right. That is, cut public spending and keep wages down and interest rates high.

Although still precarious and unpredictable, the outlook is more encouraging than before Fernando Collor, the current president, took office in 1990. Budget austerity at the federal level has been inaugurated, privatization has started, and Mr. Collor has encouraged Congress to cut civil service costs and reduce barriers to trade and foreign investment.

The Mexican example is too compelling a model to be ignored by other Latin American countries, or by long-term investors. There are still opportunities to find value in Mexico, provided investors are cautious. The same is also true in Argentina, but it probably involves making private deals with private companies and buying a piece of their equity.

Brazil will likely join its two neighbors in turning the economic corner, making its market worthy of investor attention as well.

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THE LOS ANGELES TIMES, February 7, 1992

**PERSPECTIVE ON LATIN AMERICA**

# Do-It-Yourself Recovery

**Mexico, which set off the international debt crisis, now leads in developing strategies for solvency, investment and growth.**

**By WILLIAM R. RHODES**

It was almost 10 years ago that the international debt crisis began with Mexico's disclosure that it could no longer service its external debt obligations. During the next eight years any inventory of global economic problems would include most Latin American countries.

Over the past year, however, we have seen a sea change in how the world's investors look at the region. That change is evident in the performance of Latin America's internal markets as well as in the region's access to new voluntary capital flows from international markets—both debt and equity.

Latin America, once a pariah, is now an area of great interest to investors. Mexico, Chile, Venezuela and most recently Argentina have demonstrated the ability to stick to a viable economic reform plan, including privatizations, in order to attract capital from residents and non-residents alike, achieve growth and return to the international market.

A closer look at the experiences of those countries reveals several common measures they've undertaken in order to successfully implement their programs. While not necessarily a litmus test for all developing economies, the following five elements indicate what is necessary for a government to carry out economic reform and return to the market:

—A head of state who demonstrates political will and strong leadership.

—A viable, coherent and comprehensive economic plan.

—A motivated and competent economic team that works together, not against each other.

—A belief in the plan and a shared commitment to stay the course on the part of the president, his cabinet and other senior officials.

—An integrated media program to win public acceptance of the plan.

These components are significant because they're not some kind of "wish list" put together by developed countries as a blueprint for Latin America. Rather, they represent attributes of successful programs developed by the countries' own leadership.

In looking at the individual economies, an appropriate place to begin is Mexico, which crossed its economic Rubicon in 1985 when the government of Miguel de la Madrid applied for membership in GATT (the General Agreement on Trade and Tariffs). At the same time the Mexican government began to accelerate programs to reduce the role of the public sector through privatization and the closing of a number of inefficient and money-losing state institutions.

When Carlos Salinas de Gortari succeeded De la Madrid in December 1988, he continued implementing economic reforms with a program that consisted of settling the external debt, privatizing state-run industries, moving the country to a market economy, restoring investment and growth, opening the political system and announcing a far-reaching agricultural reform package. These efforts underscored the importance of continuity in leadership in order for an economic program to be a long-term success.

**The success formula 'is derived from the experiences of the countries themselves, rather than being formulated and imposed from outside.'**

The results of the Mexican reforms are substantial and the benefits to Mexico in the world marketplace are becoming more apparent every day. Among the examples:

—The budget deficit has been reduced from 16% of gross domestic product in 1986 to 3.5% in 1990 and 1.3% in 1991. The 1991 budget would actually have been in surplus if the proceeds from current privatizations were included.

—There has also been substantial savings on financing internal debt, with government bonds called *Cetes* yielding 16% versus nearly 60% around the time the negotiations began between Mexico and its foreign commercial bank creditors in April 1989. The resultant savings from the lower interest rate is about $15 billion a year.

—Inflation is down significantly, at year-end running around 16% from a high of more than 200% in 1988.

—Economic growth reached 3.9% in 1990 and slightly more than 4% in 1991; forecasts call for roughly the same level of growth in 1992.

—Foreign investment into Mexico continues to rise, with about $10 billion of net new private investment, including portfolio investment, flowing into the country in 1991. In addition, $3 billion to $4 billion of flight capital returned to the country last year. International reserves have now risen to $18 billion.

Chile and Venezuela are also good examples of countries that have successfully implemented structural economic reforms, including privatizations, as a means of achieving sustained growth and returning to the voluntary capital markets.

Argentina's economic reform program, while not in place as long as the others, also is beginning to show results. The government has begun negotiations with its commercial bank creditors and the International Monetary Fund has announced that a new medium-term IMF loan should be in place in Argentina by March.

In conversations with the senior members of the countries' economic teams, there is clear agreement that the components of this five-point formula can lead to successful economic reform. What makes the formula even more appealing, though, is that it's derived from the experiences of the countries themselves, rather than being formulated and imposed from outside. That, I believe, is a point especially worth making when you consider the state of economic reform in other developing countries, particularly those in Eastern and Central Europe.

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U.S. AND GLOBAL MACROECONOMIC TRENDS


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WORLD BANK NEWS

Volume XI, No. 15 April 16, 1992

# Higher Rates of Economic Growth Projected For Developing Countries This Decade

Despite weak performance in 1990 and 1991, the economic outlook for developing countries in the 1990s is promising in comparison with the 1980s, according to a new World Bank report.

*Global Economic Prospects and the Developing Countries: 1992*, published April 16, says that improved policies in developing countries hold out the prospect of higher growth in this decade, even in a mixed economic environment that is likely to include slightly slower growth in the major industrial countries; lower real interest rates than in the previous decade (yet still high from a longer term perspective); an increase in real commodity prices, especially in the latter half of the decade; and scarce external finance, with access to private credit markets restricted to countries with strong creditworthiness.

Improved domestic policies in quite a few developing countries, including some of the larger ones, should offset these external factors and result in a rise in the overall growth rate to 4.9 percent in this decade, up from 3.2 percent in the 1980s, the report says.

A cornerstone of this higher growth will be better export performance, which can be aided by lowered trade barriers in industrial-country markets. A successful Uruguay Round would make a "big difference," the report declares, referring to the so far incomplete global trade negotiations. A 50 percent reduction in the trade barriers of the European Community, U.S. and Japan is estimated to raise developing country exports by over $50 billion--almost equal to the total net flow of official development assistance in 1991. Higher growth in industrial countries would also help. The report states that an annual increase in growth by one percentage point in member countries of the Organization for Economic Cooperation and Development (OECD) that is sustained over three years would raise developing country exports by $60 billion annually.


Lawrence Summers

Higher growth for developing countries through better export performance will necessarily increase exports of manufactured goods. Lower transport and telecommunications costs have stimulated the globalization of production and marketing of manufactured goods, the report observes, and several developing countries have taken advantage of their

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# Developing Countries' Per Capita Income Declined in 1990-91

PROSPECTS, *from page 1*

low labor costs and seized opportunities provided by new technology to become low-cost suppliers of these goods.

"Countries with a well educated labor force, and with open international trade and investment flows, are likely to absorb innovative production and management techniques rapidly," and these capabilities should help them successfully compete in export markets, the report says.

"If we have learned anything in the last 25 years from comparing countries that have been less successful, it is the importance of manufactured exports as a crucial engine for growth," said Lawrence Summers, World Bank Vice President and Chief Economist, at a press briefing in Washington where the report was released.

## The 1990s

The decade has not started well for developing countries. While the aggregate gross domestic product (GDP) of these countries grew by 1.9 percent in 1990 and 1991, per capita income declined in both years, the first time this has occurred since the World Bank began collecting such data in 1965.

Wars, radical political and economic change in Eastern Europe and failure to successfully implement economic reforms in some countries have combined with slow growth in the industrial nations to contribute to these results.

Even if one excludes Eastern Europe and the war-affected economies of the Gulf, the rest of the developing world experienced a slowdown that can only be compared with the past instances of major recession in the industrial countries. Meanwhile, East Asian economies continued their rapid growth, and Latin America performed substantially better in 1991 than in the previous year.

The seven largest industrial countries are expected to grow at a lower rate in the 1990s than in the 1980s--at least for the first half of the decade, after which they should equal the 2.8 percent growth achieved in the last decade.

Investment growth is expected to be weak in the first half of the decade. Short-term real interest rates in dollar terms are expected to average 3.3 percent in the 1990s, compared with 3.8 percent in the latter half of the 1980s.

But, over the next four years, the report cautions, a significant rise in rates may occur, relative to the recent cyclically depressed levels. "Traditional sources of external finance for developing countries will be scarce," the report warns and counsels that developing countries must expect to finance their domestic investment requirements largely from their own savings.

Grants and bilateral loans are expected to grow at roughly 4 percent per year over the next five years. Multilateral loans are expected to grow 9.4 percent annually. Additional demands for concessional resources from new recipients are likely in this decade, even as supplies of such funds become tighter from traditional donor nations.

### Growth of Real Per Capita Income

(average annual percentage change of real per capita GDP)

| | 1990 | 1991 | 1990-2000 |
|---|---|---|---|
| **All developing countries** | **-0.2** | **-0.2** | **2.9** |
| Sub-Saharan Africa | -2.0 | -1.0 | 0.3 |
| East Asia | 4.6 | 5.6 | 5.7 |
| South Asia | 2.6 | 1.5 | 3.1 |
| Latin America | -2.4 | 0.6 | 2.2 |
| Middle East and North Africa | -1.9 | -4.6 | 1.6 |
| Eastern Europe | -8.3 | -14.2 | 1.6 |
| **All high income countries** | **1.7** | **2.2** | **3.6** |

Note: The former Soviet Union is not included in the totals.

Commodity prices, in real terms, are expected to remain near their present low levels in the short term but should increase during the second half of the decade. Prices for commodities other than fuel are expected to rise about 15 percent in real terms after 1994, as real interest rates decline and global economic growth rates increase.

## Developing Country Prospects

The report offers projections of developing-country growth during the 1990s, warning that the projections should be interpreted with considerable caution, as they are based on a single set of global conditions.

The aggregate GDP of developing countries is expected to grow 4.9 percent per year in the 1990s, higher than the 3.2 percent growth achieved in the last decade. Reforms in trade and macroeconomic policies, initiated in the 1980s, are expected to continue, leading to increased savings and investment, and to greater efficiency in resource use.

But economic growth will vary from region to region, the report points out, with a "key uncertainty:" the performance of Eastern European nations and the former Soviet Union. "We are most optimistic about growth in East Asia and least optimistic about per capita income growth in sub-Saharan Africa," Mr. Summers said.

East Asia is unlikely to repeat its impressive economic performance of the past decade; nevertheless, it will remain the fastest growing developing region, and per capita incomes are projected to rise at a rate over 5 percent annually.

Per capita growth in real income will be small in sub-Saharan Africa, averaging 0.3 percent a year in the 1990s, but still significantly better than the decline seen in the 1980s.

Latin America's economic performance is also expected to improve sharply, based on a continued resolution of the debt crisis and on a marked shift to market-friendly policies. Per capita GDP, which shrank 0.5 percent annually in the last decade, is expected to average a positive 2.2 percent a year in this decade.

Structural reforms in the major South Asian economies will serve to keep aggregate GDP per capita growth at around 3 percent a year, near the rate achieved in the 1980s.

Peace, reconstruction and policy reforms in the countries of the Middle East and North Africa are projected to support an aggregate per capita GDP growth rate of 1.6 percent annually in this decade, compared with a decline of 2.5 percent a year in the 1980s.

The rate of export growth is expected to rise in the developing countries, from 5.8 percent in the 1980s to 7 percent in the 1990s. This expectation reflects, in part, sweeping market reforms and renewed recognition of the importance of increased integration with the global economy.

"The experience of the 1980s suggests that developing countries could considerably increase their exports in the 1990s even if industrial countries maintain their current levels of protection," the report asserts. This takes into account the rise in recent years of new forms of trade restrictions such as voluntary export restraints and direct subsidies to protect domestic industries against import competition.

Export performance for developing countries has been limited more by their own domestic policies than by constraints in industrial-country markets. Reforming these policies, as a number of countries have done, remains a "priority," the report urges, even without major reductions in industrial countries' protectionist barriers.

However, a reduction of 50 percent in the trade barriers of the European Community, the United States and Japan would raise developing-country exports by over $50 billion.

*Global Economic Prospects: 1992* is priced at $10.95. Journalists may receive a complimentary copy by writing on company letterhead to the World Bank, Publications Department, Marketing Unit, Room T-7054, Washington, D.C. 20433, U.S.A. □

WORLD BANK NEWS

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# Summers: 1992 Will Be a Difficult Year for Developing Countries

*Per capita incomes in the developing world fell in 1991 for the first time in more than 25 years. In an interview with* World Bank News, *World Bank Vice President and Chief Economist Lawrence Summers predicts that many of the events of 1991 will make 1992 another difficult period for some countries.*

**WBN: The OECD announced in late December that the world economy faces months of sluggish growth and rising unemployment. Do you agree with this prediction?**

**Summers:** This has been a difficult period for the world economy because the economic train doesn't have a strong locomotive. The current slowdown in Europe was expected as Germany deals with the strains associated with reunification and while the country takes steps to resist inflation. Meanwhile, Japan's efforts to keep prices under control are reducing economic growth in that country.

And to the surprise of most observers, including myself, the American economy has not recovered from the recession, primarily because of consumers' and businesses' reluctance to borrow. The reluctance is partially a matter of confidence and partially a matter of the large debt burdens that were incurred during the 1980s. But although the situation is bad right now, I think that the policy measures of the past year that have brought down short-term interest rates are likely to bear fruit in the form of more rapid growth at some point in the future, almost certainly by the end of 1992.

**WBN: How will the developing countries be affected by the slow growth that has continued into 1992?**

**Summers:** Slow growth in the industrialized world will be transmitted to developing countries in three major ways. Most obviously, slow growth in the industrialized countries means reduced demand for goods produced in the developing countries. Slow growth also means lower prices for commodities, which are the main source of income for many developing countries. And, slow growth means increased pressures for protectionist trade measures, including barriers to imports of products from poorer countries.

I think all three of these things will make 1992 a difficult year for the developing world. A rebound that had been anticipated

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# Difficult Year Ahead for Developing Countries, Bank VP Says

SUMMERS, from page 1

for the developing countries in 1992 was premised in part on an expectation of increased growth for the world economy. But because the world economy is not likely to grow as rapidly as anticipated, the rebound may not happen.

**WBN: If the industrialized countries fail to climb out of recession soon, will foreign aid programs be in jeopardy in 1992?**

Summers: Foreign aid is seen too often and wrongly as a luxury good. And that perception does create the danger that aid-donor nations may turn inward in 1992. I think you can already see this inward trend in the American political climate, with opposition to the Mexican free trade agreement and with recent calls for taking care of Americans first. Both the right edges and the left edges of the American political spectrum are flirting with dangerous isolationism.

**WBN: What will happen to the economies of what used to be the Soviet Union in 1992?**

Summers: It's hard to imagine a bigger economic problem than the one the countries of the former Soviet Union face in 1992. Resources are underutilized. Despite vast natural resources, petroleum reserves approaching those of the Middle East, and a pool of scientific researchers larger than those of the United States and Japan combined, hospitals are being lighted by candles, water runs black from the tap, and people are living without heat in subzero temperatures. It's clear that the visible hand of state control has broken down, and the invisible hand of the market has not yet taken hold.

The challenge for 1992 will be to get some kind of basic market system in place so that the food will get to cities, so that workers will have a reason to work, so that trade continues.

I'm encouraged by the developments of the last several weeks. There appears to be some degree of commitment to maintain trade across republics' boundaries. There appears to be a commitment by Russia to serious and real economic reform, and a

Lawrence Summers

**The end of communism creates both opportunities and dangers for the developing world.**

brave and bold team of reformers is designing the transformation program. I don't know if the reforms will work, but all these things raise the odds of success. The task will be a difficult one, and reforms are likely to proceed two steps forward and one step back, rather than moving ahead smoothly.

The countries of Eastern Europe are also going through very difficult times, but their problems are not nearly as severe as the problems confronting the countries of the former Soviet Union.

**WBN: How do you think recent events in the Soviet Union and Eastern Europe will affect the global economy in 1992?**

Summers: The end of communism creates both opportunities and dangers for the developing world. It means that much less money needs to be spent on armaments, and that will help the developing world. It means that in negotiations with the developing world, the aid-donor countries can focus more on economic strategy than on political loyalties.

The end of the Cold War means that the international community can focus more on economic and environmental challenges, and that is good for the developing world too.

But the collapse of the Soviet Union involves risks that are obviously enormous for Eastern Europe, which depended on the Soviet Union for trade and economic assistance.

The collapse could also lead to large-scale migration, which could easily change political dynamics in Western Europe. Migration of this sort is a real risk.

In general, as the old proverb has it, you don't want to be in the woods with an injured bear. I think that's the way the world should approach the new Commonwealth of Independent States in 1992.

**WBN: As all eyes are focused on Eastern Europe and the Soviet Union, is there a risk that developing countries in general and Africa in particular will face cuts in aid?**

Summers: It's too early to know. Not enough time has elapsed for it to be possible to tell whether bilateral funds slated for the new Commonwealth of Independent States and Eastern Europe will come at the expense of other foreign assistance programs.

**WBN: India has just launched a massive economic reform program. What will happen to the country in 1992?**

Summers: The benefits of India's bold reform program are already becoming visible in the form of restored private creditworthiness and increased reserves. Reform will be a long, slow process, and there are many entrenched interests, particularly in public enterprises. But if the momentum of reform continues, India could be the miracle story of the 1990s.

**WBN: What is the outlook for the major economies of Latin America?**

Summers: The situation looks brighter in Argentina than it has in decades. Real progress has been made in privatization, inflation is lower than it has been in many,

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many years, and market access has been improved. The crucial question for Argentina is whether it will restore a serious taxation system that makes possible sustainable deficit reduction. If so, I'm optimistic about its future.

I think the critical question in 1992 for Latin America--and other developing as well--will be how many countries will be able to follow in the paths of Mexico, Argentina and the East Asian countries.

**WBN: What is going to happen to the General Agreement on Tariffs and Trade? Will efforts to promote free trade die in 1992?**

**Summers:** We'll soon know what is going to happen to the Uruguay Round of trade talks. But I think that we are more likely to see in 1992 a successful completion of the Uruguay Round trade talks rather than the completion of a truly successful Uruguay Round that brings down trade barriers on a large scale.

The unfortunate truth is that even if the Uruguay Round is completed successfully, we wouldn't eliminate even the extra protectionism that built up during the 1980s in the developed world.

The world will need to find other ways of reducing trade barriers in 1992. There has been more emphasis on regional negotiations in recent years. These negotiations can have an important role to play in driving trade reform forward. ☐

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The Washington Post April 23,1992

*Hobart Rowen*

# Looking for A Locomotive

When the big names on the international financial scene gather here this weekend for a regular spring meeting of the Group of Seven industrial nations, what should they do to reassure the world that Japan's current financial sickness won't spread to the rest of the world?

What they should do and what they are likely to do are two different things.

If past is prologue for the G-7, they will echo Fed Chairman Alan Greenspan's recent bland, not-to-worry assurances. Things are under control in Japan, they will say: It's healthy that an unsustainable speculative bubble in Japanese real estate and in stocks has burst.

In a limited sense, all of that is true. But it glosses over the fact that the crash in Japanese financial markets could be a trigger for enormous economic problems in a world already beset by a capital shortage and other difficulties.

Financial markets and government bureaucracies all over the world are struggling to get answers to questions such as these:

- Does the collapse of Japan's stock market mean that the Japanese business recession will get worse this year?
- Does it mean that Japanese banks, which lent huge sums on overvalued real estate and stocks, will now retrench so dramatically that their overseas loans—especially to American customers—will be curtailed?
- Does it mean that over the long haul, this comeuppance to the Japanese economy will reduce its competitive threat to the United States?

According to analysts here and in Japan, the answers, in order, are yes, yes, and most assuredly no.

It is a mistake to think that the bursting speculative bubble in Japan is a terminal illness. The collapse of Japanese stock prices, at least in part, was deliberately precipitated by the Japanese central bank, which chose to shut off greedy speculation before it got totally out of hand.

"Indeed, the recession is fundamentally positive for Japan, for what is occurring is that the economy is being purged of many of the excesses of the 1980s," says Deutsche Bank analyst Kenneth Courtis. "In the process, Japan's economy is being once again restructured and is poised to come out of the recession still stronger and tougher than ever before."

The problem facing the G-7 is that all of the world's leading economies are in the grip of a recession that runs deeper and longer than had been forecast.

Europe, as Courtis notes, has been destabilized by the costs of German unification, which transformed Germany from a major supplier of capital into a capital importer. On top of that, the inflation-fearing Germans have boosted interest rates, causing economic pain elsewhere in Europe.

The United States, England and the Scandinavian countries are going through a recession caused by excessive consumer booms and speculation in the decade of the '80s—with high debt and weakened banking institutions.

Now comes Japan, finally paying the price for the enormous speculative boom that began after the Plaza Accord of 1985 raised the value of the yen. That result was sought by the United States as a way of choking off Japanese trade surpluses and averting highly restrictive trade legislation. Fearful that the high yen would be deflationary, the Japanese authorities flooded the nation with easy money, which helped skyrocket land and stock values.

Jeffrey Garten of the Blackstone Group Inc. notes that with the three big nations of the world—the United States, Japan and Germany—now all operating below par, there is no "locomotive for the global economy."

That casts great doubt on the International Monetary Fund's forecast for global growth of a shade under 2 percent this year and a shade over 3 percent in 1993. "There is simply no basis for these projections if we look at the behavior of the three major countries," Garten says.

"Their policies are in conflict. Germany is following a tight money policy for its own domestic reasons, and Japan is clearly headed for a period of slower growth and an easy money policy. In the United States, it is unrealistic to expect a strong American recovery when everyone else is in trouble."

In this circumstance, the G-7 should first offer a more realistic projection for 1992 and 1993 and acknowledge that a troubled period lies ahead. It could be exacerbated by potentially devastating weakness in the former Soviet states, which clearly will not have available—by a wide margin—the amount of capital that IMF Managing Director Michel Camdessus last week set as a minimum for their survival.

If G-7 cooperation is to have any meaning, the major nations will have to refocus on global concerns—rather than on narrower nationalistic goals—that motivated them from about the mid-1970s to the mid-1980s. The first priority should be pressure on Germany to lower interest rates, which would be a tonic for recovery here and in Europe.

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## SELECTED TOPICS

# U.S. Budget Projects $352 Billion Deficit; President Proposes Recovery Program

On January 29, 1992, U.S President George Bush presented to Congress his administration's budget for fiscal year 1993, which begins on October 1, 1992. The election-year budget, which projects outlays of $1.516 trillion and revenues of $1.164 trillion, will result in a deficit of $351.9 billion.

Bush's proposed tax changes are designed to spark the nation's listless economy—without adding appreciably to the ever-widening deficit. The proposals include:

- an increase of $500 in the taxpayer's personal exemption for each child;
- a first-year write-off of 15 percent for investment in new equipment;
- a reduction in the capital gains tax to 15.4 percent for assets held for more than three years;
- a deduction for so-called passive losses in real estate for those materially participating in such endeavors;
- a $2,500 nondeductible Individual Retirement Account whose earnings would be tax-free;
- a $5,000 tax credit for first-time home buyers; and
- a permanent 20 percent credit for business investment in research.

To help pay for some of these proposals, the President called for a decrease in overall defense spending to $280.9 billion from $283.8 billion currently. Actual defense spending for the fiscal year would be about $5.2 billion less than allowed under the 1990 deficit-reduction agreement between the White House and Congress. Over the next six years, defense spending would be cut an additional $42 billion below the spending plans the Administration submitted to Congress only last year. The biggest source of the spending cuts is the cancellation of the Stealth bomber, the Seawolf submarine, and other major weapons systems.

The White House presented two sets of economic assumptions in its fiscal 1993 budget—one based on passage of the President's program and the other on "business as usual." Under the former, real GDP would grow by 2.2 percent in 1992, 3.0 percent in 1993, 2.5 percent in 1994, and 2.6 percent in 1995. Under the latter scenario, growth would be 1.6 percent in 1992, 2.4 percent in 1993, 2.5 percent in 1994, and 2.6 percent in 1995.

Under Bush's program, the civilian unemployment rate is projected to be 6.9 percent in 1992, 6.5 percent in 1993, 6.1 percent in 1994 and 5.8 percent in 1995. Under the alternative scenario, the jobless rate would be 7.1 percent in 1992, 6.9 percent in 1993, 6.7 percent in 1994, and 6.3 percent in 1995. As for inflation, as measured by the GDP deflator, the Administration projects virtually no difference between the two scenarios.

### Key Elements

The key elements of the President's proposed budget, not including defense, are as follows:

***Agriculture.*** This category, which is one of the few categories that would decline each year, includes farm income supports and agricultural research and services. For fiscal 1993, $15.7 billion has been requested, down from actual outlays of $17.2 billion this year. The administration forecasts a drop to $14.5 billion in fiscal 1994 and to $12.1 billion in fiscal 1995.

***Bank Insurance and Thrift Bailout.*** This category includes deposit insurance obligations and capitalization. The cost of buying out failed institutions is far higher than was anticipated a year ago. The Administration has asked for $55.7 billion in fiscal 1993, up from actual outlays of $47.8 billion last year. This is projected to drop to $6.6 billion in fiscal 1994 and to $2.0 billion in fiscal 1995.

***Education.*** Education research and training as well as Head Start fall into this budget category. The Department of Education would receive a budget increase of 7 percent, the largest of any cabinet department. The request for fiscal 1993 is $49.6 billion, up from actual expenditures of $45.0 billion last year. The projection for fiscal 1994 is $51.5 billion and for fiscal 1995, $50.3 billion.

***Environment and Natural Resources.*** Energy regulation, public land administration, and cleanup of hazardous waste dumps fall into this category. The request for fiscal 1993 is $25.1 billion, up from actual expenditures of $24.2 billion last year. The Administration projects outlays of $25.1 billion in fiscal 1994 and $25.4 billion in fiscal 1995.

***Health:*** This is the most rapidly growing sector of the budget and includes Medicare, Medicaid, health research, health care training, and consumer and occupational health and safety. Bush asked for expenditures of $237.5 billion in fiscal 1993, up from an actual level of $213.2 billion in 1992. This amount is projected to rise to $265.7 billion in fiscal 1994 and $297.2 billion in fiscal 1995.

***Interest Payments*** The Administration assumes that, while interest rates will continue to decline, the amount of the national debt will rise over the next several years. It has estimated outlays of $214.0 billion in fiscal 1993 compared with an actual cost of $200.3 billion in fiscal 1992. This figure is projected to rise to $231.8 billion in fiscal 1994 and to $243.0 billion in fiscal 1995.

***International.*** This category includes foreign economic and military aid (including a two-year $500 million program of humanitarian aid and technical assistance for the former Soviet republics), diplomatic activities, and international financial programs. Bush's request for fiscal 1993 is $18.0 billion compared with outlays of $17.8 billion last year. The projection is for an increase to $18.6 billion in fiscal 1993 and to $18.9 billion in fiscal 1995.

***Jobless Benefits and Family Support.*** This category includes housing, food stamps, and child welfare benefits, as well as unemployment compensation. The budget assumes a jobless rate of 6.5 percent in fiscal 1993, down from 6.9 percent this year. The President has requested $199.5 billion for fiscal 1993 compared with actual outlays of

## Outlays, Revenues, and Deficits (Excluding Comprehensive Health Reform)

(billion U.S. dollars)

| Categories | 1991 Actual | 1992 Budget | 1993 Budget | 1994 Budget | 1995 Budget | 1996 Budget | 1997 Budget |
|---|---|---|---|---|---|---|---|
| *Outlays* | | | | | | | |
| Discretionary: | | | | | | | |
| Domestic | 195.4 | 216.2 | 224.7 | 229.3 | 232.2 | 236.9 | 236.8 |
| Defense: | | | | | | | |
| Department of Defense | 309.0 | 300.4 | 278.7 | 270.2 | 269.6 | 271.8 | 274.4 |
| Other Defense | 10.7 | 12.5 | 12.9 | 13.4 | 13.9 | 14.7 | 15.3 |
| **Total Defense** | **319.7** | **312.9** | **291.6** | **283.7** | **283.5** | **286.5** | **289.8** |
| International | 19.7 | 20.1 | 20.6 | 21.4 | 21.3 | 21.5 | 21.2 |
| **Total Discretionary** | **534.8** | **549.2** | **537.0** | **534.3** | **537.0** | **544.8** | **547.8** |
| Mandatory: | | | | | | | |
| Deposit insurance | 66.3 | 80.1 | 75.7 | –25.0 | –27.2 | –21.7 | –32.2 |
| Federal retirement | 75.8 | 78.3 | 81.1 | 85.6 | 88.7 | 91.2 | 96.4 |
| Means-tested entitlements | 62.6 | 74.8 | 77.4 | 82.5 | 87.5 | 89.4 | 95.5 |
| Medicaid | 52.5 | 72.5 | 84.5 | 98.2 | 113.7 | 131.1 | 150.7 |
| Medicare | 102.0 | 116.0 | 126.5 | 140.1 | 156.0 | 176.2 | 197.7 |
| Social Security | 266.8 | 284.3 | 299.7 | 315.1 | 330.8 | 347.4 | 364.8 |
| Unemployment insurance | 25.3 | 32.0 | 25.6 | 25.0 | 24.7 | 24.3 | 24.6 |
| Other | –55.7 | –10.9 | –4.6 | –12.0 | –17.8 | –28.2 | –24.9 |
| Subtotal Mandatory | 593.7 | 727.2 | 765.9 | 709.5 | 756.3 | 809.6 | 872.6 |
| Net Interest | 194.5 | 198.8 | 213.8 | 231.0 | 242.2 | 253.0 | 263.2 |
| **Total Outlays** | **1,323.0** | **1,475.1** | **1,516.7** | **1,474.8** | **1,535.5** | **1,607.5** | **1,683.6** |
| Revenues | 1,054.3 | 1,075.7 | 1,164.8 | 1,263.4 | 1,343.5 | 1,427.5 | 1,501.8 |
| Deficit | –268.7 | –399.4 | –351.9 | –211.4 | –192.1 | –180.0 | –181.8 |
| Deficit/surplus (excluding interest) | –74.2 | –200.6 | –138.1 | 19.6 | 50.1 | 73.0 | 81.4 |
| Deficit/surplus (excluding deposit insurance and interest) | –7.9 | –120.5 | –62.4 | –5.5 | 22.9 | 51.3 | 49.3 |
| **Memorandum** | | | | | | | |
| Deficit on an accrual basis | –268.7 | –365.2 | –332.7 | –242.8 | –217.8 | –193.7 | –203.3 |
| Social security (included above): | | | | | | | |
| Operating Surplus | 53.5 | 50.2 | 63.4 | 75.9 | 86.9 | 101.1 | 115.0 |
| Interest | 20.2 | 23.9 | 27.0 | 31.1 | 35.7 | 41.1 | 47.4 |
| **Total** | **73.7** | **74.1** | **90.4** | **107.0** | **122.6** | **142.2** | **162.4** |

Data: Budget of the U.S. Government, Fiscal Year 1993



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$196.0 billion in fiscal 1992. This figure is projected to rise to $206.4 billion in fiscal 1994 and to $216.7 billion in fiscal 1995.

***Justice***. Law enforcement, immigration and customs, the drug war, and courts and prisons fall under this rubric. The request is for $15.4 billion for fiscal 1993, up from actual outlays of $14.1 billion last year. The forecast is for a budget of $16.0 billion in fiscal 1994 and $15.7 billion in fiscal 1995.

***Science and Technology***. This category covers the space station and the National Science Foundation. The President has requested $17.0 billion for fiscal 1993 compared with actual outlays of $16.4 billion in fiscal 1992. The projection is for an increase to $18.1 billion in fiscal 1993 and to $18.4 billion the following year.

***Social Security***. Pledging not to reduce benefits, Bush called for outlays of $302.3 billion in fiscal 1993 compared with actual outlays of $286.7 billion in fiscal 1992. The total is projected to rise to $317.7 billion in fiscal 1994 and to $333.4 billion in fiscal 1995.

***Transportation***. The budget proposes cuts in mass transit and increased outlays for highways. The President has asked for $35.1 billion in fiscal 1993 compared with actual outlays of $34.0 billion last year. The projection for fiscal 1994 is $36.7 billion and for fiscal 1995, $37.0 billion.

***Veterans***. About half the money is earmarked for pensions and the rest mostly for health care. The Administration is requesting $34.3 billion for fiscal 1993, up from actual outlays of $33.8 billion last year. It projects outlays of $36.2 billion in fiscal 1994 and $35.9 the following year.

The President's proposed budget now goes to Congress, which is likely to alter substantially his tax proposals.

Gerald R. Rosen,
Editor, *IMF Survey*

# WASHINGTON UPDATE

**Policy and Politics in Brief**

# WILL IT BE A BUDGET TO RUN WITH?

**BY LAWRENCE J. HAAS**

President Bush's fiscal 1993 budget seems designed to maintain control of the soaring deficit while still appealing to Republican conservatives who have urged a bold, and presumably expensive, anti-recession strategy.

Bush included some high-profile proposals, particularly on the tax side, in his $1.5 trillion blueprint. The President, nevertheless, continued to adhere to the tight rules of the 1990 budget deal.

A question now is, will "deficit hawks" and right-wing conservatives both embrace Bush's budget? Or will one side turn away because of compromises made to the other?

The centerpiece of the White House's tax agenda is a proposal to raise the personal exemption by $500 per child. That measure accounts for nearly all of the $24 billion in revenue losses over five years from his tax measures. Also controversial will be Bush's plan to cut the top tax rate on long-term capital gains to 15.4 per cent (from the current 28 per cent top rate), rather than the 19.6 per cent he has pushed before.

On the spending side, the President is seeking increases in education, children's programs, antidrug efforts and research and development designed to increase the nation's long-term productivity; deep defense cuts; a freeze on total domestic discretionary spending, including the termination of 246 programs; and a 4 per cent cut in people on the federal payroll.

Also included are new ideas about controlling spending on entitlements; a call to enact nonmoney proposals, such as the President's energy bill, that have stalled on Capitol Hill; and Bush's promise to unveil a broad health care reform package in February. Originally, the budget had included some details of Bush's coming health care proposal, but opposition from key GOP lawmakers prompted the White House to order them deleted.

The Administration projects that the deficit, expected to reach $399 billion in 1992, will fall to $352 billion in 1993 and then to $211 billion in 1994 before settling near $180 billion through 1997. *(See table, this page.)*

Assuming that Bush's program is fully implemented, the Administration projects that the economy will grow 1.5 per cent in 1992 and about 3 per cent for each of five years thereafter. Inflation will drop to 3 per cent in 1992, then hover around 3.2 per cent, according to the President's numbers crunchers. Unemployment will average 6.9 per cent in 1992 and gradually drop to 5.3 per cent by 1997.

For weeks, Bush has been pulled in two directions within Republican circles: On one side are Office of Management and Budget (OMB) director Richard G. Darman, Treasury Secretary Nicholas F. Brady and such lawmakers as Willis D. Gradison Jr. of Ohio, the House Budget Committee's senior Republican, all stressing long-term deficit reduction. On the other side are right-wing Members of Congress who seek deep personal and corporate tax cuts and seem more willing to let the deficit rise.

Democrats who control Congress are similarly split. While key party leaders, particularly in the House, want to work with Bush on an anti-recession package, many other party leaders as well as rank-and-file Democrats seem more intent on further bloodying Bush before the 1992 election.

Early reaction to Bush's budget may offer some hints of how the debate will unfold.

"The President promised to offer big changes and he did not deliver," said House Majority Leader Richard A. Gephardt, D-Mo. "Rather than unleashing a serious economic recovery program, with real investments, he unveiled a list of Band-Aids and political ideas that will help rich and powerful interests, while virtually ignoring the concerns of the middle class."

Senate Appropriations Committee chairman Robert C. Byrd, D-W.Va., added, "The American people were expecting meat and potatoes on the menu tonight, and instead they got potluck and leftovers. . . . The President's proposals amount to a warmed-over stew of old ideas."

As is almost always the case, the new White House budget offers something for

## PRESIDENT BUSH'S BUDGET AT A GLANCE

(in billions, by fiscal year)

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| **Total outlays** | $1,323.0 | $1,475.1 | $1,516.7 | $1,474.8 | $1,535.5 | $1,607.5 | $1,683.6 |
| Discretionary | 534.8 | 549.2 | 537.0 | 534.3 | 537.0 | 544.8 | 547.8 |
| Domestic | 195.4 | 216.2 | 224.7 | 229.3 | 232.2 | 236.9 | 236.8 |
| Defense | 319.7 | 312.9 | 291.6 | 283.7 | 283.5 | 286.5 | 289.8 |
| International | 19.7 | 20.1 | 20.6 | 21.4 | 21.3 | 21.5 | 21.2 |
| Mandatory | 593.7 | 727.2 | 765.9 | 709.5 | 756.3 | 809.6 | 872.6 |
| Net interest | 194.5 | 198.8 | 213.8 | 231.0 | 242.2 | 253.0 | 263.2 |
| **Revenues** | 1,054.3 | 1,075.7 | 1,164.8 | 1,263.4 | 1,343.5 | 1,427.5 | 1,501.8 |
| **Deficit** | 268.7 | 399.4 | 351.9 | 211.4 | 192.1 | 180.0 | 181.8 |

SOURCE: Office of Management and Budget

everybody. The President, for instance, expressed support for the 1990 budget deal—designed to control the deficit by limiting new spending and tax cuts—but suggested he'd be willing to fiddle with it.

Within that framework, he unveiled a plan that Darman views as "a *comprehensive* program to address not only the short term, but also the long." *(For more on Darman, see this issue, p. 256.)*

Tax cuts, however expensive, would not necessarily rule out long-term deficit reduction. But, Darman and others fear, election-year pressures could prompt policy makers to cut taxes and not fully offset the costs with other tax hikes or spending cuts. If his budget is any indication, Bush wants to avoid that scenario.

For example, the President proposed $30.4 billion in entitlement cuts to finance his tax cuts. While the 1990 deal bars Washington from financing tax cuts by cutting defense spending, Darman said Bush would consider changing the rules so defense cuts could finance his plan to raise the personal exemption. *(For more on defense spending, see this issue, p. 279.)*

Past Bush budgets have been as notable for their style as their substance. For the 1991 edition of the budget, Darman wrote a colorful "director's introduction," with lofty phrases and soaring metaphors that attracted wide attention.

For fiscal 1992, Darman toned down his rhetoric considerably, sticking more to describing what was in the budget than to finding poetic phrases to illustrate the broader budget situation. In the latest version, Darman's essay is even drier than last year's—almost totally a description of tax and spending measures.

"The President's agenda for job-creating growth is comprised of both short-term measures to get the economy moving and longer-term measures to secure American growth for the future," Darman wrote.

For the short term, Bush proposed some measures that he can take on his own and some for which he needs congressional approval. The latter, some of which have been previously proposed in other versions, are far likelier to attract criticism.

On his own, Bush said, he will cut the amount of taxes withheld from paychecks by a yearly average of $345 for joint filers who want this done, accelerate spending on already-approved items, cut federal regulations, address the so-called credit crunch that is limiting borrowing and jawbone the Federal Reserve Board to handle monetary policy better.

**The White House budget calls for spending more on children's programs . . .**

Also for the short term, Bush said, he will seek congressional help to extend unemployment compensation benefits (beyond the extensions that Capitol Hill enacted last year), cut the tax rate on long-term capital gains to 15.4 per cent, enact a new 15 per cent corporate "investment tax allowance," loosen the corporate alternative minimum tax, provide a new $5,000 tax credit for first-time homebuyers, allow penalty-free withdrawals from individual retirement accounts (IRAs) for first-time homebuyers, allow personal deductions for losses on homes, ease restrictions on investors' eligibility for deductions for real estate investing and extend a variety of low-income-housing incentives.

Bush's long-term agenda is lengthier than his short-term one. In the category of "investment in the future," he wants to increase federal spending to "record" levels in research and development ($76.6 billion), children's programs ($100 billion), the Head Start program for disadvantaged preschoolers ($2.8 billion), preventative health programs, mathematics and science education, anti-crime and antidrug programs and investment in infrastructure.

Along with the $500 increase in the personal exemption for children (from the current $2,300 in 1992), Bush's pro-family tax agenda includes a restoration of the deduction for interest associated with student loans; that would partially reverse the phaseout of all consumer interest that was enacted in the 1986 Tax Reform Act.

As expected, Bush also proposes a new IRA through which investors could make penalty-free withdrawals for medical and educational expenses and first-time home purchases and withdraw money tax-free after seven years.

Aside from his proposal to raise the personal exemption, Bush's tax agenda is a variation on an old theme. Again, he suggests that a capital gains cut would raise, rather than lose, revenue over five years. That increased revenue, this time totaling $6.9 billion, would be used to help offset the costs of his revenue-losing provisions.

Again, Bush wants to extend medicare payroll taxes to all state and local employees—an often-re[illegible]ed proposal that would raise $8.[illegible] billion over five years. Among his repeat revenue losers is a plan to extend the research and development tax credit and related tax benefits, costing $8.8 billion over five years.

Also for the long term, Bush has made a bold proposal to control spending on entitlements and other mandatory programs. Entitlements include such programs as medicare and farm programs, through which individuals get benefits on the basis of age, income or other criteria.

...And for a new $5,000 tax credit for first-time homebuyers.

Other mandatory programs, for which Washington has little or no discretion about whether to make payments, include federal deposit insurance.

"Apart from returning to strong economic growth," Darman wrote in his introduction, "slowing the growth of 'mandatory' programs is the most important key to bringing the deficit under control." He also referred to "what is inescapably the case: The budget can be brought into balance in the intermediate term only by enacting *both* a growth agenda *and* restraint on the growth of 'mandatory' spending."

Over the years, mandatory spending has absorbed greater shares of federal spending. While it made up just 30 per cent of spending in 1962, it totaled 48 per cent of spending in 1991.

Under Bush's budget, all mandatory spending for fiscal 1993 totals $766 billion and—not counting deposit insurance, which will fluctuate in the coming years—is expected to rise an average of 7.2 per cent a year through 1997.

The President, in essence, hoped to respond to what some critics have considered a big problem with the 1990 budget agreement: It sets limits on nonentitlement—that is, discretionary—spending, such as for defense and domestic programs, but allows entitlements to grow as inflation rises and the population of eligible recipients expands.

To address this situation, Bush has a two-pronged approach. First, he suggests a series of program changes that are not much different from what he's offered before.

He proposed to save $14 billion over five years from medicare, nearly $1 billion from farm programs, $4.1 billion by opening the Arctic National Wildlife Refuge to oil and natural gas exploration, $3.8 billion by auctioning parts of the broadcast spectrum, $5.1 billion through changes in civil service retirement and $3.5 billion by making changes in veterans' programs.

In a controversial measure, Bush also counts on $36 billion in savings by calculating proposed changes in deposit insurance and for the Pension Benefit Guaranty Corp. on an accrual, not a cash, basis.

More dramatically, the President proposes a cap on the growth of total mandatory spending. His is not an original idea, however. In its December 1991 report "Restoring America's Future: Preparing the Nation for the 21st Century," the House Budget Committee recommended a "growth cap" for entitlements.

"The committee recommends the design of a cap, enforced through the budget process, on the growth of entitlement programs, in order to reduce their underlying growth rate to a sustainable figure," the committee wrote."

Under Bush's plan, his cap would change if the White House and Congress agree to overhaul the health care system. Spending on federal health programs, such as medicare and medicaid, has been rising at rates that far exceed inflation and also exceed the growth in non-health entitlements.

The President would limit annual growth to 2.5 per cent—above increases tied to population and inflation—in the absence of health reform. After reform, he would limit annual growth to 1.6 per cent.

Growth above those levels would trigger either "reconciliation"—through which Congress requires its policy-making committees to cut programs under their jurisdiction—or across-the-board cuts in mandatory programs other than social security.

"If enacted, this addition would force legislative action on what is now 'uncontrollable,'" Darman wrote. "It would slow the growth of the 'mandatory' spending that is the largest part of the budgetary problem. This one procedural reform would go a long way toward remedying the most serious weakness in the discipline of the current Budget Enforcement Act."

As for health care reform, that is clearly a major item on Bush's emerging agenda. But the President chose not to include the specifics of his plan in the budget, instead, he promised to do so in February. That decision came after Republican lawmakers, unhappy with some details, appealed to Bush two days before the budget's release.

Nevertheless, the issue is clearly a front-burner one for Administration officials, especially Darman. He argues that not only is health care beginning to absorb a greater share of the budget and economy, but also that "millions of Americans have inadequate or insecure insurance coverage."

In his introduction, Darman dismissed two increasingly popular approaches to reform: a Canadian-style system and so-called play-or-pay proposals pushed by prominent Democrats.

"Such approaches necessarily involve comprehensive governmental price controls, governmental rationing or major tax increases," Darman wrote. "Over time, they threaten to degenerate and require a combination of these undesirable characteristics."

But what health care reform Washington will choose in their place, and when, is an open question. ■



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The Christian Science Monitor March 17,1992

# Economic Policy That's More Than a Political Quick Fix

By Paul S. Sarbanes

THE American economy is in serious trouble. The recession has brought into stark relief many of the problems built up over more than a decade of economic mismanagement. After ignoring the recession for a year, the Bush administration has come forth with proposals that solve neither the short-run problem of recession nor the long-term deterioration in our economic fundamentals. Without a significant change in course, the American economy appears headed for a future of slow growth and diminished opportunity.

The most recent cyclical indicators demonstrate the tenacity of the current recession. The unemployment rate in February rose to 7.3 percent, representing 9.2 million unemployed workers, the highest level during the recession. Another 1.1 million people have grown so discouraged about the labor market they have given up looking for work. In addition, 6.5 million people who want full-time work can find only part-time jobs. The Labor Department calculates that if the discouraged workers and involuntary part-time workers (counted one-half) are included in the unemployment rate, that rate for February would be 10.9 percent.

The number of long-term unemployed – those out of work for 27 weeks or longer – rose to 1.7 million in February, more than two-and-a-half times the long-term unemployed at the beginning of the recession. We know more job losses are coming, since many large firms such as GM, IBM, and Bethlehem Steel have announced large permanent staff cuts.

Even those with steady jobs find it harder to make ends meet. Real per capita after-tax income is lower today than it was at the end of 1988. This is the first three-year period since the Great Depression in which real income has fallen. It is hardly surprising that consumer confidence is near an all-time low.

Unfortunately, the president's proposals are not adequate to the challenge. They indicate that he is still underestimating the severity of both our short- and long-term economic problems.

The president's Economic Report predicts that the economy will grow by 2.2 percent in 1991 if the president's plan is adopted. Without the president's proposals, the administration predicts the economy will still grow at 1.6 percent. Thus, the program the administration has submitted would, by its own calculations, add


only six-tenths of a percentage point to economic growth this year. It is predicted to have about the same impact annually, half a point, through 1997.

The growth forecasted by the administration is far weaker than the nation has ever experienced after a recession. In previous recoveries since 1959, the earliest year for which gross domestic product data are available, growth averaged 5.4 percent.

Nor does the administration hold out much hope for the jobless. The report projects that it will be 1997 before the unemployment rate will get back to 5.3 percent, where it was just before this recession began.

Earlier this year Sen. Jim Sasser (D) of Tennessee, chairman of the Senate Budget Committee, and I put forward a comprehensive program for recovery and growth, both to move the economy out of the recession and to improve long-term the overall level of growth, investment, and the real incomes of working people. Among other things, the program calls for countercyclical stimulus through an emergency package of temporary assistance to state and local governments designed to keep and create jobs and to prevent destructive cuts in education, infrastructure, and public safety programs. Currently these governments are contracting, thereby putting a downward push on an economy trying to get back on its feet and contributing to the downward spiral of the national economy.

Our recovery plan also calls for more expansionary monetary policy and more active international economic diplomacy in support of global growth. It also includes an easing of the tax burden on the middle class.

In addition to these short-term recovery measures, we called for a fundamental rearrangement of budget priorities to emphasize investment in America. We believe it's possible to shift substantial resources from the military budget to fund a Marshall Plan for America: public investment in programs that expand our country's capacity to produce and compete, including infrastructure, education, and research and development.

Our major trading partners, with whom we compete, have been investing a higher percentage of GDP than we do in such programs and have enjoyed higher rates of productivity growth, which is the key to rising wages. Potential reductions in military spending are anticipated to be large enough to fund not only new investments in America but also to reduce the federal deficit.

Dramatic changes in the international scene make this change of course in economic policy possible; our nation's plight makes such change imperative.

■ *Sen. Paul S. Sarbanes (D) of Maryland chairs the congressional Joint Economic Committee.*

# Deficit Dynamics

**It's not apparent from this year's campaign rhetoric, but there's evidence that Washington policy makers are feeling increasing pressure to come to grips with the spiraling federal deficit.**

**BY LAWRENCE J. HAAS**

The general drift of this year's presidential campaign debate has given little comfort to Washington-based budget experts who have nightmares about ever-escalating federal deficits.

On the hustings, no one has been talking about cuts in government entitlement programs that are dear to the hearts of middle-class voters, and certainly not about cuts in the ballooning federal health care programs that are widely believed to hold the key to balancing the budget.

To deflect the right-wing insurgency of Patrick J. Buchanan, President Bush has loudly stressed his commitment to social security, forcing Buchanan, who now stands behind social security, to acknowledge that he once wrote that it should be made voluntary.

On the Democratic side, front-runner Bill Clinton and since-withdrawn rival Paul E. Tsongas jousted for support in Florida's March 10 primary—with its large voting bloc of senior citizens—by trading charges that each had supported past efforts to limit social security benefits. Clinton also asserted that Tsongas would cut medicare.

For the deficit "hawks"—those most concerned about the persistent and growing federal budget deficits—such politics-as-usual gives plenty of reason for despair. "It's just amazing. When people come on the national stage, it just seems like they lose their nerve," said Rep. Jim Slattery, D-Kan., a longtime hawk. He acknowledged, however, that the voters don't seem to be demanding such bravery. "I don't hear people saying, 'We need another candidate involved to address the deficit.'"

Both government and private estimates suggest that annual deficits will soar after the mid-1990s, perhaps even exceeding a mind-boggling $1 trillion in 2005 if the economy performs poorly. Yet there's little expectation among Washington budget experts that the White House or Congress will bite the bullet next year when the political pressures of the presidential campaign are behind them.

Little ferment for corrective fiscal surgery is evident among private-sector analysts and think tanks. Unlike in 1988, few are now working on deficit reduction proposals to influence a future debate. A notable exception is the Center for Strategic and International Studies, which is completing a 15-month study by its Commission on Strengthening of America.

But superficial appearances sometimes can be deceiving. Although the deficit issue has thus far escaped the spotlight of the 1992 presidential competition, there nonetheless is some sophisticated maneuvering under way in Washington to set the stage for some hard budgetary decision making in the future.

There are some signs, for example, that the continuing flow of federal red ink is exerting new political pressures on Capitol Hill's lawmakers. "I do think that there's a certain new recognition [of the deficit problem] here," a senior congressional aide said. "It seems like we get a pendulum that swings back and forth. And all of a sudden, we get some interest in it."

The potential for greater-than-usual turnover as a result of this year's congressional elections could add to the momentum that is building for fiscal change, the aide suggested. The more that baby boomers get elected, the more that Congress will include those who are concerned that their social security retirement benefits are threatened by the deficit.

Recent Democratic-led efforts to modify the 1990 budget agreement to permit a shift of defense spending to domestic programs ran into unexpected opposition, not just from lawmakers who wanted to protect hometown weapons projects and military bases but from conservatives in both parties who preferred to use defense savings to help reduce the deficit.

The Senate this year nearly passed a tax bill amendment that would have gutted a proposed middle-class tax cut and used most of the resulting savings for deficit reduction. Although the amendment failed (and the bill was ultimately vetoed), the incident triggered a lo. g floor discussion of the embarrassment of big deficits.

Durin . that debate, Warren Rudman, R-N.H., a deficit hawk who since has announced he will retire from the Senate after this year, delivered a blistering speech. "We are literally not watching the fiddler fiddle while Rome burns; we are watching the entire orchestra," he said. "How is it that in the early spring or late winter of 1992, with a federal budget deficit reaching $400 billion, with a country in economic disarray, how can we responsibly stand on this floor and talk about doing anything that has even the slightest chance of adding, not a dime, but a penny to a budget deficit?"

Perhaps more significant is the consensus that has begun to emerge among Bush Administration officials, certain key lawmakers and private experts who try to shape public opinion that something must be done about the soaring increases projected in federal entitlement programs, principally medicare and medicaid, the big health programs.

"I think there is a growing realization that a critical, probably *the* critical, step in controlling the deficit is to contro' ·· mandatory programs," Robert E. Grady, deputy director-designate of the Office of Management and Budget (OMB), said, referring to entitlements and related programs whose costs are driven not by the annual appropriations process, but by the growth in the number of eligible recipients and the price tag of the benefits involved.

In recent speeches and seminars, liberal Democrats and conservative Republicans have echoed a similar refrain: "You can't solve the deficit problem without solving the health care problem." Members of that chorus include Congressional Budget Office (CBO) director Robert D. Reischauer and Pete V. Domenici, R-N.M., the Senate Budget Committee's top Republican.

## DOES DEBT MATTER?

As the hawks have long lamented, it's hard to convince anyone that the deficit really matters. Many experts have talked at length about how U.S. government borrowing is absorbing capital from world markets, thus leaving less for private investment that would help the economy grow. But they haven't been able to really prove that anyone is worse off because of deficits.

"It is not at all inevitable that the maintenance of today's large budget deficits will bring on some kind of cyclical crisis," Brookings Institution economist Charles L. Schultze wrote in a widely cited 1989 article from the *Brookings Review*. "There *are* risks ahead that could be reduced if the deficits were smaller. Nevertheless, with competent management by the Federal Reserve, the United States can probably continue to muddle through, maintaining economic stability despite high budget deficits, as it has done for the past six years."

**Ex-Rep. Bill Frenzel, a Brookings Institution guest scholar Constituents ask more about jobs than balancing the budget.**

Schultze, who was chairman of President Carter's Council of Economic Advisers, compared the deficit with "termites in the basement"—likelier to eat away at the foundation of America's economic house than to present an imminent, politically potent threat. Schultze's insights have proved keen: the deficit issue, so far, appears to have little impetus in the electoral arena.

If anything, concern about the deficit seemed to fall as the problem grew larger. Expressions of alarm over $200 billion deficits in the mid-1980s have given way to quiet frustration, as the borrowing so.red to near $400 billion this year.

"Constituents are bothering [lawmakers] more about jobs than they are about balancing the budget," said ex-Rep. Bill Frenzel, R-Minn., a Brookings Institution guest scholar. "And Congressmen are, among all things, extremely representative and extremely sensitive."

At the White House, where aides are on constant alert to deflect allegations of fiscal mismanagement, there is relief that Bush has faced relatively little criticism about the deficit in his reelection effort to date. "The good thing is that nobody seems to give a shit about the $400 billion deficit," an aide said. "It's a joke."

But that situation could change. Not only has economic growth been anemic since 1989, but Americans also now seem more aware that since the early 1970s the pattern of steadily improving living standards has given way to stagnation. Some budget experts see an opp[illegible]nity to channel public anger into support for bringing deficits under control.

"I think there's a growing realization among the American people and their leaders that deficits are sapping the vitality of the American economy," Reischauer said. "And that, of course, is the precondition for addressing this issue." That's why, he said, "a little piece of me has become more optimistic in the last year."

Just as significantly, economic theory appears finally to be gaining confirmation by concrete evidence. In a study for the winter 1991 issue of the Federal Reserve Bank of New York's quarterly journal, two authors quantified the effects of low national savings in the 1980s. The federal deficit, because it absorbs capital, was identified as a key component of the low savings rate problem.

"Low saving made possible a surge in consumption in the 1980s, but at considerable long-run cost," Ethan S. Harris and Charles Steindel wrote. "By 1989, low saving had cost the U.S. economy about 15 per cent of its capital stock and about 5 per cent of its potential GNP [gross national product]. Furthermore, by the end of the century, the accumulated loss could grow to 28 and 10 per cent respectively."

Similarly, the CBO recently estimated the potential economic effects of lower deficits that could result from projected defense spending cuts. It used the Administration's 1992-97 plan, submitted in early 1991, that calls for an inflation-adjusted cut of about 20 per cent.

"By the next decade, the dividend real-



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ized under the 1991 plan could result in a permanent increase in GNP of around $50 billion a year (in 1992 dollars)," the CBO reported. The $50 billion is the equivalent of nearly 1 per cent of today's economy.

Experts, studying the effects of deficits, also point out that net interest rates—interest rates minus inflation—have persistently remained high. Noting that short-term net interest rates now hover around 3 per cent, Treasury Secretary Nicholas F. Brady recently told reporters, "That is above the secular trend that economists say [such] interest rates should be, which is some 2-2.5 per cent."

Nor has it escaped notice that with Washington's election-year talk of tax cuts raising fears of higher deficits on Wall Street, long-term interest rates have inched upward in recent weeks. Many experts warn that the short-term stimulus of a tax cut would be far outweighed by the compensating obstacles to growth that higher interest rates would bring.

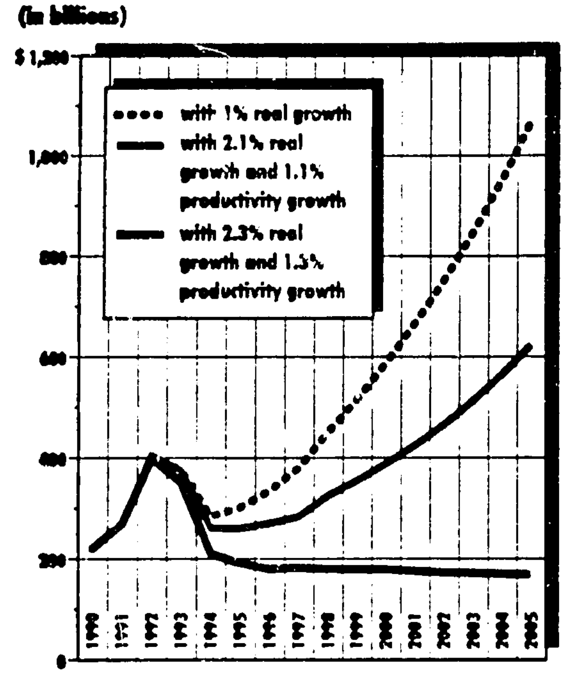
## GLOOM FROM OMB

When the lead story on the front page of *The New York Times* on March 23 reported federal forecasts of widening deficits for the mid-1990s, there was a flurry of dismayed reaction on Capitol Hill. But longtime congressional aides, who had been warning their bosses for years that the long-term deficit picture was particularly distressing, simply shook their heads at the Members' response.

"I'm a little disappointed with our elected officials who say, 'Oh, my gosh,'" a top Senate aide said. "All of a sudden, it gets a headline in *The New York Times*."

Actually, the picture could be much worse than the newspaper reported. The article detailed projections by the CBO showing that the deficit, after declining from this year's nearly $400 billion to about $200 billion by 1995, will increase to more than $400 billion by the year 2002.

**DEFICIT PROJECTIONS TO 2005**
**(in billions)**




**SOURCE: Office of Management and Budget**

What's less well-known, however, are even gloomier possibilities foreseen by Administration budget analysts. In a document prepared for OMB director Richard G. Darman's use at a March 11 private session with Senate Appropriations Committee members, future deficits are projected under various economic scenarios.

With annual real economic growth of 2.3 per cent, federal deficits would level off at about $200 billion from 1994-2005. Most government economists expect that long-term growth will settle at that rate, or, perhaps, somewhat lower. The CBO, for instance, projects long-term growth at 2.1 per cent.

If the CBO's forecast of an average growth rate of 2.1 per cent is correct, the OMB analysis predicts that by 2005, the federal deficit would exceed $600 billion. And if growth averages only 1 per cent a year, the deficit would exceed $1 trillion by 2005, a staggering amount considering that the entire 1992 federal budget is about $1.5 trillion. *(See chart, this page.)*

## CONTROLLING HEALTH COSTS

Any way you look at it, the road to deficit reduction runs through health care, experts agree. In explaining its deficit estimates, the CBO assumes that together, medicare and medicaid soar from 4.4 per cent of gross domestic product (GDP) in 1997 to 5.8 per cent in 2002. Net interest on the debt inches up from 3.5 to 3.8 per cent of GDP, social security stays level and discretionary spending plummets as a share of GDP.

Current efforts to restrain health spending offer little prospect for stemming the deficit tide. Under Bush's 1993 budget, which would limit medicare spending, the Urban Institute's C. Eugene Steuerle and Jon Bakija project that every major function of spending would fall as a share of GDP from 1992-97 except health care. Other functions are defense; social security; income security; veterans' benefits, agriculture, international affairs; education, training, employment and social services; energy, natural resources and environment, and community and regional development and transportation.

Darman has long fretted about the trends. In early 1991, he told the Senate Finance Committee that medicare, now at 7 per cent of spending, will absorb 30 per cent by 2025. The rest of the budget would have to fall by more than 20 per cent to make room.

Now, the OMB director is trying to build momentum for a serious effort at limiting entitlements in general and health care in particular. He and others hope to give the issue visibility this year and address it after the election.

Virtually everybody expects a White House-congressional negotiation of some sort, particularly if Bush is reelected and Democrats retain control of Congress. "I don't know of any other way to do it, other than working out a compromise," said William J. Beeman, the private-sector Committee for Economic Development's director of economic studies. But the bitter aftertaste of 1990's budget deal will make the next round tricky.

Any future negotiation won't be called a summit, experts agree. That would conjure up images among disgruntled rank-and-file lawmakers of closed doors, secret decisions and unsatisfying results. After all, the Administration and legislative leaders argued in 1990 that with their deal, the deficit would almost disappear by 1995.

The wide gap between that promise and the reality of recent budget projections is vulnerable to widespread misunderstanding. The 1990 budget deal will keep the cumulative 1991-95 deficits almost $500 billion lower than they'd otherwise be. But the performance of the economy has been worse than expected, while spending on health care entitlements and other items has far exceeded expectations.

Under those circumstances, both Administration officials and congressional leaders believe that a new budget agreement of some sort will have to be negotiated next year. In theory, at least, everyone will have something to gain. Liberals



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want more discretionary domestic spending, conservatives want pro-growth tax incentives and everyone wants to see a lower deficit.

Also, Darman wants to eliminate whatever loopholes exist in the budget process that let lawmakers evade spending limits. Last year, he told aides to start recommending changes.

Is there room to satisfy everybody? Probably, if all sides agree to limit entitlements. In fact, Administration officials and GOP lawmakers regard higher discretionary domestic spending—even $10 billion-$20 billion a year—as a "small price to pay for what we're talking about" in terms of entitlement reductions, a congressional aide said.

## CAPPING ENTITLEMENTS

Darman has methodically been trying to generate interest in limiting the growth of entitlement spending. He has briefed Bush who, in a March 20 speech that got notice more as an attack on Congress, repeated his 1993 budget proposal to impose such limits.

In addition to his private meeting with the Senate Appropriations Committee, Darman continues to meet in one-on-one sessions with key House and Senate Members and is working with Senate Republicans on a budget resolution addressing the issue. The House Budget Committee has already endorsed a so-called cap on entitlements.

Though its implications are profound, Bush's and Darman's idea is simple in concept. Spending on entitlements, particularly health care, is rising at rates far above the pace of inflation and the increase in beneficiaries. If the rise in entitlement spending could be limited to inflation and caseload increases, Washington would save a whopping $2 trillion from 1993-2002, OMB predicts. The savings achieved would compound over time. From 1993-97, the projected gain would total almost $400 billion, from 1997-2002, more than $1.6 trillion.

Bush hasn't proposed going quite that far. He would limit total entitlement spending to inflation and caseload increases, plus 2.5 per cent. If a "comprehensive health reform" package is enacted, the 2.5 per cent would drop to 1.6 per cent under his plan.

Addressing the Senate Appropriations Committee at the invitation of chairman Robert C. Byrd, D-W.Va., Darman pitched for support from a logical group of potential allies. Appropriators have long chafed under limits on discretionary—or nonentitlement—spending under their jurisdiction. As entitlements absorb larger shares of the budget, discretionary spending gets a smaller piece.

In a document outlining his position, Darman argued that "mandatory programs have taken over the budget." Noting that unless changes are proposed, entitlement programs do not come up for annual review by Congress, he said that "as a matter of budgetary management, this is preposterous; as a matter of public responsibility, this borders on the scandalous."

To be sure, the March 11 meeting produced seeds of discord. Some Democrats noted that in any deficit cutting package that included cuts in entitlements, Democrats would insist on higher taxes on the well-off. To suggestions that Washington could address the deficit with tax hikes alone, Darman said the problem was too big.

But Darman also hinted to the Appropriations Committee members, almost all of whom attended the meeting, that an entitlement cap would free money for their programs. "Without a cap on mandatory programs," his document stated, "it will not be possible to achieve a balanced budget—and the pressure (squeeze) on discretionary programs will tighten (perhaps dramatically)."

Not suprisingly, that message was greeted warmly. However obvious Darman's attempt to "buy off" the appropriators, experts say, his strategy may hold the key to a mandatory cap or any other measure that would limit the growth of entitlements. "Implicit in this was the outline of a deal," a senior Senate aide said.

Asked about the chances of gathering votes for such measures, former OMB deputy director William M. Diefenderfer III said: "It would be very brutal. But remember what the reward would be, if you were trading, for example, the 'peace dividend' to the domestic side in exchange for the limits on mandatories. There is a short-term benefit to these Congressmen because they've got money to spend."

## A CHANGE IN MOOD

As 1992 began, Democrats on the Hill predicted they would tear down the "fire walls" erected as part of the 1990 budget deal that bar shifting money back and forth between defense, domestic and international aid programs. Even Republicans thought that such a move was likely. Bush talked up the prospect during a televised chat with David Frost in January.

After all, the world had changed dramatically since 1990. The Soviet Union was gone, and the U.S. recession lingered longer than most economists predicted. Surely, Washington could safely boost domestic spending—particularly for such investment areas as infrastructure, education and early-childhood health—and still not endanger defense.

The budget walls had been a major plank in the five-year deal crafted in 1990. Republicans sought them for all five years as a way to protect defense. Democrats, hoping to boost domestic spending, didn't want them at all. A compromise was reached to have walls from 1991-93, but none in 1994-95.

But here's the key legal point: For 1991-93, the deal set ceilings on what could be spent for defense, domestic and international aid programs. But it doesn't require that all the money be spent. Unspent funds in any category would be applied to reduce the deficit. If the walls stay in place in 1993, for example, Bush's request for $268.4 billion in defense spending would mean a $7.9 billion reduction in the deficit.

In crafting Congress's 1993 budget plan, proponents of increased domestic spending argued they were seeking only a small change: elimination of the budget

**Budget director Richard G. Darman**
**Nonreview of entitlements "borders on the scandalous."**

walls a year before they would disappear anyway.

Democrats proceeded accordingly. In the Senate, Budget Committee chairman Jim Sasser, D-Tenn., gathered 47 cosponsors for legislation to knock down the walls; they included most Democratic leaders along with one Republican, Mark O. Hatfield of Oregon, the Appropriations Committee's ranking minority member. In the House, Government Operations Committee chairman John Conyers Jr., D-Mich., moved a bill through his committee.

Supporting those efforts was the 127-member Invest in America Coalition, a vigorous collection of private organizations that has made this issue a cause célèbre, complete with slogans, breast-pocket patches and other props. Bread for the World, a coalition member, constructed a 25-foot wall at its headquarters, alongside a wrecking crane, to attract attention to the cause.

The campaign grew from a late-1991 conversation between Lance Simmens, assistant executive director of the U.S. Conference of Mayors, and Ed Jayne, associate director of legislation for the American Federation of State, County and Municipal Employees (AFSCME). With Senate Finance Committee chairman Lloyd Bentsen, D-Texas, and GOP conservatives talking about using the peace dividend to finance tax cuts, Simmens and Jayne feared the loss of a golden opportunity to shift defense funds into domestic programs.

After checking with colleagues in other groups, the two discovered deep interest in the issue. Attendance at weekly meetings of 5-10 people soon blossomed to 70-80. Soon in the coalition were such powerhouses as teachers' unions, consumer lobbies and health, religious and charitable groups.

"We believe that for our groups, for our constituency, that this is the most important vote this year for the domestic agenda, because of the need, because of the clear-cut nature of the vote and because of the precedent that it establishes," said Jerry D. Klepner, AFSCME's director of legislation. At the Mayors' Conference, officials installed a six-telephone bank, through which they urged 300 mayors to lobby local lawmakers. Other organizations also worked the issue hard.

To cynics who took Bush's veto threats seriously, these lobbyists had an answer: The President twice vetoed bills to provide more jobless benefits before signing a third bill. If the economy doesn't pick up, he might change his mind on this, too.

Lobbyists for the domestic spending coalition challenged lawmakers who seek the support of their various member groups to put up or shut up. "This is the most definitive vote in a long, long time, when we will know who is with us and who is against us," Simmens said.

Despite such efforts, momentum stalled. House Democratic leaders, lacking a majority for the Conyers bill and seeking a compromise, delayed a floor vote. They were reluctant to "twist arms" on the issue, largely because they did so recently to gather votes for the tax cut legislation that they considered a top priority.

**Ellen Nissenbaum, foe of budget fire walls: Members are "off the reservation" on the issue.**

Senate Democrats, who had long ago decided to await House action, recently moved ahead out of frustration. But, in a procedural vote on March 26, they fell 10 votes short. Then, on March 31, the House defeated Conyers's bill 187-238.

Lobbyists, seeking support for the measure, encountered various problems. Some House Democrats, taking Bush's veto threats seriously, figured there was little to gain by voting for "more spending" at a time when their scandal-ridden House is under siege.

Others, such as Rep. John M. Spratt Jr., D-S.C., who serves on the Armed Services Committee, were loath to let liberals whack defense in order to finance domestic programs. Still others, particularly some strong supporters of Israel, worried that Congress would divert money from international aid and use it for domestic programs.

And some liberals, who otherwise would gladly vote for lower defe wanted to protect existing weapons jects and bases in their districts, espec with unemployment remaining stubb ly high. The most notable case invo Connecticut, where both Democr Senators and the local Democratic H Member are trying to save the Sea submarines built at the General Dyr ics Corp.'s Electric Boat Division.

The multifaceted nature of opposi gave fits to the domestic-spending-b forces. "There isn't one clearly ider able enemy," said Ellen Nissenbaum, islative director for the Cente Budget and Policy Priorities. "Yo got people off the reservation fo different reasons. . . . There's a odd collection of Members with funny positions."

But maintaining the fire wall ag ment gave lawmakers who are c cerned or embarrassed by big def a chance to reduce them. Though savings amount to merely a few bil dollars, it is a far less politically ex sive way of acknowledging the de problem than by cutting entitlemen

"Let's face reality," Rep. Jim C er, D-Tenn., who opposes the C ers bill, said about entitlements. " ther political party has had courage to face the real issues. the [presidential] candidate who c the closest [Tsongas] just withd from the race."

Nonetheless, Cooper values the wall vote. "I'm glad that there's a c tal-clear vote on fiscal discipline. hard to have a clearer vote on h you feel about the deficit."

Off Capitol Hill, the symbolism equally important. Consider the vi of John W. Snow, chairman of Ri mond (Va.)-based CSX Corp. transportation company. He chairs budget task force of the Busin Roundtable, a major corporate group.

Addressing the Democratic Bud Study Group, which includes moder Democrats who discuss budget issues often hear from invited speakers, Sn recently said that, if passed, the fire w bill would violate Congress's deal w business.

When business interests reluctan agreed to accept higher taxes as part the 1990 deal, they understood t unspent defense money would be used help reduce the deficit. Now, Snow co plained, some Democrats wanted change the rules. "I think it will be int preted as bad faith by a lot of people," said later.

But budget experts have a relat worry: that this fight will divert attenti from the far bigger issue of limiting en tlements.

# Worry About Under-Investment, Not Deficits

By Allan H. Meltzer

"CBO projects that the deficit will exceed $350 billion in 1992, setting a new record for the second year in a row. [The 1992 deficit will amount to [illegible] of GDP, just shy of the postwar high reached in 1983.]"

This is the way the Congressional Budget Office began its January discussion of the budget outlook. But its handwringing is unwarranted. Because CBO's budget numbers include too much and too little, they misrepresent the country's fiscal position and direct attention away from real economic issues – such as how resources are used or how tax laws favor consumption over investment. After a decade of self flagellation about the deficit and forecasts of disasters that did not occur, it is useful to pause long enough to ask what the published numbers mean.

Economists do not agree whether or how budget deficits affect the economy. They do agree, however, that if deficits matter, the two deficit measures that matter most are (1) the primary budget deficit and (2) the ratio of publicly held debt to some broad measure of spending such as GDP or GNP.

## Primary Budget Deficit

The primary budget deficit excludes interest payments and the massive outlays for the thrift bailout, two expenditures that have no impact on economic activity, aggregate spending or prices. Interest payments are a pure transfer: The government collects revenue from some people that it then pays as interest to others. This may have modest distributive consequences, but it does not affect the workings of the economy.

The huge expenditures on the thrift bailout pay for losses incurred in the past, when resources were wasted in unproductive projects or in some cases were stolen. Had the government kept its accounts more accurately, the losses would have been recorded when the net worth of many S&Ls became negative. Instead they are recorded now as part of the deficit. That makes both the reported current deficit larger and reported earlier deficits smaller. When the assets of the failed S&Ls are sold, future deficits will be reduced. Again, all this bookkeeping has no economic significance.

The ratio of public debt to GDP signals that the national debt may be rising faster than the economy's capacity to pay. From the repeated experience of countries in Latin America and elsewhere, we know that an ever increasing ratio of debt to GDP may be followed by inflation or even hyperinflation. This may be a problem for Russia or Brazil but hyperinflation is a remote danger for the U.S., where inflation has fallen during the years of handwringing about the deficit.

In fact, neither the primary deficit nor the debt ratio suggests that the U.S. budget deficit should be high on the list of current concerns. The primary budget was in surplus from [illegible] to 1990. Last year the government reported a cyclical primary deficit of about $50 billion, resulting from the recession. Before the president's tax and spending initiatives the CBO projected relatively small primary deficits for 1992 and 1993, reflecting its forecasts of sluggish growth in output, employment and tax revenues with continued growth in nondefense spending. The CBO estimated that if the economy were at full employment, the primary budget would show a surplus of 0.5% to 1% of GDP for the fiscal years 1993 to 1997.

During the 1980s the ratio of federal debt to GDP jumped from the mid 20% range to the low 40% range. Financing the S&L bailout and rising government spending (including interest payments) will move the debt ratio to about 55% of GDP in the 1990s. Thereafter the debt ratio should remain stable, according to government and responsible private projections. If the projections are correct, the debt ratio will be returning to its mid 1950s level, before the inflation of the 1970s reduced the real value of the debt. At 55% the U.S. debt to GDP ratio is not much larger than the ratios in Germany and France.

If the primary deficit and the debt ratio were all that mattered, we could be confident that the budget posed no long term threat to economic stability. Unfortunately, the government accounts are not as inclusive as they could be. Government liabilities for civilian and military employee pensions are as much an obligation as a formal bond contract.

These claims are not included as part of the government's debt, but they should be. Estimates by Henning Bohn of the Wharton School show that pension obligations for government employees increased the federal government's liabilities at the end of 1988 by $1.2 trillion – and government pensions are only one of many liabilities excluded from the debt to GDP ratio. Among some of the notable others: federal deposit insurance, guarantees of private pensions and of shareholders' brokerage accounts. The thrift crisis is an example of a contingent liability that came due.

Accounting for the federal government's hidden liabilities is not a mere matter of detail. While official documents show that the federal government added $1 trillion to its net debt between 1962 and 1990, Mr. Bohn estimates that a more accurate measure of the increase in net government liabilities for these years is $1.5 trillion – and even that is without including future obligations for Social Security and Medicare.

*Looking at the budget deficit alone makes it seem that federal investment in infrastructure has the same effect as hiring more regulators.*

The government reported total net financial liabilities of $1.6 trillion at the end of 1989. But Prof. Bohn estimates that the government's total negative net worth is in fact twice that amount, again excluding Medicare and Social Security liabilities. If Mr. Bohn is correct, the federal government's indebtedness is equal to about 27% of Americans' total private wealth.

Mistaken assumptions about deficits and the public debt matter because they lead presidential and congressional candidates, journalists and citizens to draw incorrect conclusions and become concerned about the wrong set of issues.

The major question is not the deficit itself, but how the federal budget affects the way Americans use resources. Looking at the deficit alone makes it seem that federal investment in infrastructure has the same effect as hiring more regulators. The effects on the economy of these two ways of spending money are, however, quite different. If the government's investment is effective, private sector productivity is enhanced. Consequently, the government adds assets that offset its liability for debt. The private sector too may add additional assets, so wealth increases.

On the other side, regulators often reduce private sector productivity by diverting resources to unproductive tasks. And here there is no asset to offset the liability. Computation of government net worth shows that the government has accumulated debt without generating assets to pay for it, either directly or by increasing productivity in the private sector.

Of course governments everywhere are concerned with issues other than productivity, such as the protection of persons and property, protection of the environment and redistribution of incomes and wealth. These concerns are not advanced by fevered worry about an imprecise and mismeasured number.

None of this should suggest that budget deficits are irrelevant. But when [illegible] express concern about what this generation will leave to its progeny, we need to be clear about what government has done and can do and what we as a nation want it to do. Instead of concentrating on the deficit we should ask three questions about administration and congressional spending and tax proposals:

1) Does the program benefit the present at the expense of the future?

2) Does it further the practice of encouraging consumption at the expense of saving and investment?

3) Does it encourage growth or redistribution?

## Present and Future

With a few exceptions, most of what has been proposed this year by the president or Congress favors the present over the future, consumption over saving and redistribution over growth. These choices do not address public concern about slow growth of income and productivity. They add to future liabilities without providing government assets or encouraging acquisition of private wealth to pay for debts when they fall due.

It is a mistake to allow concerns about the budget position to prevent actions that raise standards of living and add as much or more to assets than to debt. Budget decisions that encourage investment, raise productivity and reverse the bias toward current consumption should be welcome even if the people with green eyeshades turn blue.

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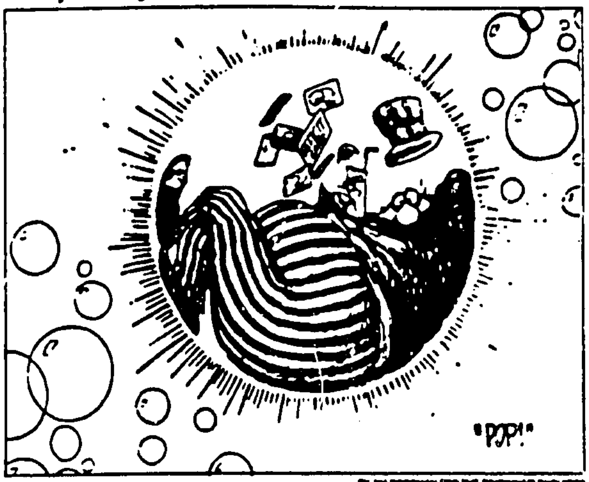
*Mr. Meltzer is professor of economics at Carnegie Mellon University in Pittsburgh and a visiting scholar at the American Enterprise Institute.*

*Lloyd Bentsen*

# A Straddle Into Irresponsibility

## *"The deficit has not been a priority for President Bush."*



If Bob Dole had been elected president in 1988, dealing with the federal deficit would have been his top priority, and there's little doubt in my mind it would be under control by now.

The deficit has not been a priority for President Bush, except for a brief period in 1990, and so it has ballooned from $154 billion to $400 billion a year. Given the course of his campaign so far, there's every reason to expect more of the same if he is reelected.

The Post rightly honors Dole as one of a small group of senators who have courageously fought to eliminate the deficit over the years. And he really paid a political price for his courage in the New Hampshire Republican primary of 1988.

Dole came into New Hampshire as the front-runner, leading in the polls and having beaten Vice President Bush in Iowa. The vice president actually ran third in Iowa, behind both Dole and the Rev. Pat Robertson.

Bush came out swinging in New Hampshire. He ran TV ads unfairly charging that Dole would increase taxes, simply because that was among the options Dole felt a president shouldn't categorically rule out. "Senator Straddle," the ads called him.

That wasn't the end of it. Dole had supported establishment of the bipartisan National Economic Commission to find ways to cut the huge federal budget deficits. Many believed the commission—headed by two savvy political insiders, Democrat Robert Strauss and Republican Drew Lewis—offered the last best hope of finally breaking the impasse that had nearly paralyzed the budget process for most of Ronald Reagan's tenure.

Vice President Bush didn't see it that way. In one of his New Hampshire TV ads, he said the commission "exists to provide political cover for a tax hike. If it doesn't recommend a tax increase, I'll not only eat my hat, I'll eat Bob Dole's hat."

After beating Dole in the primaries, the vice president went on to the Republican National Convention, where he was nominated. In his acceptance speech, to ensure that everyone knew of his adamant stand against tax increases, he uttered his famous "read my lips" pledge. The commission, which had become a political football in the New Hampshire primary, broke up in disarray a year later. Unable to reach agreement, it issued two separate reports in early 1989. Neither report recommended a tax increase, but there's no evidence Bush made good on his offer to eat both his and Dole's hats.

President Bush insisted his "flexible freeze" was the way to eliminate the deficit. That and some budget sleight of hand. During his first year in office, he proposed an S&L bailout that was not only financed with more government borrowing but, at the Bush administration's insistence, was exempted from the discipline of the Gramm-Rudman budget law. This drove up the cost of the bailout, which is adding more than $100 billion to the deficit this year.

In his 1990 State of the Union address, the president was still claiming he would bring federal spending under control. His new budget, he said, would balance the budget by 1993 and do it "with no new taxes."

But a few months later, facing the need for lower interest rates to soften a coming recession, the president admitted his flexible freeze and budget gimmicks weren't up to the job and entered budget negotiations with Congress. This ultimately led to agreement on a series of spending cuts and tax increases intended to reduce the deficit by some $500 billion over five years.

In New Hampshire this election year, the wheel came full circle. The issue again was taxes, only this time Bush wasn't attacking Dole for refusing to sign a "no taxes" pledge. He was under attack himself from Patrick Buchanan for breaking a pledge he should never have made in 1988.

It was the president's reaction to the Buchanan challenge, far more than the challenge itself, which convinced me his reelection would likely doom us to another four years of ballooning deficits. He reacted, first, by pulling away from the relatively modest tax increases in his own 1993 budget, adding $17 billion to the deficit over the next five years. Second, Bush reacted by disavowing the 1990 budget agreement as a "mistake."

I am encouraged by recent bipartisan signals that the Senate may be getting serious about deficit reduction. A Democratic amendment to the recent tax bill would have eliminated a middle-income tax cut and instead have used money from an upper-income tax increase to reduce the deficit and help replace our aging transportation infrastructure. On the Republican side of the aisle, there is growing discussion about the need to rein in entitlement programs, which account for the lion's share of the federal budget.

I have reservations about both approaches. The deficit is not our only legacy from the 1980s. Another is a tax system tilted in favor of the well-to-do. A tax reduction for middle-income families is needed if we are to restore a measure of fairness to that system. As to entitlement cuts, if by this my Republican colleagues refer to cuts in Medicare and Medicaid—the federal government's primary health care programs—they need to carefully consider cause and effect. The cause is the rising cost of health care, which not only threatens to push the cost of Medicare and Medicaid through the roof in coming years but has already pushed private health insurance beyond the reach of nearly 40 million Americans.

But disagreeing with these proposals does not mean I dismiss them. Both are worthy of consideration as good starting points for a vigorous debate on deficit reduction.

Without leadership from the White House, however, any effort to make a significant dent in the federal deficit is doomed at the outset, and we're not getting that kind of leadership.

Consider the president's tax plan. Republican and Democratic senators alike agree that he fails to pay for his proposed tax cuts, and the Joint Tax Committee estimates his cuts would add $32 billion to the deficit over the next six years.

His own administration maintains that adding to the deficit poses more economic risk than stimulus. The Office of Management and Budget warns that abandoning the discipline of the 1990 budget agreement "could trouble financial markets, cause interest rates to rise . . . slow recovery and threaten job creation." Many of the same Republican senators most concerned about the budget deficit—though not all of them—felt compelled to vote for the president's tax cut, budget buster or not. The political pressure to support an initiative by a president from one's own political party can be irresistible, especially in an election year.

I would like to see President Bush prove me wrong. I would urge him to campaign on a pledge to eliminate the budget deficit no matter what it takes, and I would urge his Democratic opponent to try to outdo him in this regard rather than seek to undercut him.

It is not my purpose to lay the blame for our deficits at the feet of the president or at the door of the Republican Party. There's enough blame to go around. We Democrats in Congress have added our fair share to the deficit, and there's no question that some of those among us would adamantly oppose the best efforts of any president to deal with the deficit.

The president didn't cause the deficit by himself and can't be expected to deal with it alone, either. But unless the president takes the lead, there'll be no dealing with it at all.

*The writer, a Democratic senator from Texas, is chairman of the finance committee.*

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# OPINION

*As Bush, like his predecessors, scurries to find short-term remedies for an ailing economy, will long-term prosperity be neglected?*

# The President and the Economy

**■ *The deficit will not be a major campaign issue in the presidential elections because the solutions are so painful and require such sacrifice from so many constituencies that no one dares deal with the issue honestly.***

**By Stuart E. Eizenstat**

PRESIDENT George Bush and his White House aides understand fully the modern lesson of presidential elections in the United States: Presidents stand or fall on the state of the economy whether they can be fairly blamed for it or not.

Their reading of election history explains the president's abandonment of his passive policy of relying on low interest rates to get the American economy out of the ditch in favor of new economic measures which ironically may actually exacerbate the long-term problems of the economy.

Every presidential election since 1960 involving an incumbent or the retiring president's own vice president has hinged powerfully on the state of the economy, with the exception of the 1968 victory by Richard Nixon over Hubert Humphrey, which was dominated by anger and disenchantment over the Vietnam war.

In 1960, for example, alleged "missile gaps" notwithstanding, it was John F. Kennedy's promise to "get the country moving again" after the 1959-60 recession that helped propel him to victory over Mr. Nixon.

In 1972, Nixon wanted to be certain the economy would not undo his administration. He reversed the traditional Republican free-market philosophy and applied wage and price controls to stop inflation while simultaneously leaning on the Federal Reserve Board to lower interest rates and stimulate growth.

Jimmy Carter's 1976 victory owed as much to the recession of 1975-76, and the seeming lack of stimulative action by President Gerald Ford, as it did to Watergate and the pardon of Nixon.

More recently, the same pattern has held. Ronald Reagan's reelection in 1984 over Walter Mondale owed much more to his decision to weather a severe recession early in his term in order to squeeze inflation and high interest rates out of the economy than to his fabled skills as the "Great Communicator."

In point of fact, the American people are unforgiving about the economy. They hold the incumbent president to account for it, and President Bush and his advisers know it. Only a few months ago, Bush was content to let normal market forces, combined with lower interest rates from the Federal Reserve, lift the economy out of recession. The president asserted he did not want to take short-term stimulative action that could cause long-term problems for the economy. Yet that is precisely the course on which he has embarked.

The president realized that Americans lock into a state of mind about the economy several months before the November election. He saw his polls go into a free fall from over 70 percent approval to under 50 percent in a few short months.

The president felt compelled to act – as his predecessors would have before him.

In his State of the Union message, Bush proposed an increased personal exemption for children, a tax credit for first-time home buyers, and incremental investment tax credits. To these tax measures he added a decision to more quickly spend money Congress has already appropriated for transportation, housing, and farm programs. The goal: a short-term shot in the arm for the economy.

Likewise, his emphasis on passing these by March 20 – though partly designed to put congressional Democrats in a bind – comes from a careful political calculation that unless Congress enacts the measures early, the economy may not turn around fast enough to prevent his defeat in November. While his package includes long-term incentives, such as a permanent research-and-development credit, they are overshadowed by the short-term emphasis.

THE greatest danger from this typical "election-year fix" is that, as proposed, it will likely increase the budget deficit, which at its current astronomical levels has already been an impediment to the investments we must make for the US to become stronger at home and more competitive abroad. Enactment of his tax cuts, with the lower revenues they will produce, is certain; passage of the dubious spending cuts the administration has proposed to pay for the tax reductions is far less probable.

The Omnibus Budget Enforcement Act of 1990, hammered out in the secrecy of Andrews Air Force Base shortly before that year's mid-term elections, was designed to balance the budget by 1995. Instead, the US has since experienced the two largest budget deficits in its history. [illegible]

For the current year [illegible] will exceed [illegible] single biggest [illegible] of our nation's [illegible] percent of GNP. [illegible] surplus [illegible] deficit is at [illegible] plus billion.

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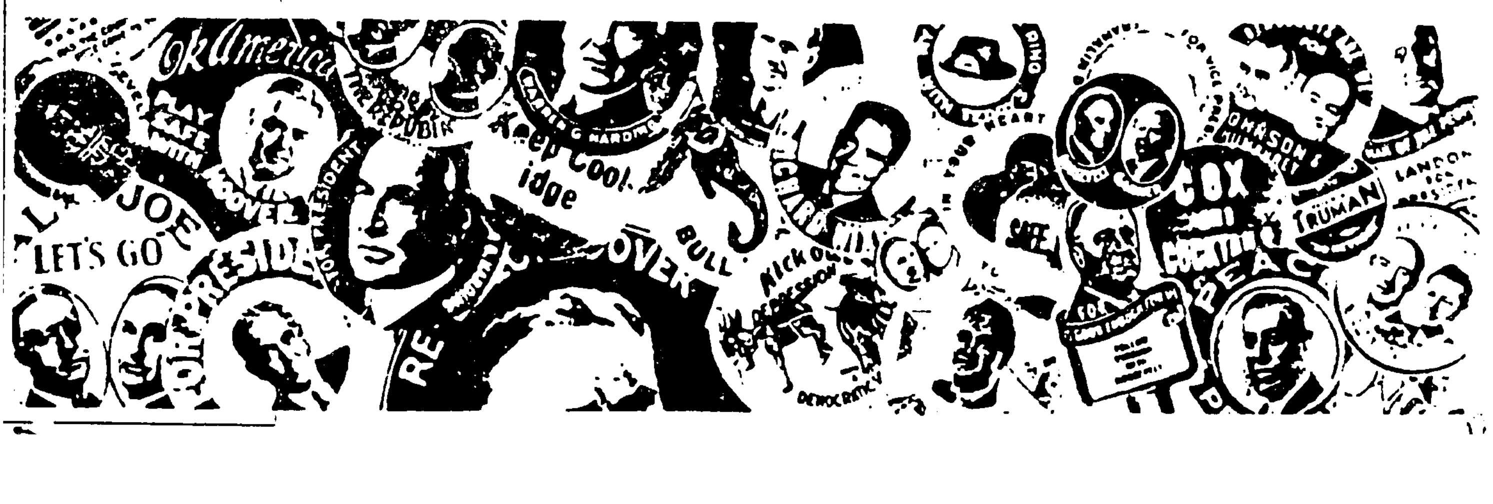
Yet the [illegible] major campaign [illegible] identity [illegible] Republic[illegible] because [illegible] painful [illegible] from so [illegible] no one dares [illegible] honestly.

All of this [illegible] – from the def[illegible] competitiveness [illegible] ery out for a [illegible] the priorities for [illegible]

But we are unlikely to [illegible] many serious proposals to address these problems during the coming presidential election. [illegible] Bush's economic program – with its traditional short-term [illegible] cession economic proposals – is any example.

■ *Stuart E. Eizenstat is chairman of the Washington office of Powell, Goldstein, Frazer & Murphy. He was chief domestic policy adviser to President Jimmy Carter during 1977-[illegible]*



The New York Times April 6.1992

## Foreign Affairs

LESLIE H. GELB

# *Clinton's Promise*

New Yorkers have the power to destroy one of the most promising Presidential candidates in decades. Or they can give Bill Clinton a chance to be heard fully and clearly for the remainder of this campaign.

More than anyone now on the national scene, the Governor from Arkansas could be what we most need: a Great Experimenter in foreign and domestic policy.

No one has good answers for the kind of world descending on us, nor for the complexities of health and education in post-industrial societies.

A leader through this haze and maze must be committed to solutions, as are Democrats, and possessed of a practical skepticism about means, as are Republicans. Such a leader has to be a bleeding-heart conservative, a bold experimenter like Franklin Roosevelt, Harry Truman and John Kennedy.

To get a sense of these qualities in Mr. Clinton, just compare the world he talked about in his foreign policy speech last week with the worlds of Jerry Brown and George Bush.

The world sketched, stingily, by Mr. Brown seems to be a very simple place inhabited by destructive environmental Martians — and little else.

Mr. Bush's world seems still peopled by dictators like the Chinese whom he wants to protect and tyrants like President Assad of Syria whom he seeks to befriend. It is an old, crumbling chessboard where kings play with each other and are indifferent to their subjects.

Mr. Clinton does not pretend to understand or describe the world of the 21st century. Instead, he concentrates on what he does know and on what really matters — on people, their problems and aspirations.

**We need a bold experimenter.**

Unlike Mr. Bush, he is committed to doing something dramatic to combat global warming. But he is not bound to particular actions regardless of cost and before clearer remedies are at hand, unlike Mr. Brown.

Unlike Mr. Bush, Mr. Clinton still worries about U.S. energy security and dependence on Persian Gulf oil. But he is still searching for politically palatable solutions like increased gas taxes, unlike Mr. Brown, who never seems troubled by political realities.

Unlike Mr. Bush, who would keep U.S. military spending near current levels and have Americans police the world alone, Mr. Clinton would make significant cuts in the Pentagon budget and stress the need for collective military action against aggression. Unlike Mr. Brown, he would do so with a scalpel, not with a meat cleaver.

Above all, Mr. Clinton's every pronouncement centers on the new and profound connections between foreign and domestic affairs. This connection is at the heart of modern diplomacy, and Mr. Clinton understands this. No nation, even one as mighty as the U.S., will be able to exercise sustained influence abroad unless it is economically strong at home, and Mr. Clinton understands this, too.

So Mr. Clinton speaks of America first, but never of America only.

In his treatment of domestic issues he also brings commitment to ends and flexibility about means.

He accepts the necessity of a new national health care plan. But given the massive disagreements about means and costs, he talks about trying different approaches, about experimenting. He presses for reform in education. And while he highlights the idea of giving parents a choice of schools as a way to generate quality, he is open to other ideas as well.

Jerry Brown talks as if he really had all the answers — and they are all simple. But mostly it seems that he has returned from his latest deep space probe as Jack D. Ripper, full of anger and nastiness. Mr. Bush, by contrast, seems to have no ideas and offers gimmicky slogans like "family values" and "Congressional reform." His new "change thing" is every bit as convincing as his "vision thing."

Bill Clinton may not have vision either. We do not yet know. But he does have energy, drive, ideas and an incredible fund of knowledge about domestic policy issues, second only to Senator Pat Moynihan of New York.

Yes, we all have questions and doubts about somebody labeled Slick Willie. And we should have lots of questions and doubts about Turnstile Jerry, No New Taxes Bush and a Paul Tsongas who so abruptly quit the campaign.

But Bill Clinton could be special: a bold experimenter in a world searching for answers. New Yorkers could defeat him or they could work through the tabloid garbage to glimpse that promise — and put it to a further test. □

# The Long Good-Bye

**Why won't the recession go away? Why has the vaunted Bush recovery refused to materialize? The answer: a debt-soaked national balance sheet. What's more, America may be on the verge of an economic comeback . . . if the politicians don't hit the panic button first.**

**BY JONATHAN RAUCH**

This is the recession that makes no sense. By most conventional measures, the downturn has been relatively mild. Unemployment has been much lower than in the previous two recessions. The same goes for the decline in national output. Yet American consumers have talked and behaved as though the Great Depression has returned. Moreover, the vaunted Bush recovery has refused to appear. Where is it? Why is the Bush economy so stubbornly slow? Why so much disappointment and gloom?

Among analysts of the economy, the outlines of an answer have begun to form. Call it the balance-sheet shock hypothesis, or "BSSH" (pronounced *Bush*) for short. To focus on the recession proper, the theory goes, is to miss the more important half of the Bush-era economic story.

The hypothesis, briefly stated, is this: The economy is slowly squeezing out unprecedented excesses of debt and debt-financed commercial real estate. This squeezing appears to have begun well before the 1990-91 recession and now appears to be outliving it. For more than a year before the recession, the economy grew at an annual rate of less than 1.7 per cent, making George Bush the President who has presided over the slowest period of growth in the postwar era. By the same token, the economy may stay disappointingly slow for a while after the recession. Nonetheless, the current adjustment appears to be a healthy one—if nobody panics and tries to block it.

Not everyone accepts the balance-sheet shock hypothesis. "There is some balance-sheet restructuring that needs to be done," Robert Giordano, the director of economic research at Goldman, Sachs & Co. in New York City, said in an interview, "but I don't see it as that much out of the ordinary." Still, adherents of the theory include such luminaries as Alan Greenspan, the chairman of the Federal Reserve Board, and Dave Stockman, the director of the Office of Management and Budget in the Reagan Administration.

Here is Greenspan, from a speech in December to a meeting of the Securities Industry Association in Boca Raton, Fla.: "The normal forces of economic expansion are running up against countervailing forces that I have likened elsewhere to a 50 mile-per-hour headwind. To a considerable extent, the factors restraining expansion are working through the financial sector. For example, a heavy overhang of debt, an accumulation of bad loans and doubts about the future have produced an unusual degree of caution."

And here is Stockman (now a investment banker with Blackstone Group Inc. in New York City), speaking in December at a conference of the American Enterprise Institute for Public Policy Research (AEI): "I think we have not a classic recession, but a balance-sheet shock, a correction process in which unsustainable business, household and even public-sector debt ratios are being geared back down gradually to levels consistent with sustainable earnings coverage and deflated asset values."

All that the politicians want to know is when it—whatever *it* is—will be over. To that question, economists reply promptly and unequivocally: We dunno.

"It will probably unwind gradually," John H. Makin, an AEI economist, said in an interview. "But you tell me: When are people going to decide that their balance sheets are back in line? I don't know. Neither does anyone else."

To understand what's happening now in terms of balance-sheet shock, it's necessary to forget about the 1990-91 recession and look at longer-term forces, particularly at two ways in which the expansion of the 1980s was exceptional: One, debt. Two, real estate.

## THE DESCENT INTO DEBT

The story of the economy that wouldn't bounce back begins in the late 1960s, when high and unpredictable inflation became a fact of life in the United States. In the 1970s, Americans got used to the idea that real estate was a great way to ride the inflationary spiral to wealth. You could borrow against the ever-rising value of your home or office building while repaying your mortgage in debased dollars. In the early 1980s, financial deregulation and tax giveaways made real estate investments more attractive still. New loopholes made investors eager to speculate on office buildings; deregulation and heightened competition made the banks and savings and loans able and eager to help.

Speculate they did. The total stock of commercial buildings in the United States doubled during the 1980s, despite, as Greenspan noted, "a huge increase in vacancy rates." Stockman cited the 16 square feet of retail space "for every man, woman and child in the United States, compared to 7 square feet pre-1980." Thomas W. Synnott III, the chief economist of U.S. Trust Corp. in New York City, has noted that the big burst of commercial real estate lending pumped an extra $300 billion of credit into the economy from 1982-88.

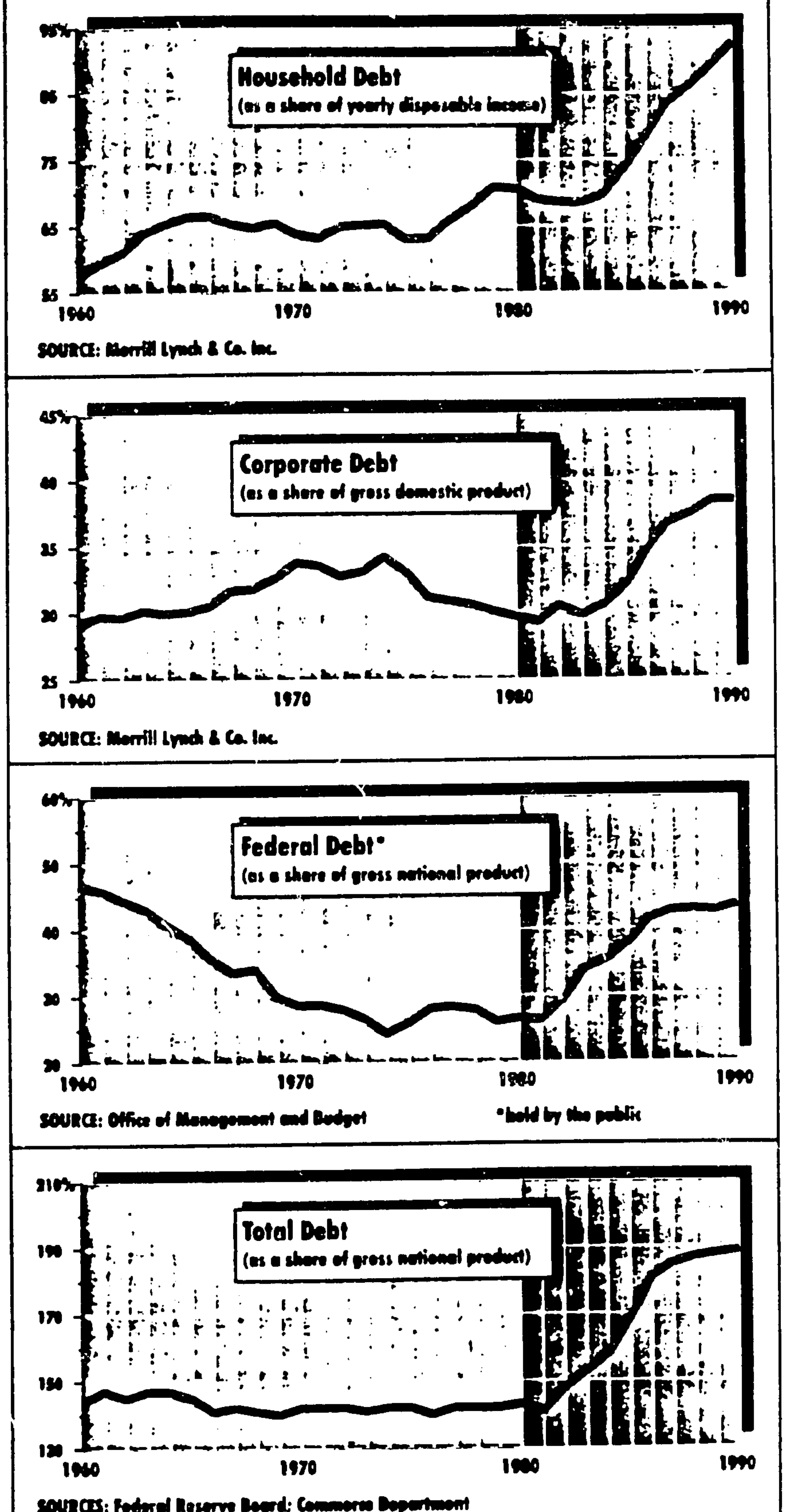
Consumers were engaged in a similar practice. The prices of homes and other assets were rising smartly; those higher asset values became collateral against which banks could lend and householders could borrow—which they did. According to Merrill Lynch & Co. Inc., about 40 per cent of the growth in consumer spending during 1983-87 was financed by installment debt, including home equity loans, compared with about 20 per cent during earlier expansions.

"There's been a steady increase in the debt load in the 1980s," said Joanne R. Kerstetter, the president of Consumer Credit Counseling Service of Greater Washington. "Clients reacted to the preapproved lines of credit and thought, 'If I'm preapproved, I must be able to afford it.'"

People borrowed most heavily to buy real estate. According to Merrill Lynch, mortgage debt rose from 46 per cent of after-tax income in 1982 to 56 per cent in 1987, "a far higher level and steeper gain than in previous expansions." The spurt in home borrowing, Synnott writes, "meant close to $500 billion in additional mortgage credit outstanding by the end of 1988." Yet new-home construction was not abnormally strong. "What seems to have happened," Synnott observed, "is that the rapid growth in mortgage credit fueled a surge in home prices." This is what's known as asset-price inflation, and it can't go on forever. Eventually the cycle—debt chasing prices chasing debt—had to stop.

Meanwhile, corporations were also busy loading up on debt. Companies can raise capital by issuing either equity (stock) or debt (bonds); in the 1980s, they moved sharply from the former to the lat-

## THE 1980s—A DECADE OF DEBT



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ter. Fror.. 1982-88, more than $400 billion in corporate equity was replaced by debt. Leveraged buyouts mortgaged some companies up to their eyeballs. By the end of 1989, interest payments absorbed more than 21 per cent of corporate cash flow, a level previously seen only during recessions

Put together households and corporations, add record government borrowing and top it off with see-through office buildings from Los Angeles to Boston, and you have in the 1980s a decade of debt. *(See box, p. 439.)* "Americans just went into debt on a scale without precedent, and basically we've exhausted our credit lines right now," Bruce Steinberg, Merrill Lynch's senior economist, said in an interview. "It's going to take a long time to reliquify household balance sheets."

**Alan Greenspan, the chairman of the Federal Reserve Board**
**The normal forces of economic expansion are running up against "a 50 m.p.h. headwind."**

What goes up must usually come down. According to the balance-sheet shock hypothesis, here's how it happened.

Rising debt isn't a problem when it's offset by rising assets (increasing home values, for instance) or by rising incomes. But by the time Bush came to office, assets in general and real estate in particular were overvalued. The economic expansion was getting old and inflation was creeping up, to more than 6 per cent by 1990. In response, the Federal Reserve had been steadily tightening the money supply. In reaction to Fed policy and office building oversupply, asset prices began to fall

Signs of trouble appeared in 1989, with a string of high-visibility business collapses under the weight of debt. Down went, among many others, Integrated Resources Inc., Campeau Corp., Bank of New England, Drexel Burnham Lambert Inc., Eastern Air Lines Inc., Pan American World Airways Inc. and, most recently, R.H. Macy & Co., which filed for bankruptcy in January.

The failures were not, in themselves, of great economic importance, but they were clear signs that the age of borrow and borrow, buy and buy was over. "For the first time in eight years," *The Wall Street Journal* reported in 1991, "the balance sheets of nonfinancial corporations will end the year with more equity relative to debt than they had when the year started." On Wall Street, "deleveraging"—the shedding of debt—is the word of the day. A spectacular example: RJR Nabisco Holdings Corp

In the spring of 1989, RJR became the target of the biggest leveraged buyout in history—a staggering $25 billion deal. When the dust had settled, RJR had a mountainous $30 billion in debt and only $1.5 billion in equity, according to Fred Zuckerman, the company's treasurer. That was a debt-to-equity ratio of 20-1. The company's securities had the status of junk bonds.

Since then, in a series of financial pirouettes, the company has rushed to issue stock and clear its books of high-cost debt. Today, RJR has $14 billion in debt and $8 billion in equity. In other words, RJR's debt-to-equity ratio has come down from 20-1 to under 2-1 in less than three years. "We now are a flexible company," Zuckerman said in an interview. "We can now run our business with the long-run interest of our shareholders in mind, rather than being fixated on debt."

Because of RJR's enormous size and cash flow, the company's flight from debt is of exceptional magnitude. But the direction is typical. "We're maybe the tip of the iceberg," Zuckerman said, "but it's a big iceberg there."

Meanwhile, householders had their own balance sheets to worry about. Caution was emerging before the '80s were over. Stagnant or declining home values reduced households' wealth and, therefore, their borrowing capacity. "According to the Federal Reserve, the growth of consumer debt peaked in 1988, leveled off in 1989 and began shrinking early last year," Albert B. Crenshaw recently reported in *The Washington Post*. "By last spring, consumers were paying off debt at an annual rate of more than $20 billion. In 1988, by contrast, consumers were adding $50 billion a year to the amount they owed." That shift, economists say, reduced consumer spending by something like 1-2 per cent of gross domestic product (GDP)

Most important of all was the aftershock of the bust in commercial real estate. Developers were stuck with 5 and 10-year supplies of empty office space. No longer would banks finance new projects, and so commercial construction jobs began to disappear. High vacancy rates led to mortgage defaults and so commercial real estate loans began going bad. Bad loans and falling asset prices began dragging the banks and S&Ls down. Healthy institutions pulled in their horns and unhealthy ones went belly-up. The banking mess magnified the real estate mess by tightening credit and spooking the public

The end result was that by the time Bush's term was a few months old, the economy was in what David D. Hale, the chief economist of Kemper Financial Cos. in Chicago, calls a "cul-de-sac." That wasn't terrible, it just meant slowish growth until excesses of debt and real estate were worked off.

And then came Saddam Hussein and the shock of war. That may well have been what tipped the economy into recession. It's worth noting, however, that the recession neither caused nor cured the underlying conditions of the Bush economy. In the spring of 1991, the economy climbed out of the recessionary ditch—only to find that it was still in the cul-de-sac. Expectations of a zooming takeoff were sadly disappointed. A wave of gloom built in the public and the news media

S. Robert Lichter, the co-director of the Center for Media and Public Affairs in Washington, counted a sudden doubling of economy-related network news stories in November and December of 1991; the great majority were negative, with particular emphasis on unemployment. "It was like something awful happened, but nothing had—it was a psychological shift," Lichter said. "Partly, there was a loss of optimism that the economy was going to swing up quickly."

The gloom was deepened by the opening of the political campaign—in New Hampshire, where balance-sheet shock was particularly intense. From 1976-86, New England's speculative building boom had doubled the office space in Boston. According to *The Economist* magazine, New Hampshire's employment in construction rose from 26,800 at the beginning of 1985 to 36,300 only three years later—and then, when the bust came, two of every three construction jobs were lost.

Because New Hampshire has the nation's first presidential primary, its suffering reverberated through the political system. The President himself rushed there to announce that the economy was in "free-fall." It wasn't and isn't. But in politics, perception is reality. *(For more on New Hampshire politics and economics, see NJ, 2/8/92, p. 324.)*

## WRINGING OUT THE OLD

Today, the two leading questions about the shifting balance sheet are: How will it affect growth? And what should be done?

The consensus answer to the first question is that balance-sheet adjustments shouldn't prevent a recovery. They'll probably just make the recovery less robust for a while than it otherwise would have been. As Stockman put it, the coming recovery "is likely to be back-loaded into the mid-1990s rather than front-loaded into 1992 and 1993, as would normally occur."

The consensus answer to the second question is that the adjustment should be allowed to run its course. Other than lowering interest rates, which the Fed has already done, there doesn't appear to be much that Washington can or should do, many economists say.

Indeed, what's happening now is just what the experts were calling for five years ago. In the mid-1980s, the U.S. trade deficit soared as the country's huge appetite for debt sucked in imports and foreign capital. (The Japanese own a lot of those empty hotels and office buildings.) What the country needed, policy makers agreed, was to devote more resources to manufactures for export, fewer to debt-financed office buildings.

Now it's 1992. The merchandise trade deficit has fallen sharply, from more than $150 billion in 1987 to half that amount now. Why? Because the country is producing more manufactures for export and fewer debt-financed buildings.

"We've done exactly what the policy makers said we should do, but everybody's wringing their hands about it," said Mickey D. Levy, the chief economist of CRT Government Securities Ltd. in New York City. "It's crazy."

The good news is that we got what the doctor ordered. The bad news is that we don't like the good news.

A look at the GDP tables vividly illustrates what's happened. In 1985, the trade imbalance (as measured by net exports) was about 3.6 per cent of GDP; by the third quarter of 1991, it had fallen to only 0.6 per cent. Yet over that period, imports, as a share of GDP, had actually grown a bit. So where did the United States get the extra goods to ship abroad? Answer: It shifted resources out of real estate and into exports. The share of GDP devoted to buildings fell from 9.4 per cent in 1985 to 6.7 per cent in 1991. Meanwhile, exports grew from 7.2 per cent of GDP to 11.2 per cent over the same period—a remarkable 4-point swing.

In plain English, ever since the borrow-and-buy real estate boom ran out of gas, the economy has been running on exports. "Commercial construction will make no contribution to economic growth in the 1990s; that sector is basically down for the count," Merrill Lynch's Steinberg said. "Exports will play a major, major role in keeping this economy moving forward."

By implication, then, the health of the domestic economy may be strongly influenced by the outcome of the market-opening General Agreement on Tariffs and Trade (GATT) talks in Geneva, which have been hanging by a thread for six years. Yet, in his recent trip to Japan, Bush veered toward import and export quotas ("managed trade"); the Europeans are drifting in the same direction. If the movement toward quotas continues, or if the GATT talks sink, the upshot could easily be to reduce U.S. imports *and* exports. Given America's current reliance on export-led growth, such a worst-of-all-worlds outcome couldn't catch the economy at a more vulnerable time.

Montaigne wrote in 1577, "Men are in agreement about nothing. I mean even the most gifted and ablest scholars, not even that the sky is over our head." He might have been talking about modern economists. But even the economists agree on one thing: After a while, balance sheets will be righted and BSSH will be a memory.

The key words there, however, are "after a while." Americans are impatient for robust growth, and yet balance-sheet shock may bring a period of disappointment as two decades of inflationary expectations—manifested as a heightened preference for borrowing—are wrung out of the system. Election-year politics tends to magnify disappointment into hysteria. One Democratic candidate, Paul E. Tsongas, has already announced that "as President, my first act will be to declare an immediate economic emergency." If the balance-sheet shock hypothesis is right, then the economy is doing what it has to do, and the real question is whether the politicians will let it. ■

**Fred Zuckerman, treasurer of RJR Nabisco Holdings Corp. "We're maybe the tip of the iceberg, but it's a big iceberg."**

Journal of Commerce April 3,1992

# Killing the Economic Debate

By WILLIAM R. NEIKIRK

WASHINGTON — Just like learning a little recovery is a dangerous thing

Even the slightest upturn changes moods. It causes people to spend more of their money. It creates some new hiring. It makes the country feel better about itself.

It makes people want to forget the past or even who might have caused their hardship. They just want to get on with their lives and on with the business of accumulating income and assets.

But oh, how deceiving it will be this year. The emerging economic revival will serve as a brightly colored facade to a weak, unstable economic structure.

That's why a little recovery is potentially injurious. It would push the economic issue into the background and make it less likely that the candidates will resolve to do anything about the economy's long-term structural problems.

Why do I sound so cynical about this? My two-word answer is this: past elections. The American people have proven to be easily hypnotized by the rosy glow of election-year rhetoric and short-term economic stimulation. They went with the flow. They believed an invisible hand guided their holy economy.

For many months analysts have been saying that this year is different. People have been genuinely frightened about the economic outlook after a wave of layoffs and bankruptcies and collapse of local real estate markets.

Now though, the economic news is getting a little better. Economists David Jones of Aubrey G. Lanston & Co. and Stephen Roach of Morgan Stanley Inc. believe the ensuing rebound will be just enough to put President Bush back into the White House for another four years.

They lament, as I do, that this could be accompanied without any significant debate on the nation's long-term economic health. It's a debate the country has sorely needed for more than a decade.

If an improving economy enables him to sneak by, Mr. Jones said, Mr. Bush will inherit an economy with horrible savings and investment problems, a huge overhang of debt, a glut of real estate, dysfunctional banks, lagging competition of business and a country uncertain about its economic future.

Without any plans to address these problems, he said, the country will continue on its long-term economic slide.

"Unlike four years ago, he'll be inheriting his own problems," Mr. Roach said. "The burden will be on him to make his place in history. We face some real challenges — competition, productivity, job creation, education."

In other words, he said, the country needs more than a mood change, a yearlong prescription of economic Prozac, to solve these deeper problems. Mr. Jones, who a year ago correctly forecast a lengthy economic sluggishness, said he saw no chance of a lasting economic recovery until 1994. He believes this year's snapback will last just long enough to get Mr. Bush into the White House.

Already the economic discourse has deteriorated with Paul Tsongas' departure from the race. Neither Bill Clinton nor Jerry Brown seems interested in laying out a long-term economic plan. In New York, the media don't relish candidates with thoughtful, sane (read "boring") ideas. They like them angry, petty, sinful, mean-spirited and shortsighted, and Mr. Clinton and Mr. Brown have obliged.

The president is lying back with no inclination toward candor about the United States' economic future. With business activity beginning to perk up, he hopes to ride the improving business cycle to re-election as the Democratic Party tears itself apart.

The emerging direction of the campaign will cheat Americans out of a long-neglected debate over the future of their livelihoods. As it stands now, the country appears doomed to a long-term economic growth rate of roughly 2%.

It needs to be higher than this to absorb new workers into the labor force and to drive incomes up. At 2% growth a year, federal and state deficits will still be a problem, and life in the United States will be tougher and meaner in the ensuing fight over income shares.

Allen Sinai, an economist for Boston Co. Economic Advisers, says it does not have to be this way if Americans demand for the first time in their history that the candidates come clean on the economy.

"We're the bosses," he said. "We have to tell them what we want."

Sorry, Allen, but they don't seem to be listening.

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*William R. Neikirk is a senior writer for the Chicago Tribune, based in Washington.*

THE BUDGET

# Senate Yields to President On Size of Defense Cuts

## *$1.5 trillion budget resolution headed for conference; House version would hit defense harder*

Unable to use defense savings for anything but deficit reduction, the Senate yielded to worries about job loss and a rapid defense build-down, and decided to stick with President Bush's moderate defense cuts for fiscal 1993.

Senators approved a fiscal 1993 budget resolution (H Con Res 287) on April 10 that included $281.0 billion in discretionary spending authority for defense. The vote was 54-35. With their horizons sharply constricted by budget rules and election-year politics, senators barely touched the other four-fifths of the $1.5 trillion federal budget.

The decisive vote on defense came April 9, when the Senate rejected, 45-50, an amendment by Jim Exon, D-Neb., that would have roughly doubled Bush's defense cuts. Exon's defeat continued a pattern that has developed on defense-related votes in both the House and the Senate this year. In this case, a nearly solid bloc of Republicans joined with 13 Democrats to hold the line, warning that deeper cuts would threaten both hometown defense jobs and national security. *(Vote 69, p 975)*

The Senate resolution will now have to be reconciled with a House-passed measure that contains deeper defense cuts.

Bush's proposal, as re-estimated and approved in the Senate budget resolution, would cut the 1993 defense budget by about $8 billion in spending authority and $5.3 billion in outlays below caps set by the 1990 budget summit. Those cuts would put discretionary defense spending authority at $281 billion and actual spending at $291.5 billion.

Despite a lengthy debate, the Senate sidestepped efforts to change politically sensitive mandatory spending programs, which make up more than half of federal spending.

And save for the defense debate and

*By George Hager*

**BOXSCORE**

**Bill:** H Con Res 287 — fiscal 1993 budget resolution.

**Latest action:** Senate approved, 54-35, on April 10.

**Next likely action:** House-Senate conference.

**Reference:** Senate committee, Weekly Report, p. 867; House passage, p. 523; House Budget Committee, p. 457; peace dividend, pp. 479, 394; Bush's budget, p. 217.

a largely symbolic move to cut legislative and executive branch spending by 25 percent over the next two years, the Senate resolution would make only minor modifications to the one-third of the budget devoted to discretionary spending. Budget Committee Chairman Jim Sasser, D-Tenn., conceded when his committee was considering the measure that Congress is likely to spend as much as budget rules allow for domestic appropriations, despite the budget resolution's attempt to cut that spending back slightly.

With both the House and Senate having failed in the last three weeks to change budget rules to permit the shift of defense money to domestic appropriations, neither chamber's budget makes any of the sweeping changes many members expected in the wake of the collapse of the Soviet Union last year.

Congressional budget-drafters appear resigned to waiting until after this year's presidential elections to make wholesale changes to the 1990 budget summit agreement. But in four days of debate on the budget, the Senate provided a preview of the difficulties Congress will have.

### Entitlement Caps Debated

Debate on the final day centered on a bitterly controversial amendment by Budget Committee ranking Republican Pete V. Domenici of New Mexico to cap spending for entitlement programs such as Medicare, Medicaid, farm subsidies and food stamps.

While virtually all sides agree that limiting entitlement spending is critical to getting control of the deficit, there is no consensus on how to do it. The plan, sponsored by Domenici, Armed Services Chairman Sam Nunn, D-Ga., Warren B. Rudman, R-N.H., and Charles S. Robb, D-Va., tracks a proposal first aired in Bush's 1993 budget and pushed since then by White House budget director Richard G. Darman.

As modified by Domenici and others, the plan would impose a cap on all mandatory spending, except for Social Security and interest on the debt, beginning in 1994. The cap would allow for increases to accommodate population growth, inflation and an additional factor that would start at 2 percent in 1994 and fall to zero by 1997. Any violation would presumably trigger unspecified, across-the-board cuts in all non-exempted entitlements, although that process would have to be determined by subsequent legislation.

Domenici said the plan was the only way to constrain out-of-control entitlement spending that threatens the nation with bankruptcy.

But critics warned that capping entitlements would harm elderly and needy Americans who depend on such programs for survival. "They're in here trying to chisel down what's left of the programs that help the people in this country who rely on that kind of help,"

# Fiscal 1993 Budget Resolution

*(In billions of dollars; totals may not add due to rounding)*

| | Bush's Budget[1] | House Baseline[2] | House Plan B | Senate Passed[3] |
|---|---|---|---|---|
| **National Defense** | | | | |
| Budget Authority | $ 281.0 | $ 288.4 | $ 274.4 | $ 280.4 |
| Outlays | 292.2 | 296.2 | 287.2 | 290.9 |
| **International Affairs** | | | | |
| Budget Authority | 19.4 | 19.0 | 19.7 | 19.0 |
| Outlays | 17.5 | 16.6 | 17.4 | 16.6 |
| **Science and Space** | | | | |
| Budget Authority | 18.4 | 17.7 | 17.1 | 17.1 |
| Outlays | 17.0 | 16.7 | 16.2 | 16.3 |
| **Energy** | | | | |
| Budget Authority | 5.6 | 6.1 | 5.9 | 6.0 |
| Outlays | 5.0 | 6.5 | 5.4 | 5.4 |
| **Natural Resources** | | | | |
| Budget Authority | 21.3 | 22.2 | 20.9 | 21.3 |
| Outlays | 21.0 | 21.5 | 20.6 | 20.9 |
| **Agriculture** | | | | |
| Budget Authority | 16.2 | 16.6 | 16.2 | 16.5 |
| Outlays | 15.8 | 16.3 | 16.0 | 16.1 |
| **Commerce and Housing** | | | | |
| Budget Authority | 83.0 | 82.6 | 82.4 | 82.4 |
| Outlays | 75.4 | 75.6 | 75.4 | 75.4 |
| **Transportation** | | | | |
| Budget Authority | 39.7 | 41.6 | 41.0 | 40.9 |
| Outlays | 35.2 | 36.0 | 35.4 | 35.2 |
| **Community Development** | | | | |
| Budget Authority | 6.2 | 7.6 | 6.9 | 7.4 |
| Outlays | 7.0 | 7.3 | 7.1 | 7.2 |
| **Education and Social Services** | | | | |
| Budget Authority | 51.8 | 51.9 | 51.7 | 50.7 |
| Outlays | 49.4 | 50.2 | 49.6 | 49.8 |
| **Health** | | | | |
| Budget Authority | 104.5 | 105.0 | 105.2 | 104.3 |
| Outlays | 103.7 | 104.4 | 104.5 | 104.0 |
| **Medicare** | | | | |
| Budget Authority | 130.9 | 132.4 | 132.2 | 132.2 |
| Outlays | 129.2 | 130.5 | 130.4 | 130.4 |
| **Income Security** | | | | |
| Budget Authority | 196.8 | 199.2 | 199.5 | 198.6 |
| Outlays | 195.0 | 197.0 | 196.7 | 196.8 |
| **Social Security** | | | | |
| Budget Authority | 306.2 | 306.2 | 306.2 | 306.2 |
| Outlays | 303.2 | 303.3 | 303.2 | 303.1 |
| **Veterans Benefits** | | | | |
| Budget Authority | 34.8 | 35.5 | 35.3 | 34.7 |
| Outlays | 34.4 | 35.3 | 35.0 | 34.7 |
| **Justice** | | | | |
| Budget Authority | 15.8 | 15.3 | 15.2 | 14.6 |
| Outlays | 15.9 | 13.3 | 15.3 | 14.8 |
| **General Government** | | | | |
| Budget Authority | 13.5 | 13.3 | 12.3 | 12.6 |
| Outlays | 14.1 | 13.7 | 12.9 | 13.1 |
| **Net Interest** | | | | |
| Budget Authority | 213.8 | 214.3 | 213.8 | 213.8 |
| Outlays | 213.8 | 214.3 | 213.7 | 213.8 |
| **Allowances** | | | | |
| Budget Authority | −0.5 | .0 | −2.3 | −4.1 |
| Outlays | −0.4 | −0.3 | −3.5 | −3.8 |
| **Offsetting Receipts** | | | | |
| Budget Authority | −41.5 | −39.9 | −40.6 | −39.9 |
| Outlays | −41.5 | −39.9 | −40.6 | −30.9 |
| **TOTALS** | | | | |
| Budget Authority | $1,516.8 | $1,535.0 | $1,513.0 | $1,514.7 |
| Outlays | 1,503.0 | 1,515.5 | 1,497.9 | 1,600.8 |
| Revenues | 1,171.2 | 1,173.4 | 1,173.4 | 1,173.4 |
| Deficit | 331.8 | 342.1 | 324.5 | 327.4 |

[1] *Congressional Budget Office re-estimate*

[2] *House Budget Committee baseline: 1992 enacted, adjusted for inflation, excludes emergency spending; defense based on 1993 projections in Bush's 1992 budget*

[3] *Does not reflect last-minute amendments, including cuts in legislative and executive branches*

SOURCES: Congressional Budget Office, House and Senate Budget committees

said Donald W. Riegle Jr., D-Mich.

Opponents argued that the real problem is rapid growth in Medicare and Medicaid, and the real solution is comprehensive health-care reform that constrains costs. Countered Domenici: "You will never get cost containment until you set a target for the money that is available for health-care expenditures by the federal government."

Domenici withdrew the amendment after the Senate approved, 66-26, what promised to be the first of a series of amendments exempting veterans and other groups from the cap. "The handwriting was on the wall," said Rudman.

### Battle Over Defense

Debate on Exon's defense amendment illustrated the divergent views in the Senate on the issue of defense spending. Exon characterized his rider as a modest and reasonable attempt to save a small amount of additional defense money by leaving big-ticket weapons systems such as the B-2 bomber and a proposed aircraft carrier alone, instead cutting increases in procurement and research and development costs for scores of smaller projects.

The defense budget "can be cut without pink-slipping troops by the tens of thousands, as many in the administration would have Congress believe if we dare cut a penny below the president's numbers," Exon said, charging that arguments about job loss were an "artful, emotionally charged, yet inherently dishonest snow job."

But John H. Chafee, R-R.I., warned that "we're dealing with human beings here." And Ted Stevens, R-Alaska, said Exon's cuts "would seriously harm our present defense posture" by disrupting an orderly transition to a peacetime military. "There is no way to absorb the outlay cut in this agreement solely through procurement and R&D costs," he said, arguing that personnel cuts would be inevitable.

### Amendments Considered

During debate on the budget resolution, the Senate also:

- Approved, 94-3, an amendment by Lloyd Bentsen, D-Texas, to impose a 60-vote point of order against any budget-resolution floor amendment that violates the Social Security "fire wall" by raising Social Security benefits without increasing the payroll tax, or cutting the tax without cutting benefits. There is a 60-vote point of order against any budget resolution that comes to the floor containing a provision that would break the fire wall, but an amendment to break the fire wall can be approved by a simple majority vote. *(Vote 68, p. 975)*

● Approved, by voice vote, an amendment by John C. Danforth, R-Mo., expressing the sense of the Senate that the U.S. government should not condone foreign trade subsidies that harm U.S. industries. Danforth said the amendment was intended to repudiate a tentative agreement by the U.S trade representative to abandon further action on subsidies by European governments to their commercial aircraft consortium, Airbus Industrie — subsidies that Danforth said hurt Missouri-based aircraft manufacturer McDonnell Douglas.

● Approved, by voice vote, an amendment by Don Nickles, R-Okla., to express the sense of the Senate that senators should approve by June 5 a constitutional amendment requiring a balanced budget. The Senate first voted 84-11 to approve an amendment by Robert C. Byrd, D-W.Va., adding a requirement that the president submit a balanced budget every year. Then the Senate voted 63-32 to waive a budget act point of order that would have declared the Nickles amendment out of order. *(Votes 71, 72, p. 980)*

● Agreed, by a vote of 36-62, not to waive the Budget Act to allow an amendment by Bill Bradley, D-N.J., that would have cut defense spending authority $7 billion below Bush's request for fiscal 1993 and split the proceeds equally between high-priority domestic spending programs and deficit reduction. Bradley's amendment was then ruled out of order. *(Vote 70, p. 975)*

● Approved, by voice vote, an amendment by Hank Brown, R-Colo., to require a study of all mandatory spending programs, except for Social Security and interest on the debt, to determine who receives the benefits of those programs.

● Tabled (killed), by a vote of 53 to 40, an amendment by Tom Harkin, D-Iowa, that would have cut defense spending authority $6 billion below the president's request. *(Vote 73, p. 980)*

● Approved, 52-42, an amendment by John Seymour, R-Calif., as further amended by Sasser, to reduce the congressional and executive branch budgets 25 percent below the 1992 level over the next two years. Seymour proposed the reduction in Congress' budget, while Sasser added the identical executive-branch cut on a voice vote. *(Vote 74, p. 980)* ■

THE NEW YORK TIMES, April 16, 1992

# Banks? What Banks?

By R. Dan Brumbaugh Jr.

SAN FRANCISCO

In 1989, there was a post-election February surprise: the new Bush Administration announced that it would seek $90 billion to close insolvent savings and loans. This is worth remembering, because we might see another post-election February surprise, this time involving banks.

In the 1988 campaign, George Bush and Michael Dukakis avoided discussing the S. & L. mess. Democrats had robbed themselves of the issue because their Congressional leaders were embroiled in S. & L. wrongdoing. Saved from attack, the Republicans relied on the Federal Home Loan Bank Board's claim that the cost of closing insolvent S.& L.'s would fall well below outside estimates. In March 1988, the board's estimate was $25 billion, well within the capacity of Federal deposit insurance, the board said. But after the election, the official estimate rose and then came the $90 billion February surprise.

What have the Presidential candidates said about the S. & L. and banking crises in 1992? Nothing. Yet, on March 11, the Federal Deposit Insurance Corporation announced that assets in banks on its problem list, those with the greatest chance of failure, rose from about $400 billion in June 1991 to more than $600 billion in January. The total is staggering: nearly 20 percent of bank assets, equal to 70 percent of the entire S. & L. industry.

## Candidates ignore the financial mess.

Because the number of problem banks actually dropped while total assets of the troubled institutions soared, it is almost certain that one or more large banks are on the list. The Government may be contemplating what it has always said might cause widespread financial instability: the failure of a big bank.

But the F.D.I.C. is playing down the deterioration. In January, it began investing in a large failed bank, Crossland, rather than accept private takeover bids that would have meant higher Federal payouts. Though couched as a plan to save taxpayers' dollars, the strategy is likely aimed at postponing the day of reckoning.

Why aren't the Democratic candidates raising the banking issue? The answer is that even if they convinced Americans that the Administration was responsible for the crisis, the solution means bad news for taxpayers, and no candidate wants to tell voters something they don't want to hear.

In December, Congress lent the F.D.I.C. $70 billion, to be paid back by the banks. There is no political mileage in coming back a few months later and saying that more banks are on the verge of failure and that more money will likely be needed.

Thus, the issue, as well as proposed reforms that would help healthy banks, will probably lie dormant through the election. But we can't say we weren't warned this time. □

*R. Dan Brumbaugh Jr. is author of "Thrifts Under Siege" and co-author of "The Future of American Banking."*

THE WASHINGTON POST, May 5, 1992

*Hobart Rowen*

# 'The Problem Is Jobs'

Since the demise of the Soviet Union, some Americans have been looking for an enemy. In the past week, the riots in Los Angeles and elsewhere in America have shown who the enemy is. It is us.

Our enemy is a national failure to make the commitment to produce the jobs, education, shelter, and health care for blacks and other minorities in the same degree and quality that we provide for the white majority.

But above all, the problem is jobs—dignified work without which so many black Americans, especially black men, lose their self-respect.

"Stagnation at the bottom of the income distribution, together with the poverty, disappointment, and rage of America's disadvantaged minority population, threatens our social order," wrote Tom and Mary Edsall in their brilliant book on racial polarization, "Chain Reaction."

America is really two nations divided along rigid economic class lines—the privileged who have jobs and the underclass who are denied hope because they were born with a skin of the wrong color. This ugliness has been festering for a long time: Too many of us turned our faces away from the obvious and refused to look at the reality of racism.

In a 1964 book on Kennedy and Johnson, I wrote: "In the midst of plenty, the world's most affluent society quietly tolerated an island of poverty—an underdeveloped nation within a nation as real to those in it as the desiccated South of Italy or the back bush of Africa."

That was written in the context of the nation's casual acceptance of unemployment from the mid-1950s to the early 1960s averaging about 6 percent—and double that number for blacks. The then secretary of labor, W. Willard Wirtz, one of the few officials to show concern, said at the time: "One of the things that whips us is the 'I'm alright, Jack' attitude of those who have jobs."

Nothing much has changed, as Wirtz observed last week on his 80th birthday. There are few left, he said, "who get emotional" about the nation's inability to reduce unemployment to, say, 4 percent, the target set as far back as 1946. In recent years, when unemployment began to slide below 6 percent, the inflation-fighters at the Federal Reserve and elsewhere in Washington have swung into action to slow down the economy.

Why has the nation, all these years, been unable to pursue social and economic justice? Presidents Reagan and Bush, over an 11-year period, concentrated their attention on improving the welfare of the upper middle class and the wealthy, not that of the poor. Their priority, as was true of the Carter administration, was price stability, not maximum employment.

Two years ago, the Brookings Institution put out a study called "Policy for the Nineties," a volume in its continuing series, "Setting National Priorities." It made the point that because there was no palpable evidence of direct economic crisis at home, the nation was able to muddle through without "decisive leadership." But the Brookings authors acknowledged that the problems of the underclass were not addressed in its study, and that millions of underprivileged persons would not share in any future growth.

They then added: "We think that a sustained, vigorous attack on [the problems of the underclass] will be possible only when the American people as a whole enjoy a rising standard of living and regain their faith that the nation can meet challenges at home and abroad."

Brookings had lots of company. Its study is cited here only as a convenient metaphor to illustrate how the conventional wisdom of the economics establishment as a whole missed the boat.

Conservative economists always worry more about inflation than unemployment or inequality of incomes. Liberal economists pay more attention to income distribution. But liberals, going way back to Walter Heller in the Kennedy days, have tended to overestimate the ability of aggregate demand to soak up unemployment, and underestimate the amount of so-called "structural unemployment"—the kind that comes from the lack of training, or from logical change.

Economic growth is badly needed, b nomic growth alone can't deal with racis Kennedy believed that "a rising tide boats," but that's basically trickle-down e ics. It's plain that the nation could ach overall economic growth rate of 6 perce percent without making a dent in the hu of unemployed blacks in Los Angeles an urban centers.

The ultimate irony is that the nati desperately need a highly educatec force made up of nearly half blac Hispanics in another decade to compe other industrialized nations. We n abandon racism, or risk shattering the ica that once was the dream of the imr parents of most of us.

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# Global Environment Facility makes its debut

By Mohamed T. El-Ashry

In late 1990 the international community took unprecedented action to tackle global environmental problems by setting up the Global Environment Facility (GEF). It was unprecedented because GEF was expressly intended as a partnership between industrial and developing countries and between several international agencies to help developing countries deal with a range of global environmental issues. Industrial countries recognized that it was in their own interest to help developing countries avoid the patterns of environmentally degrading growth which industrial countries themselves had followed in the past. As such, the facility may be the beginning of a new kind of global endeavour for sustainable development.

But GEF is already no stranger to controversy. Some observers see it as the handmaiden to a new international environmental order which recognizes the mutual dependency of development and environmental protection. Others see GEF as hiding the true culprits of global destruction—the industrialized countries—while diverting resources from development priorities. Questions have also been raised about the structure and governance of GEF.

What is GEF? How does it work? What does it do? What is its future?

GEF is a pilot programme with about $1 billion to spend in developing countries for investment projects and technical assistance to protect the global environment and transfer environmentally-benign technologies. GEF funds are additional to regular development assistance and are grants.

A guiding principle has been to make GEF membership and participation in it open to as many countries as possible. The funds are provided mainly by industrial country members. But any country can become a participant for a minimum contribution of about $5.5 million. About 30 countries, half from the developing world, have joined so far.

Co-operation between international agencies without creating additional bureaucracy is another guiding principle. GEF is overseen jointly by the World Bank, the United Nations Environment Programme and the United Nations Development Programme. These agencies have set up small units to manage the facility, but overhead has been kept to a modest 4 per cent of spending.

By pooling their experience and expertise, the agencies have much more impact collectively than they would individually. Although the World Bank administers the facility and manages the investment projects that will account for about 70 per cent of GEF's spending during the pilot phase, the close relationship between the agencies has forged a common sense of stewardship that has allayed fears of an imbalance of power among the troika.

Projects can be proposed by governments, GEF implementing agencies, and non-governmental organizations. A panel of 16 independent scientific advisers has broken new ground in ensuring the scientific integrity of GEF activities by setting criteria and priorities for project selection. To the great credit of all participants, more than 50 projects worth some $450 million have been presented and six had been approved by early February.

> *There is growing consensus that GEF should be the conduit for financing the conventions on climate change and biodiversity which are now in the final stages of negotiation.*

> ### *Voices for Development*
>
> *A new phase of international co-operation around environmental issues has been inaugurated with the establishment of mechanisms such as the Global Environment Facility (GEF). Mohamed T. El-Ashry, chairman of GEF, explains the special role of the facility. William Pace, co-chair of the International NGO Task Group on Legal and Institutional Matters for the United Nations Conference on Environment and Development, expresses some of the concerns of developing countries and non-governmental organizations regarding GEF.*

## Pilot phase

For the pilot phase the focus is on global warming, ozone depletion, biological diversity, and the protection of international waters—all problems for which the industrialized world bears historic responsibility but which will grow with population pressures, urbanization and industrialization in the developing world.

The list of problems covered by GEF is not exhaustive. Indeed, one lesson from GEF's young life is that environmental problems often spread across a continuum of local, national, regional and global levels. Thus several countries—developed and developing—have called for GEF funds to deal with national environmental problems, such as lack of clean water, or regional blights, such as desertification.

Those and similar needs are certainly acute. The best response, however, is probably to provide assistance through existing bilateral and multilateral development programmes.

But GEF's participating governments agree that it must support beneficiaries' national environmental priorities. These are, or should be, inextricable from their developmental goals. The link with the global level is national environmental action plans which place countries' priorities within wider contexts. In this way, GEF can meet local needs while promoting global environmental protection.

This question of coverage is part of the discussion on the transition from the pilot project to GEF II. Other issues include the connection between the facility and future global environmental conventions, the status of participants, and the way decisions are taken.

## Financing new conventions?

In the run-up to the United Nations Conference on Environment and Development (UNCED), there is growing consensus that GEF should be the conduit for financing the conventions on climate change and biodiversity, which are now in the final stages of negotiation, and other agreements which could emerge (for example, on forests). Providing finance would help developing countries meet their global commitments under the conventions.

But a good deal more work is needed to determine how the conventions would tie into the facility. A central issue is to avoid loopholes through which GEF might fund projects in countries that have not signed, or are not in conformity with, the conventions.

Participating governments are also taking a close look at their own role. There is a growing sense that broader representation would improve their effectiveness. One suggestion is to lower the $5.5 million entry fee for developing countries while introducing a formula for other contributors that reflects their ability to pay.

Any changes in GEF's mandate must retain its democratic functions. Countries must have a say in decision-making without crippling the facility with micro-management and constant ballots. Most governments agree that the best approach is a consensual one with recourse to some form of majority voting only as a last resort. If all these thoughts become reality, GEF will be a new model for promoting closer international co-operation, more effective global environmental protection, and sustainable development. ■

*Mohamed T. El-Ashry is director of environment at the World Bank and chairman of GEF. His responsibilities for GEF include representing the facility, assisting the implementing agencies fulfil their roles, and building consensus among participating governments on policy and strategy.*

## PrepCom 4 Adopts Draft Declaration of Principles for Rio Summit

Despite unresolved differences on several points, the final UNCED PrepCom agreed early in the morning of April 4 to send a draft "Rio Declaration on Environment and Development" without brackets, to the Rio Conference for further negotiation and final approval by governments. The Rio Declaration, formerly known as the "Earth Charter," is a set of principles to guide states in regard to sustainable development.

PrepCom Chairman Tommy Koh prevailed on all delegations except Israel to agree to this unusual procedure by promising that further negotiations on the document would take place in Rio. Several delegations confirmed that they did not accept one or more paragraphs of the draft. Israel objected to a paragraph on protection of the environment and natural resources of "people under oppression, domination and occupation," inserted in the text at the insistence of Arab states, and refused to go along with Koh's proposal.

The draft declaration embodies most of what the developing countries wanted regarding developed country responsibilities for bringing about sustainable development. It urges states to "reduce and eliminate unsustainable patterns of production and consumption" and acknowledges the "common but differentiated responsibilities" of states. It refers to the "special responsibility" of developed countries "in view of the pressures their societies place on the global environment and of the technologies and financial resources they command." The United States indicated at the final plenary that it still objected to that language, as well as other principles.

The draft urges "national authorities" to "endeavor to promote the internalization of environmental costs" and calls on states to "recognize and duly support" the interests of indigenous people and enable them to participate effectively in sustainable development. A key North-South compromise in the final text was to link the "right to development" -- formerly opposed by the United States -- with meeting the "developmental and environmental needs of present and future generations." The formulation thus brought the concept of a "right to development" into line with sustainable development.

> *The draft declaration refers to the "special responsibility" of developed countries "in view of the pressures their societies place on the global environment and of the technologies and financial resources they command."*

The negotiations on the declaration were the focal point for emotional North-South issues at the final PrepCom. The text drafted by the G77 served as the basis of negotiations for most of the discussions. It was criticized by most developed countries for lacking balance between environment and development and for imputing guilt to developed countries in global environmental degradation.

One of the biggest points of contention was a proposal by the G77, that identified unsustainable consumption patterns, particularly in industrial countries, as the "main cause of the continuing deterioration of the global environment." That statement was ultimately dropped from the text. A separate paragraph blaming most of the world's pollution on the developed countries also was deleted.

The United States, the European Community, Canada and Australia also objected to a paragraph on the responsibility of states for environmental damage caused by weapons of mass destruction. The paragraph was ultimately changed simply to urge respect for international law providing protection for the environment in times of armed conflict.

When negotiations on the G77 draft in the "contact group" broke down April 1, Conference Chair Tommy Koh stepped in to create a 16-nation drafting group under Indian and Norwegian co-chairs. The co-chairs themselves drew up a new draft which became the text conditionally approved for Rio.



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# PrepCom 4 Forwards Agenda 21 to Rio; Many Ambitious Proposals Are Blocked

Despite media reports that the UNCED PrepCom had collapsed over financial resources, PrepCom 4 adopted all the remaining chapters of Agenda 21 at its final plenary April 3-4, sending them to the Rio conference in June for final approval.

The result is a package of 29 documents that represents a modest advance rather than a major leap toward the integration of environment and development. Both developing and developed countries blocked more ambitious initiatives that were perceived as contrary to their national interests.

Many of the chapters of Agenda 21, the non-binding agreement on national and international actions on environment and development, still reflect unresolved issues and contain little concrete innovation in national and international policies. But they also contain a number of useful tools for developing a North-South partnership for sustainable development, including the possibility of a U.N. Commission on Sustainable Development that could be a focal point for monitoring and reporting on implementation of the agenda.

*See Agenda 21, page 5*

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**Agenda 21,** *continued from front page*

The chapter on poverty, consumption and demographic dynamics has none of the targets for reducing global poverty that were in the secretariat draft for PrepCom 4. It says that developed countries "should take the lead" in achieving sustainable consumption patterns but does not indicate what specific actions they should take. All countries are urged to carry out research on sustainable patterns of consumption, develop a policy framework to encourage more sustainable patterns of production and consumption and improve price signals through environmental charges and taxes. But China insisted on the qualifier "in light of country-specific conditions" on the latter. Policies and action programs on population are urged only "where appropriate" – another qualifier added to Agenda 21 texts in many places by states who wished to avoid commitment to the proposal.

The chapter on international policy for accelerated development urges market-oriented macroeconomic reforms in developing countries but offers no new initiatives on commercial debt or finance by developed countries.

The chapter on atmosphere recommends pricing policies to discourage fuel-inefficient vehicles and encourage research on how to incorporate the social costs of environmental impacts of industrial production and the disposal of wastes into the prices of final products. The entire chapter, including the section on ozone protection, was put in brackets by Arab oil-producing states, but the Rio conference is expected to adopt it anyway.

The paper on "Strengthening the Role of Major Groups" calls for national strategies for eliminating obstacles to women's full participation in sustainable development by the year 2000 and the establishment by the year 1995 of mechanisms at national, regional and international levels to "assess the implementation and impact of development and environment policies and programs on women and ensure their contributions and benefits." It also calls for measures to ensure that women have equal rights with men in deciding "the number and spacing of their children."

The chapter on institutions offers two options for a follow-up mechanism to UNCED. One is a proposal for a revived ECOSOC (the Economic and Social Council), which would include monitoring progress in the implementation of Agenda 21 among its functions. The other option is a Commission on Sustainable Development under ECOSOC which would monitor Agenda 21 implementation and other activities related to integration of environment and development. Such a commission, with a limited membership chosen by the General Assembly, would provide maximum access for nongovernmental organizations (NGOs) interested in pursuing the implementation of Agenda 21 in their own countries. The commission proposal, by the Netherlands, was supported by the NGO working group on institutions at the PrepCom.

The paragraph on government plans for implementation of Agenda 21 says that states "should consider the preparation of national action plans" for implementation of Agenda 21, thus leaving it to their discretion. Language specifying that reports on progress in implementation of Agenda 21 would be "provided periodically" to an international institution was put in brackets (i.e., was objected to) by Brazil. The G77 decided to water down references to plans and reports because of the lack of commitment by developed countries to new funding for Agenda 21, according to well-informed sources.

The technology transfer negotiations could not reach any agreement on some of the most fundamental issues. Even the title of the chapter as adopted includes four alternatives in brackets. The most important proposed actions for transfer of environmentally sound technologies, including provision of financial resources to developing countries for their acquisition, were placed in brackets by developed countries. A U.S. proposal for "regional clearinghouses" to disseminate information on available technologies was agreed to, but it involves only existing information systems and promises no information not already available.

The chapter on biodiversity urges: 1) actions to promote traditional methods of agriculture, forestry and wildlife management that maintain or increase biodiversity, and 2) the introduction of "appropriate environmental impact assessment procedures" for projects that could affect biological diversity. A paragraph on the promotion of "fair and equitable" sharing of the benefits from indigenous and local communities' traditional knowledge and practices was undermined when the United States put "fair and equitable" in brackets.

*The May issue of Earth Summit Update will report on other Agenda 21 issues.*

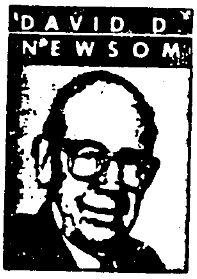
# Paving the Road to the UN Environmental Conference

AN important milestone on the road to the United Nations Conference on Environment and Development (UNCED) in Brazil this June was reached April 4 in New York. The 161 nations represented in the UN Preparatory Committee for the conference reached agreement on a draft declaration of principles for "encouraging environmentally responsible development." Although the declaration, if agreed to in Rio de Janeiro, will not be legally binding, it will form a basis for public and diplomatic pressures on violators. Yet this progress still leaves tough problems ahead, especially for the United States.

From the outset of planning for the UNCED, developed countries and developing countries have been sharply divided over the focus of the agenda. It became clear early in the process that the conference was to be as much about the North-South dialogue between the rich and the poor as it was about the environment.

Poorer nations argued that the industrial North was primarily responsible for pollution and had an obligation to assist all nations in mitigating its effects. They demanded, further, that efforts to clean up the global environment be linked to "sustainable development" in their societies. Richer countries, including the US, resisted, seeing these demands originally as primarily a move by the less developed South to press the wealthier North for more aid.

But as time has passed, the poorer nations have forced recognition of the fact that cleaning up the environment is as much an economic as a scientific issue. In the New York session they also gained agreement that "the developed countries acknowledge the responsibility that they bear in the international pursuit of sustainable development in view of the pressures their societies place on the global environment and of the technologies and financial resources they command."




Despite agreement on the declaration, substantial issues remain unresolved. Participating nations are far apart on questions of meeting costs of reversing environmental degradation, providing the necessary technology, and protecting the Earth's forests. On issues that strike directly at how people live, work, and travel, questions of the power of an international regime over sovereign nations also arise.

The UN organizers of the Brazil session hope to achieve not only the broad statement of principles, but also agreement on two binding conventions – on global warming and on biodiversity (the protection of plant and animal life). The first, on global warming, is the more controversial. Many nations, including America's European allies, believe that the conference will be successful only if this convention is adopted.

Many see the US as standing in the way. Most nations have reportedly accepted the need for established global limits on emission of the carbon dioxide gases that cause global warming. The US has not. Clayton Yeutter, newly installed chief of domestic policy at the White House, was quoted March 28 as saying, "I have not seen any arguments yet that would persuade me that the US ought to agree to definitive targets and timetables."

For the Bush administration, not only global warming but most of the remaining unresolved issues on the Rio agenda present major difficulties. The US is the leading emitter of gases damaging to the global climate. For this reason, and because of its wealth, Washington will be expected to take a leading role in measures to reverse environmental decline and contribute to the related costs. Spokespersons from other countries have already stressed that the success of the conference will depend upon the US's taking a leadership role.

In the current Washington scene, support for such a role seems unlikely. The normal unpopularity in America of foreign aid is compounded by concern over the deficit, the domestic recession, competing claims of the former Soviet nations, and political apprehensions in an election year. Added to these factors is the ideological resistance in a conservative administration to any acceptance of scientific evidence of global warming.

The decisions of the UN preparatory committee announced April 4 suggest, however, that the US is feeling the pressure of the world's concern on these issues. Meetings on global warming are scheduled with European nations April 15 and with the UN preparatory committee April 30. The chance remains that the US, despite its reservations, can still contribute to a successful outcome of the critical conference in Brazil.

■ *David D. Newsom, former undersecretary of state, is Cumming Memorial Professor of International Affairs, University of Virginia.*

**COLUMN RIGHT/**
**TOM BETHELL**

# Earth Summit Is Just a Ruse to Rob the Rich

■ **Blaming the West for Third World pollution is extortion; Bush should stay home.**

President Bush is under considerable pressure to attend the United Nations-sponsored Earth Summit in Brazil early in June. He should pluck up the courage to say no, even if some of the pressure is coming from within his own Administration, notably from William Reilly, the head of the Environmental Protection Agency.

It is estimated that the conference will bring representatives of 160 countries and maybe 40,000 participants to Brazil. Taxpayers will be picking up the tab one way or another. To the National Audubon Society this will be "the most important meeting in the history of mankind." Maurice Strong, a conference organizer and a senior U.N. official from Canada, says that the conference is the last chance to avert "the environmental crisis which threatens the collapse of the planet."

Some environmentalists really do want a cleaner environment. Others (and they will be running the show at Rio) want to remake the world. President Bush played into their hands when he said he wanted to be the "environmental President." Now he has a choice: Sign on to Draconian but unnecessary policies or face accusations of being indifferent to the environment. Within the United States there are few severe environmental problems. Those that do exist are mostly created by government policy rather than private business. Agricultural price supports and very low prices have encouraged the wasteful use of water in the West, for example.

By far the most serious environmental problems are found in Third World and former communist countries. But the underlying purpose of the conference will be to blame the West for the world's pollution. The West has most of the economic growth, and pollution is proportional to growth, runs the spurious argument. Therefore we should impose limits on our own growth by "stabilizing" energy use, reducing carbon dioxide output by 20% or more, taxing the consumption of energy and putting the proceeds into a fund that will be transferred to the Third World.

The redistributionist agenda is familiar. In the 1970s, under the rubric of the New International Economic Order, Western countries were accused of imperialism, and by way of reparations cash transfers were sought. "Third World kleptocrats now view the U.N. conference as the vehicle to reconstitute this scheme under the guise of ecology," says Fred Singer, director of the Science and Environmental Policy Project in Washington.

**'We are confronted not with pure science but with highly politicized findings.'**

There's a question whether the conference has any scientific basis at all. The environmental scare that has captured most attention is global warming, supposedly induced by the increase of carbon dioxide and other "greenhouse gases." In fact, there has been an increase of 0.5 degree centigrade since 1890. A survey of U.S. atmospheric scientists found "no consensus about the cause of the slight warming." Since 1940 (when the carbon dioxide increase began) there has been no global warming at all. Projected temperature increases in the years ahead lack any scientific basis, and the slight increase that might have occurred can be viewed as beneficial. "It would increase nighttime temperatures, causing fewer frosts and a longer growing season, and also increase precipitation," says Singer.

Not so long ago we were being warned about global cooling. This alone should alert us that we are confronted not with pure science but with highly politicized findings, a form of activity that gives new meaning to the phrase *political science.*

All of this might be harmless enough if viewed as an academic exercise. But the rush to impose global regulations could have a serious impact on the world economy, especially on the standard of living in the Third World countries whose governments (rather than peoples) will be the beneficiaries of reparation payments.

"These Third World leaders want capital without the accompanying capitalism," says Fred Smith of the Competitive Enterprise Institute, an outspoken critic of the conference. But as long as they are unwilling to reform their political institutions—in particular by establishing private property and the rule of law—they will continue to doom their subjects to impoverished lives within polluted environments and denuded landscapes. Giving them money will only postpone the needed reforms.

President Bush seems to understand none of this. He accepts the efficacy of aid without question, and he has already capitulated in principle (if not yet with huge dollar amounts) by making token contributions to the U.N. bodies set up to extract resources from Western taxpayers. Bush should say *no* to the Rio meeting, turn the ensuing uproar against those of his political opponents who try to capitalize on it and pay attention to more serious problems at home.

*Tom Bethell is a visiting fellow at the Hoover Institution.*

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*Jeane Kirkpatrick*

# Earth Summit Traps

## *Beware of admirable goals being represented as Third-World rights.*

Preparations have stepped up for the "Earth Summit" of the United Nations Conference on Environment and Development (UNCED), scheduled for Rio de Janeiro in June. And a breakthrough of sorts occurred earlier this month, when, after five weeks of discussion, the 160 countries participating in the Preparatory Conference ("PrepCon" in U.N. jargon) accepted Chairman Tommy Koh's draft declaration.

Koh, an extremely able diplomat from Singapore, reduced a 1,000-page global agenda to 27 simple "principles" to which no country raised serious objections.

Western media have almost all treated UNCED preparations as if they posed two important questions for developed countries: How to deal with the demand to cut energy consumption to stabilize carbon dioxide output and how much money should developed countries offer as an annual incentive to secure Third World cooperation on environmental issues—$3 billion, $6 billion, $15 billion or $125 billion?

But the draft declaration adopted at the "PrepCon" is not chiefly concerned with the environmental issues that dominate American media discussion of the Rio summit.

Koh's declaration avoids specific questions of environmental policy and instead reaffirms briefly key elements of the Third World ideology that has dominated "North/South" negotiations for two decades.

It deals with justice between rich and poor nations. Its key concept is "sustainable development," a notion developed in the 1987 Brundtland Report, which stretches and blends selected environmental issues with an extremely broad conception of "development" to which all peoples have a "right."

"Sustainable development" is the concept that links a particular environmental doctrine to familiar schemes for redistribution of the world's wealth. It is the centerpiece of a new U.N.-based strategy for eliminating poverty, social inequality and injustice.

Thus, environmental protection is seen as an integral part of "sustainable development." But it is only a part. "Eradicating poverty is another indispensable requirement for sustainable development," the draft says. So are decreasing inequalities in wealth and raising living standards for the majority of the world's people.

As usual in such enterprises, goals are presented as rights. "All human beings are entitled to a healthy and productive life in harmony with nature," principle No. 1 states.

BY MARGARET SCOTT

> ***The doctrine of "sustained development" seeks large-scale resource transfers from the developed world and is not much concerned with economic growth.***

According to the draft, the needs of less-developed countries have greatest priority because they are "environmentally vulnerable."

The obligations of the developed countries are heaviest because those countries "place special pressures on the global environment" and also because they command large financial and technological resources. The developed countries, therefore, should limit production and consumption, share the newest technologies, adopt environmental legislation such as a limit on energy consumption and understand that less should be asked of less-developed countries.

Women, youths, indigenous people, (whoever they are—one doubts they include indigenous Celts or Saxons) have especially vital roles in achieving "sustainable development." So do people under "oppression, domination and occupation," whoever they are. War is not helpful to "sustainable development," the draft notes, and should be avoided.

Obviously, the draft declaration restates the ideology of the New International Economic Order adopted by the U.N. General Assembly in 1974, the sea-bed mining provisions of the Law of the Sea Treaty (in which Tommy Koh also played a crucial role), and various "consumer codes" of the late 1970s that sought to subject transnational corporations to punitive international regulations.

This ideology assumes that the Third World has mainly rights and the developed world mainly obligations. It seeks large-scale resource transfers as an answer to poverty and is not much concerned with economic growth. It assumes that international organizations have a right to regulate international behavior and redistribute the world's goods.

It evinces little concern that the international authorities in which it proposes to vest great power lack the technical expertise required to make the judgments offered or to implement the programs proposed.

The tactics being used to promote the adoption of the recommended "environmental" policies are as familiar as the rhetoric. A two-step—buy-now, pay-later—tactic encourages adoption of goals and time tables at Rio, with implementation, monitoring and a chance to revise details coming later.

As usual, the United States is specially targeted, even though other developed countries share many of the same concerns about costs and expensive regulations that may not prove scientifically warranted or compatible with needed levels of economic growth. For example, the European Community's ambitious plans to curb "greenhouse gases" have been curtailed in recent days in the face of member-state opposition and foot-dragging.

Where will it all lead?

Will George Bush attend the Rio summit? Will John Major, Helmut Kohl and Francois Mitterrand? Does it matter?

In fact, it does not matter much. What matters is whether American representatives and those of other developed countries sign on to a declaration containing many "principles" that are incompatible with their experience and interests.

I feel certain that President Bush—who knows the U.N. General Assembly from his time there—sees the Old World Order expressed in the preparations and pressures surrounding the Rio summit. There is no reason to suppose he will forget what he has learned.

# The State of the Union – an Opportunity Missed

By Jay D. Hair

GEORGE BUSH'S total silence on the environment in his State of the Union address not only undermines his claim to be the "environmental president" but also bodes ill for the nation. The issue is one of substance not just that the president didn't tip his hat to the environmental agenda along with his list of national priorities.

Just as hard times and doubts about our international competitiveness are dominant, Mr. Bush missed his best chance to strike the key link that needs to be forged between the economy and the environment.

The linkage is efficiency. It is redirecting the research and development capacity of now redundant weapons labs into the technologies that produce better and cheaper goods by lowering the demand for resources. It is encouraging the development of alternatives to waste. It is understanding that sanctioning the extinction of species is an ethical squandering in the short run and an unraveling of our economic foundations in the long run. It is recognizing that taxpayer subsidies for grazing, mining, and timbering are a form of inefficiency. It is providing incentives for business innovations that produce wealth by lowering stress on the environment.

Our chief competitors are applying these lessons. A dollar's worth of Japanese goods is produced with half the energy needed by its American equivalent. That same unit of goods from Japan is made with one-fifth of the byproduct waste that adds to the cost of its American-made competitor.

Efficiency is the unavoidable name of the future for the economy and the environment. We can either play the game and retain a chance to win, or continue to avoid it and lose. To win, presidential leadership is essential.

**Efficiency is the unavoidable name of the future for the economy and the environment.**

The closest thing we heard from Bush on this score was a renewed call for Congress to enact his national energy strategy, a policy firmly rooted in the past. The president advocates an almost single-minded determination to pursue increased petroleum production, tapping dwindling reserves located in environmentally fragile areas, including the Arctic National Wildlife Refuge. The Senate has already answered that this is a non-starter. A necessary element in charting a course into the 21st century is a policy that begins to steer the economy away from its dependence on fossil fuels.

The president spoke glowingly of free trade. Free trade's market efficiencies offer potentially great benefits. Irretrievable environmental damage is virtually certain if future free-trade agreements continue past patterns of unrestricted drawdowns on natural resources. Based on his address, we may be sure of Bush's enthusiasm for free trade's market potential. But the address gives no assurance he sees the connection between open markets and environmentally sustainable development.

As a short-term measure to boost the economy, the president announced a moratorium on new regulations and a review of existing ones. We cannot yet see if this will become a formula for long-term damage to health, safety, and environmental protections.

His budget does contain some welcome requests. The president wants additional funds for parks, for ecological hot spots like the Everglades, for clean water, to deal with pollution along the United States-Mexico border, and to begin cleaning up nuclear contamination and other pollution that is part of the cold war's environmental legacy. It is the big picture, a vision, that is lacking.

Part of the reason we are in an era of unprecedented global environmental stress is that past leaders often convinced themselves that the environment and the economy were separate and divisible. They are not. The depletion and degradation of one to boost the other is at best shortsighted and at worst disastrous. The health of both are intertwined.

The international community has recognized this truth in preparing for the United Nations Conference on the Environment and Development scheduled in Brazil this June. The conference's success relies on the US lending the full weight of its support through the president's leadership. Bush must show his commitment to the reality that environmental protection and the conservation of natural resources are integral to economic development.

By this measure, his State of the Union address was a disappointment. He missed an opportunity to deliver a State of the Environment address showing his commitment to an environmentally and economically sustainable future.

■ *Jay D. Hair is president and CEO of the National Wildlife Federation.*

# GLOBAL WARMING CAUSES POLITICAL HEAT

BY MARGARET E. KRIZ

At a time when domestic and international pressures are increasing for the White House to support stronger measures to curb global warming, the Bush Administration is trying to figure out how to keep environmentalists and foreign critics at bay while not adopting government controls that corporate America could portray as damaging to the shaky U.S. economy.

ENVIRONMENT

With the June U.N. environmental summit in Rio de Janeiro fast approaching, foreign leaders, Congress and the environmental community are turning up the heat in an effort to persuade President Bush to attend the conference and to agree to European proposals to freeze national carbon dioxide emissions at 1990 levels by the year 2000.

But top Administration officials argue that tough carbon dioxide emission cuts could disrupt the U.S. and the world economies.

In December, when former White House chief of staff John H. Sununu, who favored a stand-tough position at the global warming negotiations, resigned, environmentalists hoped Bush would back stronger carbon dioxide control measures. But Sununu's replacement, Samuel K. Skinner, and White House domestic affairs counselor Clayton K. Yeutte: are sticking with past proposals under which each country would draw up broad plans for lowering warming gas emissions, without committing the nations to specific targets or deadlines. *(For more on the politics of global warming see NJ, 2/8/92, p. 319.)*

To press U.S. and Western European officials to settle their differences over a global warming treaty, government representatives of the world's industrial countries are holding an Organization for Economic Cooperation and Development (OECD) meeting on April 13 in Paris. The Paris-based group consists of 24 industrialized nations, including Western Europe, the United States and Japan.

The session is planned to hammer out an OECD position on global warming before the last set of U.N. treaty negotiations, scheduled to begin on April 30 in New York City.

But bad blood remains between U.S. and European officials. After a March negotiating session, European Community environmental commissioner Carlo Ripa di Meana accused the White House of caving in to pressure from U.S. industry, which opposes tougher carbon dioxide controls. Di Meana, quoted in *The New York Times*, said the U.S. position on global warming was "an attack on the very heart of the Rio conference."

As the White House struggles with the international criticism, Congress has launched its own attack. On April 2, Rep. Henry A. Waxman, D-Calif., chairman of the Energy and Commerce Subcommittee on Health and the Environment, introduced legislation that would mandate a freeze on national carbon dioxide emissions.

The legislation, which is designed to be attached to the House omnibus energy bill, has more than 100 co-sponsors, including six committee chairmen. Notably absent from the list is Energy Committee chairman John D. Dingell, D-Mich.

The energy bill is expected to go to the House floor in May, shortly before the June 2 conference in Brazil. "We want to send a very strong message to the Bush Administration and also to the negotiators from other countries that Congress doesn't share the Administration's position on global warming," a Health subcommittee staff aide said.

Many environmentalists, who support the Waxman bill, accuse the Administration of trying to bully other industrialized countries to accept the weaker U.S. position on global warming. "So far, they've been content to sit back and play this last-minute game and hope the rest of the world will kowtow to their ridiculously weak arguments," said Daniel F. Becker, Sierra Club energy director.

Will Bush attend the Rio summit? Yeutter said on March 27 that the President will be there only if the meeting promises to be "productive."

Other Administration officials privately say that means that Bush may not show up if the United States and the Europeans are still at odds. They note, however, that Bush is the only Group of Seven leader who is not committed to attend the environmental meeting.

The Earth Summit presents a critical environmental decision for Bush, particularly in an election year, noted Alden Meyer, climate change and energy policy director for the Union of Concerned Scientists. "If he doesn't change his position, but goes anyway, he'll be criticized by other world leaders for sabotaging the world treaty," Meyer said. "If he doesn't go, he'll take a beating in the world and U.S. press for not being an environmental leader." ■

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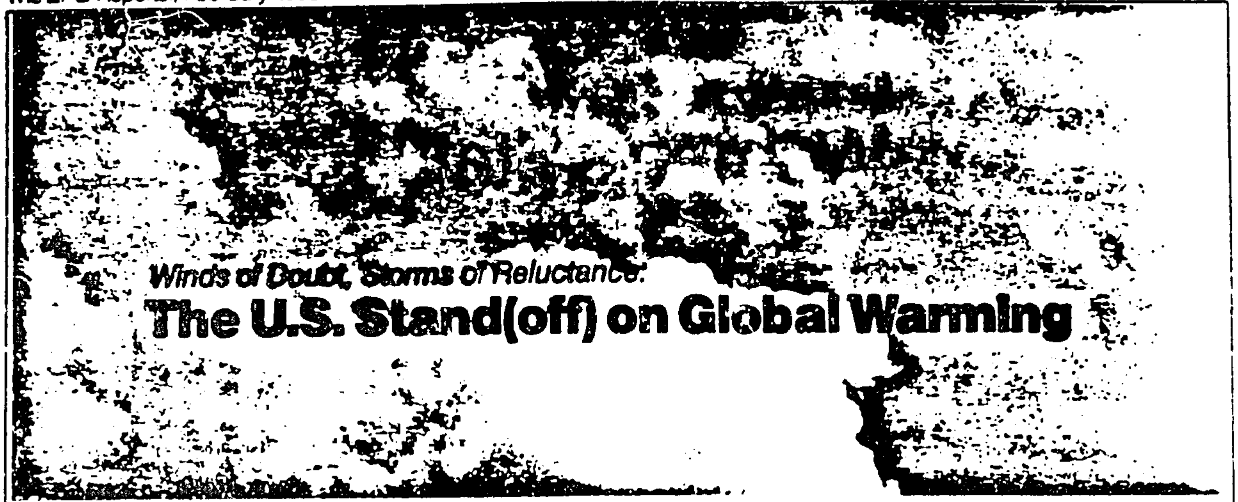

## Winds of Doubt, Storms of Reluctance:
# The U.S. Stand(off) on Global Warming

Now that John Sununu is out and Samuel Skinner is in, can the United States finally warm up to global warming agreements?

Global warming, considered by many to be the direct result of unchecked population and economic growth, is arguably the most all-encompassing and daunting environmental problem threatening the planet. Because the United States emits the world's largest share of gases responsible for global warming, a U.S. commitment to reducing those emissions could have a tremendous impact in slowing global climate change, and in encouraging other nations to limit their emissions.

Some environmentalists are guardedly optimistic that Mr. Skinner, President Bush's new chief of staff, at least understands the gravity of global warming. But it remains to be seen whether the Bush administration will now participate significantly in the current international climate change negotiations.

### The Dark Cloud of $CO_2$

During the last century, industrial societies have pumped into the atmosphere billions of tons of gases that absorb heat emitted from the planet's surface. Many scientists believe that if current trends continue, the buildup of these so-called greenhouse gases will trap enough thermal radiation to warm the atmosphere as much as 8 or 9 degrees Fahrenheit by the middle of the next century. Many assert the warming has already commenced. The 1980s were the warmest decade, and 1990 the warmest single year on record.

The atmospheric concentration of carbon dioxide ($CO_2$), which constitutes the largest share of current greenhouse gases, has increased a startling 25 percent over the past century.

The primary sources of $CO_2$ emissions are fossil fuel combustion and deforestation. The United States remains the largest contributor to $CO_2$ emissions, responsible for 22 percent of the world's total output. Although energy efficiency has improved in some sectors of the U.S. economy, those gains have been more than offset by continued population growth and, subsequently, more energy demand and use. In the past 20 years, for example, the United States has added close to 50 million to its population, and an additional 50 million cars to its roads. Motor vehicles contribute approximately one-third of all $CO_2$ emissions in the United States today.

But while developed countries are currently responsible for approximately three-fourths of the planet's total buildup of greenhouse gases, developing nations are expected to contribute a much greater share within the next century. An estimated 90 percent of the doubling or even tripling of the world's population is projected to come from nations now working toward industrialization.

The relationship is really very simple. As Francesca Lyman from the World Resources Institute makes clear: "The more people on the planet, the more energy and materials needed to feed, house, clothe, and employ them, and the more exhaust gases and other pollutants released by that energy."

### Weathering the Worst

But what does the buildup of greenhouse gases mean?

Scientists rely on data gathered from sophisticated versions of long-range weather-forecasting computer models to predict the consequences of global warming. Because the models are not detailed enough to include all of the factors that affect climate, especially in any given region, the scenarios vary. But few are pleasant.

Generally, scientists anticipate temperature increases to be less around the equator and greater at higher latitudes. Though the global average amount of precipitation is likely to increase, especially in areas already prone to heavy rainfall, continental interiors are expected to experience drier summers. Oceans will undoubtedly expand and rise as they absorb additional heat from the atmosphere and as polar ice melts.

Scientists estimate that sea level at the end of the next century could be a full meter higher than it is today. More than one-half of the world's population lives on land likely to be flooded. In the United States, already-eroding East Coast beaches and the Gulf Coast states—where population is rapidly expanding—are most likely to be affected first.

Vulnerable industrialized nations, like the United States, could consider raising roads and bridges, erecting seawalls and dikes, and constructing canals and levees to shield their human population. But at what cost? And could the elaborate protection systems be completed soon enough?

Low-lying Third World nations, on the other hand, have no such options. As a result, many industrialized countries, which already feel the pressure of multitudes of political and economic refugees, can expect an escalation in the demand for services and resources needed to accommodate millions of environmental refugees.

Wildlife, too, will be affected by climate change. Mammals, birds and insects may be able to migrate toward the poles, but that could be impeded by farmland and ever-growing cities and urban sprawl. And plants can move only as quickly as their seeds are dispersed, which may not be soon enough to prevent widespread extinction and devastation of entire ecosystems. Some say 25 percent of the world's species could become extinct within the next two decades.

Agriculture may stand a better chance of adapting to climate change than does wildlife, but food supplies and markets are apt to be seriously disrupted. The EPA estimates that U.S. corn, wheat and soybean yields could drop by as much as 80 percent by the year 2050, devastating the U.S. position as the world's breadbasket.

While "agroclimatic zones" are likely to shift toward the poles, many wonder if new crop mixes, proper soil conditions and water supplies can be put in place in time. There is also doubt that technological advances and equitable distribution of resources can keep pace with both rapid climate change and a doubling or tripling of the world's population.

### The Economic Snow-Job

Scientists have warned world leaders about the potential devastation from global warming for over a decade now. But only in the past couple of years have policymakers attempted to reach agreement on slowing climate change.

Much of the work during the past year has focused on negotiating an international climate change convention—containing legally binding commitments—ready for heads of state to sign during the United Nations Conference on Environment and Development in June.

The United States' refusal to commit to targets and timetables for the reduction of greenhouse gases, especially $CO_2$, continues to be a—if not *the*—major obstacle in the treaty negotiations. Why the refusal? In a word, economics.

The John Sununu school-of-logic has so far dominated the Bush administration's attitude: We don't know enough about the actual impacts of global warming to risk "either national or international decisions that are multi-trillion-dollar decisions in terms of impacts on the economy and jobs."

Further, a report issued last fall by the National Academy of Sciences (NAS) went so far as to suggest that industrialized nations, in particular, are in a good position to *adapt* economically to global warming. The basic argument? The life of most capital equipment and structures is short compared to the projected time frame of climate change, making it relatively inexpensive to change technology or location to accommodate the weather.

The NAS "adaptation panel" was not without dissenters, however. Jane Lubchenco, an ecologist from Oregon State University, issued a strong objection, saying: "Divorcing humans from their ecosystems ignores the intimate, if often complex and subtle, dependencies of humans on the natural landscape." She and other environmentalists say the panel made a crucial error in trying to separate economics from ecology.

Former Deputy Assistant Secretary of State Richard Elliot Benedick shares that view. In his book *Ozone Diplomacy: New Directions in Safeguarding the Planet*, Benedick writes: "[Economics'] traditional methods of measuring income and growth appear increasingly irrelevant in the modern world: the more chlorofluorocarbons a country produces, for example, the greater is the growth in its gross national product. ... Thus, the application by policymakers and investors of the tools of conventional economics may result in ecologically very misleading decisions."

Oddly, a global warming report issued last spring by another NAS panel did recognize the intimate relationship between humans and ecosystems. The chair of that study, Daniel J. Evans, called "continued human population growth ... the biggest single driver of atmospheric pollution." The panel stopped short of making specific $CO_2$ emission-reduction recommendations, but it did call upon the United States to "resume full participation in international programs to slow population growth."

Unfortunately, the subject of population growth will probably not be identified in the final draft of the international climate change convention now being negotiated. Nonetheless, slowing the effects of global warming depends upon the ability of every nation to limit its greenhouse gas emissions *and* its population growth. Undoubtedly, the United States, still the fastest growing industrialized nation and the highest per-capita energy user, should take the lead.

—Jennifer Merrill

THE WASHINGTON POST, March 8, 1992

*Jessica Mathews*

# Tiny Steps Toward a Greenhouse Treaty

Rather than bear the blame for the failure of international negotiations to slow global warming, the Bush administration blinked last week. At nearly the last minute, the United States turned the stalled United Nations talks from gloom to hope by announcing that it would voluntarily adopt a set of measures to limit emissions of greenhouse gases.

Europe has been pushing hard for an agreement that would require the developed countries to stabilize their emissions of carbon dioxide, the chief greenhouse gas, at 1990 levels by the year 2000. Washington has adamantly opposed such "targets and timetables." But while the administration is not yet ready to say what the overall effect of its limitation measures would be, the chief U.S. negotiator opined that it would "compare favorably" with the European target.

In effect, the administration has found a way to reverse its position while maintaining that it has not changed at all. The likely scenario signaled by last week's surprise announcement goes like this. The first step is to calculate optimistic assessments of the effects of the various measures, which are a medley of long-standing programs and recent commitments in transportation and energy legislation. Next, factor in lower projected GNP growth and, *voila*, instead of the 13 percent increase in carbon dioxide emissions predicted in last year's National Energy Strategy, emissions are stabilized, or close to it.

Washington will then be able to negotiate a deal among the OECD countries, not to stabilize emissions (a still unacceptable "target") but to adopt a set of measures that would stabilize emissions. Neat.

This happy outcome is not a foregone conclusion. Energy producers, led by the coal industry, will lobby hard against it. So will extreme right-wingers, who view any international agreement as the first step down a slippery slope to world federalism. The administration itself is deeply divided internally. But there is at least a fighting chance that the White House will at last acknowledge that there are things the United States can do to limit its fossil fuel use at little or no cost. The measures themselves are modest. The significance of the policy shift, if it holds up, is substantial.

The administration's other announcement, that it would contribute $75 million toward helping the developing countries deal with global warming, is in the same vein. It is clearly intended to meet those countries' demand that an international agreement provide additional financing, which Washington has opposed. But the announcement was purposefully murky as to whether the $75 million is "new" money or funds shifted from other accounts, so the U.S. stance is officially unchanged.

The new policy stems in part from John Sununu's departure. It owes something as well to last month's news of greater ozone loss in the Northern Hemisphere, which was a sobering reminder of the potential costs of delay when dealing with gases that last for more than a century in the atmosphere.

More important was the recent discovery that chlorofluorocarbons, rather than being a major contributor to global warming, may have no net greenhouse effect (because the ozone loss they cause creates an offsetting cooling). Since getting rid of CFCs no longer helps slow the greenhouse trend, the administration is now forced to confront the biggest greenhouse gas, carbon dioxide.

Bush well knows from his 1988 Boston Harbor attack on Michael Dukakis how politically damaging a bad environmental image can be. This fall he has to defend not only his record as "the environment president," but his outright pledge to use "the White House effect" to take care of the greenhouse effect. Last week's initiative was the first sign in three years that the Bush White House effect could be anything but obstructive.

A greenhouse treaty ready for signature and photo ops at the Earth Summit in June must still be judged a long shot. But with the new U.S. policy, the odds have shifted dramatically. If an agreement is reached, it will likely contain few specifics, but formalizing a commitment to slow greenhouse warming and creating the mechanism for international cooperation, would be a major achievement—one that seemed a farfetched goal just two years ago.

In nature's terms, however, even an agreement to stabilize the industrial countries' emissions would be only a tiny first step toward eventually wrestling greenhouse forces to a standstill. Because present emissions are so much greater than natural levels, and because carbon dioxide lasts so long in the atmosphere, stabilizing emissions is a far cry from stabilizing the amount of the gas in the atmosphere. If that ultimately proves necessary, it will require cutting present global emissions by a staggering 60 percent.

If successful, a greenhouse agreement in 1992 would say a lot about a new world order. It would be by far the most demanding, domestically intrusive, international treaty ever attempted. It would be the first global security arrangement to require the active engagement of every nation. It would have been achieved at blinding speed, setting a new standard for what can be expected of international negotiations. And, worth noting by the last remaining superpower, it would be the first great international achievement of the 20th century achieved without American leadership.

*The writer, vice president of World Resources Institute, writes this column independently for The Post.*

The Washington Times MONDAY, MARCH 9, 1992 / PAGE E3

JONATHAN ADLER

# A greenhouse road to serfdom

On Feb 27, the Bush administration announced that it was beginning to give in to the demands of environmentalists and Third World countries by pledging $75 million in aid to developing countries.

This aid is intended to induce these countries to forego the use of those energy sources that produce "greenhouse" gases. While this action marks a decided turn in administration policy, the environmental establishment is far from satisfied. As Michael Oppenheimer of the Environmental Defense Fund told the New York Times, "If it's the last thing we hear about global warming, then its a sham."

What the environmental community is demanding is that the United States commit to reducing emissions of greenhouse gases to 80 percent of 1990 levels by the year 2000. Senate Majority Leader George Mitchell has charged that "eventually, we must ourselves reduce consumption of fossil fuels by 50 percent or more."

However, in these calls to action, there is little discussion of the costs of such measures. Given the results of a recent study by the Energy Department, this is not at all surprising. According to this report, reducing carbon dioxide emissions 20 percent below 1990 levels over the next decade would bring an annual price tag of $95 billion dollars by the year 2000. This would represent a more than 50 percent increase in annual expenditures on environmental regulations and would surely have dire economic consequences. Such an effort would require massive energy taxes, and would be likely to as much as double the price of gasoline.

Merely freezing greenhouse gas emissions at 1990 levels, considered the baseline for any serious talks on climate change by the European Community, would also be quite expensive. This would require the imposition of a $100 per metric ton carbon tax, and would likely increase gasoline, heating oil and electricity prices by more than 25 percent. As goes without saying, much of the economic impact of these changes would fall upon the working class and urban poor. Given the costs of these "modest" scenarios, just imagine the impact of Mr Mitchell's 50 percent reductions.

All this is based on the assumption, regularly repeated in journalistic circles, that a scientific consensus supports the need for such actions. After all, any price would be a small price to pay to save the world. However, a recent survey by the Center for Science, Technology & Media (CSTM) demonstrated that there is hardly a scientific consensus that industrial emissions of greenhouse gases will have catastrophic consequences. According to this survey, conducted by the Gallup organization, only 41 percent of experts believe that the current scientific evidence supports the possibility of "human-induced global warming." Interestingly enough, a companion CSTM study revealed that among scientists who had been quoted in major media outlets, there was greater support of global warming theories than in the scientific community as a whole.

*Congressional leaders and environmental activists have been urging that President Bush listen to the scientific "consensus" and embrace the apocalyptic scenario of a catastrophically warming world. Yet now members of the scientific community are demonstrating that this supposed consensus does not now, and never did, exist.*

What is more, a statement just released by the Science and Environmental Policy Project, and signed by more than 40 U.S. atmospheric scientists, goes even further, charging that the environmental agenda being pushed at the U.N. Conference on Environment and Development, which includes a proposed global climate treaty, "will have catastrophic impacts on the world economy, on jobs, standards of living, and health care, with the most severe consequences falling on developing countries and the poor." Not only does the public statement directly challenge the "unsupported assumption" that human activity is causing global warming, but it also points to the wealth of scientific evidence that carbon dioxide enrichment of the atmosphere has "beneficial effects on most crops and on world food supply."

Most startling about the public statement was the willingness of so many climate scientists who had previously kept quiet to challenge what passes for the conventional wisdom on climate change and take a stand against the rush to embrace the "Earth Summit." As the statement read, "We are disturbed that activists, anxious to stop energy and economic growth, are pushing ahead with drastic policies without taking notice of recent changes in the underlying science."

For the past few months congressional leaders and environmental activists have been urging that President Bush listen to the scientific "consensus" and embrace the apocalyptic scenario of a catastrophically warming world. Yet now members of the scientific community are speaking out and demonstrating that this supposed consensus does not now, and never did, exist.

For the first three years of the Bush administration, the president held firm against the calls for precipitate U.S. action on this issue. The cries of the environmental establishment notwithstanding, the demonstrated absence of a scientific consensus justifies what has been a rational and prudent approach to global climate change.

Yet now it appears that the administration is on the verge of capitulating to the green establishment in a cynical attempt to woo the environmental vote. No "gimmick," embracing a policy of massive reductions in greenhouse gas emissions will cost the American people dearly. If the president is serious about jump-starting the flagging economy, it would be best not to cut off its fuel.

*Jonathan H. Adler is an environmental policy analyst at the Competitive Enterprise Institute.*

# Economic Scene

Sylvia Nasar

## Can Capitalism Save the Ozone?

CREATING free markets in Russia and other poor countries may do more to slow global warming than any measures that rich countries are likely to adopt in the 1990's, a World Bank study has found.

The study is helping to forge a consensus among economists in advance of a 100-nation conference on global warming scheduled for Rio de Janeiro in June. Third-world economic reform, not foreign aid for pollution-abatement programs, should be the top priority, they say.

"To a large extent, environmental problems are the consequence of policies that are misguided on narrow economic grounds," said Lawrence H. Summers, chief economist of the World Bank. "In the next decade or so third-world countries should do things that are in their economic interest anyway," said William Cline, an economist at the Institute for International Economics.

Energy subsidies, economists say, are a prime example of misguided policies with large environmental as well as economic costs.

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For years, many poor countries have been practically giving away oil, coal and natural gas to domestic buyers in hopes of fostering industry and keeping living costs low for urban workers.

Eliminating energy subsidies would improve trade balances, shrink government budget deficits and reduce wasteful energy consumption. But it would also cut emissions of carbon, the substance whose buildup, scientists fear, could eventually destroy the ozone layer, resulting in higher average temperatures and harmful climate changes around the world.

If Russia and other states of the former Soviet Union — which accounted for two-thirds of the huge $232 billion in total world subsidies — let fossil-fuel prices rise to the world market level, carbon emissions would decline roughly 6 percent globally, estimates Anwar Shah and Bjorn Larsen, both World Bank economists.

And if all developing nations, including China, which accounts for about 20 percent of worldwide carbon emissions from coal use, eliminated their energy subsidies, the authors say, global carbon emissions would fall by 10 percent.

To achieve that big a reduction in worldwide emissions, they say, the world's rich countries would have to adopt a $40-a-ton carbon tax or its equivalent. That kind of Draconian action is extremely unlikely in the near future. "Trying to tax the coal industry out of business is just not in the cards," said Thomas Schelling, a University of Maryland economist and the departing president of the American Economics Association.

In any case, third-world countries are under extreme pressure to improve the performance of their economies.

Mexico and Venezuela recently tripled subsidized domestic gasoline prices, steps that are likely to reduce urban air pollution even as they ease a major burden on government budgets.

On Jan. 2, Russia quadrupled domestic fossil fuel prices. "What they've already done will lead to a 10 percent decline in Soviet carbon emissions and a 2 percent reduction in global emissions," Mr. Shah said.

Some environmentalists play down the environmental significance of economic reforms. "Freeing energy prices doesn't promptly produce energy savings because the infrastructure and technology aren't there," said Amory Lovins, director of research at the Rocky Mountain Institute, an environmental research organization.

But others agree with the economists. "Removing energy subsidies in the ex-Soviet union would be a major contribution to global efforts to reduce carbon emissions," said Lester Brown, director of the Worldwatch Institute, an environmental group.

As an indication of how powerful the effect of freeing prices might be, Mr. Brown points to the large impact of the lifting of fertilizer price controls in the Soviet Union in the mid 1980's. In three years, he said, Soviet fertilizer use plunged 26 percent and world use fell nearly 5 percent.

Ultimately, economists like Mr. Summers and Mr. Schelling think that economic development is, in itself, a powerful antidote to environmental degradation.

• • •

A recent study by two Princeton University economists, Alan B. Krueger and Gene M. Grossman, supports that view. Based on a sample of several dozen countries, the economists conclude that pollution rises with each dollar of per capita gross domestic product up to $4,000. But as countries get richer, the study shows, per-capita pollution declines. The reasons: more efficient production methods, a shift toward cleaner industries and more effective government regulation.

Russia and Mexico, as it happens, which have per capita incomes of about $4,000, may be among the countries right on that threshold.

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# People and Parks

***Linking Protected Area Management with Local Communities***

Michael Wells and Katrina Brandon
with Lee Hannah

# *Summary*

National parks, wildlife reserves, and other types of protected areas are at the forefront of efforts to conserve biological diversity. But many protected areas are in crisis. Already underfunded, they have come under increasing pressure from the expanding scale of human activities outside—and sometimes inside—their boundaries. Conflicts of interest have thus arisen in many areas of the world between protected areas and local people. Traditional approaches to park management and enforcement activities have been unable to balance these competing objectives.

In response, a new set of initiatives, introduced here as integrated conservation-development projects (ICDPS), has been launched. These projects attempt to ensure the conservation of biological diversity by reconciling the management of protected areas with the social and economic needs of local people. The smaller ICDPS include biosphere reserves, multiple-use areas, and a variety of initiatives on the boundaries of protected areas, including buffer zones. Larger projects include the implementation of regional land use plans with protected area components, as well as large-scale development projects with links to nearby protected areas.

This study looks at the early experiences of twenty-three such projects in Africa, Asia, and Latin America. The report explores the social, ecological, technical, and institutional issues that arise from these attempts to link protected area management with local development. It identifies the vital elements in the design of ICDPS and assesses the effectiveness of field experience. Last, it elaborates lessons for future programs to conserve biodiversity in developing countries.

### What are integrated conservation-development projects?

Understanding integrated conservation-development projects requires understanding the evolution in conservation thinking toward a greater emphasis on the broader societal role of protected areas and their potential contributions to sustainable development. Although the ICDP approach has been heavily publicized and is rapidly expanding its influence, assessment of activities to date has been limited. The twenty-three case study projects examined in this report were selected from among those that have been described as the most promising and effective (chapter 1).

The physical and ecological characteristics of the case study projects varied substantially, as did their management objectives and their relations with local people. Variability in the institutional influences—laws, policies, social changes, and economic forces—was also considerable. It was apparent that many of the projects had begun with only a very limited understanding of the root causes of the threats to the protected areas that they were attempting to conserve, threats that arose from complex social, economic, cultural, and political interactions (chapter 2). To provide more insight into this diversity—and the similarities as well—three case study projects, one in each region, and their accomplishments are examined in some detail (chapter 3).

### Design and implementation issues

To achieve their objectives, ICDPS engage in three distinct types of operations. *Protected area management* activities include biological resource inventories and monitoring, patrols to prevent illegal activities, infrastructure maintenance, applied biological research, and conservation education. Some ICDPS try to establish *buffer zones* around protected areas. While the concept has strong intuitive appeal, there are many difficulties in trying to put it into practice, and actual working examples of buffer zones among the case study projects were virtually nonexistent. *Local social and economic development* activities constitute the third type of op-



The World Bank • The World Wildlife Fund • U.S. Agency for International Development

eration, and these use approaches that are comparable to those in rural development projects, or simpler approaches that rely on compensation and substitution strategies (chapter 4).

Efforts to promote social and economic development among communities adjacent to protected area boundaries represent the central concern of the ICDP approach and clearly distinguish it from other conservation approaches. Promoting local development is a highly complex and challenging task for conservation practitioners, and in this effort, many of the lessons from earlier rural development projects are applicable to ICDPs as well. To achieve their aims, ICDPs must ensure that the activities of their development components are consistent with the overall goal of conserving biodiversity. One of the most challenging tasks for ICDP managers is to promote development activities that not only improve local living standards but also lead to strengthened management of protected areas.

At a more general level, ICDPs need to challenge the widespread but unsupported assumption that people who are made better off as a result of a development project will refrain from illegal exploitation of a nearby protected area even in the absence of the negative incentive provided by more effective penalties. Such expectations appear naive, and the need to strengthen guard patrols and to impose penalties for illegal activities in protected areas remains strong. Enforcement activities are not inconsistent with the ICDP concept when they are integrated with genuine local development efforts and serious attempts to improve local people-park communications through educational campaigns and other means.

These complexities all reemphasize the importance of establishing *explicit linkages* between the different components of an ICDP. Many types of development activities have the potential for increasing local incomes and living standards. What is less clear is how such activities can be expected to enhance the conservation of biological diversity, particularly in the absence of more effective enforcement. In other words, very careful thought needs to be given at the design stage to the following question: what are the anticipated linkages between the planned realization of social and economic benefits by people living *outside* the park or reserve boundaries and the necessary behavioral response the project seeks to achieve to reduce pressure *inside* the boundaries (chapter 4)?

Attempts to generate local social and economic benefits through the development components of ICDPs were concentrated in five areas: (1) natural resource management outside protected areas, particularly in agroforestry, forestry, irrigation and water control, and wildlife; (2) community social services, such as schools and health clinics; (3) nature tourism; (4) road construction for market access; and (5) direct employment generation.

The case study projects have resulted in numerous benefits for local people, principally through income gains and improved access to social services. From a strictly development perspective, several of the projects appear quite promising, and one or two of them quite successful. But in virtually all the projects, the critical linkage between development and conservation is either missing or obscure.

Thus it is questionable whether many of the project activities have generated local benefits that have reduced pressures on the parks or reserves they are trying to protect—the key objective of ICDPs (chapter 5).

### Empowering local people

Involving local people in the process of change and development and enabling them to wisely manage the resource base is a necessary, but difficult, component of ICDPs. Few of the projects specified what they meant by local participation, and most have treated local people as passive beneficiaries rather than as active collaborators. Some ICDPs found it necessary to generate short-term benefits to establish credibility. But such immediate gains are not a substitute for the time-consuming and intensive process of involving communities in project design and implementation over the long term. Achieving a balance between the short- and long-term goals is essential, as is balancing participation with enforcement activities (chapter 6).

### Participating organizations

The case study ICDPs were executed by a mix of government agencies, conservation and development nongovernmental organizations, and development agencies operating independently or in partnership. Nongovernmental organizations ranged from small local organizations to large international conservation groups, yet few had the capacity to design, implement, evaluate, or fund large ICDPs. Government agencies often lack adequate financial resources and personnel, and jurisdictional conflicts between agencies responsible for activities inside protected areas and those operating outside these areas were common. The nongovernmental organizations participating in ICDPs brought important strengths and experience in conservation but sometimes lacked the expertise needed to design, implement, or evaluate integrated projects with development components.

There is debate over whether ICDPs should be top-down or bottom-up in their design and implementation. Top-down tends to be associated with governments and international organizations, and bottom-up with nongovernmental organizations. The case studies revealed little convincing evidence that, working independently, governments, conservation organizations, or development organizations can effectively plan and implement ICDPs. Partnerships between conservation and development organizations and between these organizations and government agencies are proposed as essential for the success of ICDPs (chapter 7).

### Measuring effectiveness

The ultimate objective of ICDPs is the conservation of biological diversity in parks and reserves. All ICDPs must eventually face the test of whether they have strengthened the ability of protected areas to conserve the species and ecosystems the areas were established to protect. It is possible for a project to have successful social and economic development components without being an effective ICDP.

The scale of projects was an important element in their effectiveness. For example, if a project works in only a few of the communities surrounding a protected area, its overall influence in protecting the park may be weak, even if the project's effectiveness in those communities is strong. Several other factors were also associated with improvements in biodiversity conservation at case study sites, including more effective enforcement, mitigation of the adverse impacts of tourism, specific agreements for local development, and direct linkage of conservation goals to development benefits (chapter 8).

### Lessons

ICDPs cannot address the underlying threats to biological diversity. Many of the factors leading to the erosion of biodiversity and the degradation of protected natural ecosystems in developing countries originate far from park boundaries. Among them are public ownership of extensive areas of land unmatched by the capacity of government agencies to manage these lands; powerful financial incentives encouraging overexploitation of timber, wildlife, grazing lands, and crop fields; an absence of linkages between the needs of conservation and the factors encouraging development; and laws, policies, social changes, and economic forces over which poor people in remote rural areas have no influence.

Addressing these issues in a meaningful way would require engaging the highest levels of governments throughout the industrialized and developing worlds and mobilizing resources on a much larger scale than has been done so far. Today, even under the best of conditions, ICDPs centered on protected areas and directed to local populations can play only a modest role in mitigating the powerful forces causing environmental degradation.

In these circumstances, it is perhaps remarkable what the case study projects *have* managed to achieve. ICDPs are attempting to combine the most difficult aspects of conservation and park management with rural development. Despite formidable constraints, what many of this first generation of projects have achieved is significant. While traditional enforcement will continue to play a critical role—and in many cases needs desperately to be strengthened and expanded—it will have to be coupled in many instances with efforts to benefit local people. This means that innovative, well-designed ICDPs that constructively address local people-park relationships at carefully selected sites are an essential element in the conservation of biodiversity, and therefore of sustainable development efforts.

But for ICDPs to play a significant role in conserving biological diversity, decisive actions need to be taken by implementing organizations, by national governments, and by lenders and donors, including international development agencies. Without deliberate and concerted actions by these groups, the outlook for biodiversity will be bleak. The long gestation periods needed for ICDPs to produce results clearly means that these actions must be taken sooner rather than later. Recommendations for future ICDP initiatives are made in several categories: (1) projects as part of a larger framework that includes such preconditions as adequate political support, enabling legislation, realistic institutional arrangements, and compatibility with regional development, resource tenure, and institutional orientation; (2) scale of projects; (3) participating organizations; (4) site selection; (5) local participation; (6) financial resources; and (7) project design and implementation (chapter 9).

The challenge for the future is not just to design and implement more effective ICDPs. That will be feasible, although it will require more financial support, creative modifications of existing approaches, and application of a much more thorough understanding of the rural development process. The greater challenge will be to engage the individuals and organizations that have the capacity and the commitment to establish social, economic, legal, and institutional environments that facilitate rather than frustrate achievement of the ICDP goal of conserving biodiversity.



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WORLD BANK NEWS

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# Kenya Acts to Halt Degradation of Wildlife Resources

Kenya is launching a 10-year program to conserve the country's wildlife resources. The International Development Association (IDA) has approved a credit of SDR 44.8 million ($60.5 million) to support the program.

Kenya's elephant population has declined 85 percent, from an estimated 130,000 in 1973 to 16,000 in 1989, while the rhinoceros population has declined 97 percent, from 20,000 in 1970 to 500 in 1989.

The program is designed to assist the government's efforts to protect these and other animals from extinction and to get communities involved in protecting and managing parks and other areas where wildlife lives.

Approval of the IDA credit marks the first time any World Bank agency has supported a project devoted entirely to protecting wildlife.

The IDA credit will help finance improvements of parks and wildlife preserves and training and technical assistance for Kenya Wildlife Services, the government agency in charge of managing the parks and enforcing laws against poaching. The credit will also finance a nationwide education program to increase people's awareness of the importance of Kenya's wildlife.

"This is an integrated effort to protect Kenya's wildlife in the long run," according to World Bank official Owaise Saadat, who points out that the program includes plans for carrying out research and implementing policies that will provide people with incentives to participate in the effort.

"The program will not succeed if people living around the parks are not actively involved and if their concerns are not integrated into future plans for wildlife park management," Mr. Saadat says. Animals currently roam freely in and out of protected areas and commonly damage farmers' crops and sometimes even attack people, so villagers often kill animals that wander onto their land. "For many people living near parks, there have been only costs associated with wildlife protection. The people see no benefits." The program will ensure that people do benefit from wildlife protection, he says. Tourism revenues will be shared with communities that participate in anti-poaching programs, fences will be built to protect people's farms, and people will receive financial assistance to help them start up wildlife-related businesses, such as tourist facilities and small-scale handicraft shops.

Tourism revenues will also be used to build health care and education centers for

See KENYA, page 2

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## Program Calls On Communities To Help Protect Kenya's Wildlife

KENYA, *from page 1*

communities participating in the program. Non-governmental organizations will participate in the program to ensure that people's interests are taken into account in any decisions related to wildlife management.

Mr. Saadat notes that Kenya has already made impressive progress in controlling poaching. In the past, poachers killed about 5,000 elephants a year. During the last two years, a total of 52 elephants were killed. The wildlife-protection program is expected to reduce this number even further, while enabling the government to strengthen its system for tackling environmental problems in the long run. ☐

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SPECIAL NETWORK SUPPLEMENT:
REVIEWS OF AGENDA 21

# Some Thoughts on Biological Diversity

*by Thomas E. Lovejoy*
*Assistant Secretary for External Affairs*
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**A. Providing Information on Biodiversity**

As fundamentally important to a society as biological diversity is, it is not very well known scientifically nor very well understood by the general public. Therefore, as Agenda 21 states, major efforts need to be undertaken in both regards, but it is essential to recognize that this must not delay possible action. Action and information must go hand in hand. Action programmes must be based on the best current scientific information and public understanding, as well as subjected to frequent refinements and revision as scientific and public understanding grow.

While estimates are understandably imprecise, the 1.4 million species currently described in the scientific literature represent perhaps but 10% of the total biological diversity on the planet. Consequently, there is an urgent need for a crash programme in the exploration of life on earth with biological surveys in every nation. This will require the establishment of institutions such as Costa Rica's National Institute of Biological Diversity (INBIO), and the strengthening of museums and botanical gardens where the world's flora and fauna have traditionally been studied.

Without such inventory work most action programmes will be seriously inefficient. Put very simply, informed action depends on knowing what there is and where. The best general approach would seem to be to fill the gaps in existing information about well known plants and animals representing a variety of biological requirements; then systematically add other groups of plants and animals to the inventory exercise.

The inventory work will not be simple. There is a severe shortage of specialists worldwide and an even greater shortage in the tropical countries where the biological diversity is greatest and the knowledge least. In addition, the great bulk of reference collections necessary for proper identification are in the institutions of the industrialized nations. They in turn have been underfunded for quite some decades. Therefore, in addition to the creating and strengthening developing country institutions, we must strengthen relevant Northern institutions.

Inventory, nevertheless, is still insufficient in itself, for the world's biota are part of inherently dynamic systems. Further, they are constantly subjected to a wide variety of human-generated environmental stresses. Indeed, the biota are the most sensitive indicators of environmental stress. So it is wrong to assume that species that were somewhere yesterday or last year, will be there tomorrow. This calls for constant worldwide monitoring in addition to the basic inventory.

It needs to be recognized that biological systems and biological diversity provide the fundamental basis for sustainable development. However, public awareness and understanding are probably less well developed with respect to biological diversity than they are relative to any other major environmental problem. This is because the human species has increasingly isolated itself from the natural world over decades and centuries. A great deal of today's rapidly developing economic activity with respect to biological diversity operates at a molecular level and, as such, is not easily recognized as stemming from wild natural sources. As a consequence, most concern about biological diversity tends to be about individual species of vertebrates valued in an aesthetic or moral fashion. This is indeed justified and useful, but until all the values (i.e. moral aesthetic, and economic) of the full array of biological diversity are properly understood by the public, it will be difficult for public policy to undertake the necessary steps.

The role of biological diversity in the functioning of ecosystems —in their cycling of water, carbon or phosphorous for example— is very poorly understood. It is now attracting some research attention and this is reflected in Agenda 21. In any given ecosystem at any particular time, the bulk of

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the energy flow or other cycling work is carried out by a relatively few number of species, generally the more abundant ones or those with the greatest amount of living tissue (biomass). The rest of the species are comparatively rare; in a tropical forest ecosystem, for instance, 98% of all species could fall into the rare category. A species that is rare at the moment of study may well play a highly significant role under some other set of circumstances. So it is extremely important to regard research on the role of biological diversity in the functioning of ecosystems as mostly preliminary. The conclusion that ecosystems could be stripped of most of their biological diversity and still function should be approached with serious caution.

## B. Maximizing and Spreading the Benefits of Biodiversity

At present the economic treatment of biological diversity largely leads to its ongoing impoverishment. Forests are valued for their timber or cellulose when a single enzyme in an insect, plant, or micro-organism could by itself be the basis for far greater economic activity. The discovery of the value of the taxol compound (used in treating ovarian and breast cancers) found in the bark of the Pacific Yew in the old growth forests of the US Pacific Northwest is a typical example.

Another important fact that needs to be recognized is that the ability to capitalize on value from biological diversity may often lie in an industrialized nation, far from the country of origin. The industry may be concerned with the intellectual property rights of the product resulting from expensive research and development efforts, or even from the biological entity itself such that the economic benefits that accrue from biodiversity may not end up going to the country where that biodiversity is found. Resolving this issue could involve a long and complex procedure, but it also requires a recognition by all parties of the values involved. The important point is to allow access while acknowledging property rights. It is my personal belief that a great deal can be learned about how these arrangements can work best by encouraging the development of contracts such as that between INBIO and Merck and Co. Inc.[1] There is implicit recognition in this deal of all the principles and values involved. Not only that, but it appears to be a mechanism whereby the financial returns from biodiversity can flow to all the relevant parties. Such arrangements can also include provisions for the transfer of environmentally sound technology. In fact, these are the ways that such transfers generally take place from a country such as the United States.

Another interesting initiative has developed in Mexico, where President Salinas has recently established a National Commission on Biological Diversity reporting directly to him. This is probably the first such commission on biological diversity reporting directly to a head of state and it provides an example of the kinds of mechanisms that are needed to ensure that the real value of biological diversity is recognized and that its assets are properly distributed.

## C. Improving Conservation of Biological Diversity

This section is pretty straightforward; basically it looks to augment and strengthen what are fairly traditional kinds of conservation activities.

It is increasingly important, however, to recognize the social matrix within which such activities take place. It is wrong to consider that the alteration of activities for the sake of conservation represents an opportunity cost, unless it is also recognized that the loss of biological diversity itself represents an opportunity cost.

It is equally important to recognize that biological diversity, while perhaps largely confined to protected areas of traditional sorts (parks, refuges, etc.), needs to be conserved in more manipulated parts of the landscape. Indeed, the ecological need (especially when faced with the spectre of climate change) requires that protected areas be reasonably well connected to one another to allow for the dispersal of organisms. Further, protected areas are not only vulnerable to internal dynamic change (which can occur in reserves of too small size), but also to external, even global factors such as acid rain, etc.

An additional, very serious challenge is the lack, in many instances, of strong and stable institutions geared towards the protection of biological diversity. Likewise the infrastructure needed for this kind of preservation is often weak or non-existent. No conservation plan can succeed in the face of these institutional deficiencies. Clearly, mechanisms (including financial mechanisms) need to be found to correct these problems. A vital element here is the involvement of the private sector. Public/private partnership is essential for the viability of biodiversity programmes and it should be actively encouraged.

## D. Enhancing Capacity to Manage Biological Resources

Human resources, from science to management to education, are indeed very scarce and also need to be built up as rapidly as possible. This can only be accomplished with the consequential creation and strengthening of appropriate institutions in developing countries.

## E. Relation to Other Environmental Problems

It must be recognized that biological diversity is not just a problem in itself. It is also affected by, and affects other problems under consideration at the United Nations Conference on Environment and Development and thereafter. Forest destruction, climate change, human population growth, indeed the full array of environmental problems on the UNCED agenda, all affect biological diversity. In effect, the issue of biological diversity integrates all other environmental problems. That is one of its greatest values. It is also why the conservation of biological diversity is a tremendous challenge.

[1] **EDITOR'S NOTE** According to sources provided by the Smithsonian Institution, the agreement reached by Merck, Sharp and Dohme, a pharmaceutical company, and INBIO involves Costa Rica granting limited, non-exclusive rights to Merck and Co. Inc. allowing it to explore Costa Rica's biodiversity for new medicinals. In return for this right, Merck and Co. Inc. will provide INBIO with a substantial royalty from any products produced over time. A key feature of the agreement is that Merck has agreed to pay one million dollars up-front as well as provide the initial research equipment to INBIO as a sort of "prospector's fee" which will go to support INBIO's and other conservation programmes in Costa Rica. This agreement is precedent-setting not only because it implies a recognition (in the form of monetary entitlements) on the part of industry of its interests in preserving biodiversity, but also because it provides finances that developing countries like Costa Rica need immediately to preserve their biological diversity.

**These supplements will be periodically produced by the Centre For Our Common Future to stimulate discussion of Agenda 21 and to allow people to voice their views on one of UNCED's major outputs. If you have any comments or suggestions, or if you wish to review a chapter of Agenda 21, please contact the editor of *Network '92* at the address on the front page. Limited copies of these reviews can also be obtained, free of charge, from the Centre.**

# Saving Endangered Species Doesn't Endanger Economy

In an effort to prevent the reauthorization of the Endangered Species Act, the ex[illegible] of any cost crowd has [illegible] that the [illegible] to [illegible] growth while consistently underestimating the economic value of a healthy environment.

Clearly, there have been well publicized conflicts between the protection of certain species and development, the most prominent being the case of the northern spotted owl. But these kinds of disputes have been the exception, not the rule, since the act was passed in 197[illegible].

In the past five years, some 34,000 development projects were evaluated by the U.S. Fish and Wildlife Service for their impact on endangered species. Only 2[illegible] — less than one tenth of one percent — were halted because they put species in jeopardy.

To put this in perspective, in the same

## Counterpoint

By John C. Sawhill

period 2[illegible] airplanes crashed into commercial or residential buildings in the U.S. That means that a developer faced a greater chance during that time of having an airplane crash into something he built than having a project stopped by the Endangered Species Act.

Contrary to the impression left by a Jan. 15 editorial in this newspaper, "Species Act Endangered," most Americans don't seem to be buying the arguments of people who seek to devalue the importance of biological diversity. A new poll conducted by the bipartisan polling team of Tarrance, Greenberg Lake shows that [illegible] of registered voters support the Endangered Species Act. Only 1[illegible]% of voters oppose the act. There is strong support for the act even in regions where the most contentious conflicts have occurred.

Voters came down on the side of species even when presented with a stark choice between saving species or protecting local businesses and jobs [illegible]. Nearly a quarter of those polled did not want to make this choice.

Fortunately, we don't have to choose. Critics of the act have tried to frame the debate in "either or" terms — either you're for jobs or for species, with no middle ground. But in emphasizing these isolated incidents where species protection threatens jobs, they ignore the many success stories associated with the act.

The truth of the matter is that the act works for people as well as for animals and plants. For example, of the roughly 600 species that have been listed as threatened or endangered over the past two decades, only seven have become extinct. Nine species have recovered sufficiently to be removed from the list and many others have made remarkable recoveries — animals like the bald eagle, American alligator, California gray whale and peregrine falcon. The provisions of the act ensured that these magnificent creatures could survive in the wild.

Experience has shown that the conflict resolution mechanisms already found in the act can succeed. Perhaps the most promising of these mechanisms are Habitat Conservation Plans or HCPs, which have resolved disputes by accommodating the interests of both business and the environment. For example:

- An HCP was approved last summer to protect the endangered desert tortoise in the rapidly growing area around Las Vegas, Nevada. Working together, environmental groups, the development community and government agencies created a plan that set aside 400,000 acres for the tortoise in the outlying desert. Meanwhile, 2[illegible],000 valuable acres adjacent to Las Vegas were freed up for commercial and residential development.
- In the Coachella Valley near Palm Springs, Calif., development plans with a potential value of $1[illegible] billion threatened the habitat of the endangered fringe-toed lizard. Under the terms of an HCP, a [illegible] acre preserve was set aside for the lizard, paving the way for construction in other parts of the valley. Developers found that property values and tax revenues went up because of the proximity to the lizard preserve.
- Planning for an HCP is currently under way near Austin in Travis County, Texas. At risk are two endangered bird species and five other species that live in the Hill Country to the west of Austin, an area targeted for hundreds of millions of dollars of development projects. Current plans call for the creation of about [illegible],000 acres of preserves, with the remaining 6[illegible],000 acres in the area opened to development. The HCP will also help to safeguard the aquifer that provides the drinking water for three million people.

*The act works, for people as well as for animals and plants.*

Of course, not every endangered-species conflict can be so neatly resolved. But even in cases that appear to involve a short term economic sacrifice, protecting the diversity of species is really a long term investment in the future.

This point is clearly articulated in the 1990 report of the President's Council on Environmental Quality, which flatly states, "Domestically and worldwide, it is a healthy environment that makes wealth possible."

The decline of species that led to the enactment of endangered species legislation is an indicator that our environment is not healthy. And we are already feeling the economic consequences.

The spotted owl controversy in the Pacific Northwest provides a classic example. Far from being an impediment to growth, the plight of the owl reflects the destruction of a once plentiful resource — the old growth forest. As U.S. Judge William Dwyer wrote in his celebrated opinion last spring, owls are not responsible for the decline of the logging industry; rather, a combination of factors are at work, including overlogging, mechanization and exports.

Then there's the fishing industry. On any given day, a third of this country's shellfish waters are closed because of pollution. Since 1962, commercial landings of fish and shellfish along the southeast Atlantic and the Gulf of Mexico have dropped [illegible]%. The populations of every fish species harvested commercially or recreationally in North American waters are at or near all time lows.

And in the Everglades watershed, pollution, conversion of land, and the diversion of water for agricultural and residential uses has led to a malfunctioning of the entire ecosystem. Not only could this devastate the balance of life in the Everglades, but it also poses a direct threat to the long term supply of fresh water for Miami and other rapidly growing cities of south Florida. What do the Journal's editorialists, who portray environmentalism as uneconomic, say on this one?

The depletion of species is an urgent alarm, a signal of the severe stresses on our environment. The Endangered Species Act seeks to answer that alarm. To turn back the clock and return to the policies that have led us to the brink would be more than foolhardy — it would violate one of our most basic commitments to our children and theirs.

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*Mr. Sawhill, president of the Nature Conservancy, was formerly president of New York University and served in the Carter and Ford administrations.*

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RESEARCH AND PUBLICATIONS

# Raising Forest Fees Encourages Conservation

Setting "proper" prices for forest products can contribute to long-term management of the developing world's forests, states a recent World Bank study. Still, many governments have paid little attention to the role of prices in forest management.

According to the study, *Forest Pricing and Concession Policies: Managing the High Forests of West and Central Africa*, charging higher fees for cutting timber can contribute to the "financial sustainability" of tropical forests, generating revenue to finance the management and protection of these areas. A key issue in forest management is setting appropriate fees for the timber cut by logging industries. "The forest industry, of course, would prefer low forest fees," say the study's authors Mikael Grut, John Gray and Nicolas Egli. "The government should seek forest fees which reflect the value of the resource."

Mikael Grut and Nicholas Egli are forestry specialists at the World Bank. John Gray is a professor of economics at the University of Manitoba, Canada.

Setting minimum fees for forest concessions is appropriate to ensure that the benefits to the country of cutting timber cover all the costs involved, the report states. These fees should include expenses such as the cost of protecting and administering forests, the costs of selling forest products, and possible environmental costs, for example, from increased soil erosion.

The authors say many forests are destroyed as a result of policies that make timber artificially abundant and discourage conservation, low concession fees that encourage acquisition and holding of concessions beyond company needs, and low forest fees that allow firms to survive even with inefficient logging practices.

"Concession policies in most West and Central African and other tropical countries accommodate the demand of commercial firms for concessions," the study says. But the problem also exists in developed countries, say the authors, who note that the United States' Forest Service has been criticized for subsidizing logging.

According to the study, forestry departments face difficulties in regulating and supervising concessions distributed throughout the country. "The concessionaires, being on the spot and generally having greater resources than the government forestry departments, will be better able to protect and improve the forests in their area, and carry out regeneration where necessary, provided a good system of incentives and inspections is in place."

The authors conclude that "the introduction of bidding for concessions would allow governments to capture more of the economic value of timber, and the resulting higher timber price would reduce the demand pressure on the forest."

*Forest Pricing and Concession Policies: Managing the High Forests of West and Central Africa* is priced at $7.95. Journalists may receive complimentary review copies by writing on company letterhead to the World Bank Publications Department, Marketing Unit, 1818 H Street N.W., Room T-7054, Washington, D.C, 20433, U.S.A. ☐

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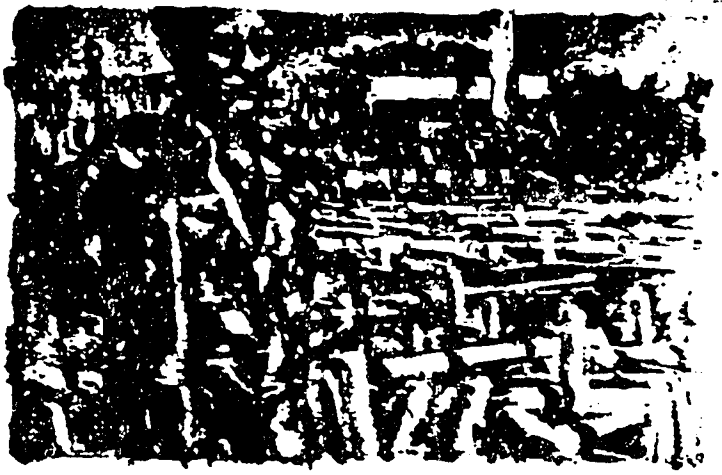
# Forests and People – Victims in Burma



By Matthew Burnett

TEAK and other hardwoods that the West and Japan import from Thailand are tainted on two counts. First, most of the trees come from Burma, where Thai companies log without forestry regulations. They will, within three or four years, permanently destroy what was until recently one of the world's most pristine jungles. Second, profits from the teak go directly to Burma's military junta, whose human rights violations and suppression of democracy have attracted world attention.

The profits give the junta funds for its recently invigorated campaign against the Karen people of southeast Burma. Since this human and environmental destruction is fed by the teak market, an embargo on teak exported from Thailand would help limit the damage. All Burmese teak goes through Thailand, where most of it is either made into furniture or exported in raw form.

Approximately 20 percent of Thailand's original rain forest is left. Though an official ban on the logging of virgin forest exists, it is not strictly enforced. Still, illegal logging and plantations in Thailand can't meet the demands of foreign markets, so most Thai logging companies work in Burma, where the government doesn't have the means to harvest the trees itself.

Standing among tons of logs waiting to be processed in a furniture factory in Northern Thailand, I asked my guide where they all came from. "Burma," he replied tersely, as though wishing to avoid the subject. "Who cuts it?" brought an exaggerated smile and an invitation to tea in the exhibition area.

Almost all Thai logging companies are owned either wholly or partly by military officers or their relatives. The Burmese government sells lumber concessions to these companies without restrictions on methods or tree size. This encourages loggers to use the cheapest and most destructive methods, devastating large areas for only a few trees.

Burma's junta is attracted to the quick cash and foreign currency and shows no interest in "minor forest products," such as resins, rattan, nuts, and fruits, which are less damaging and more profitable in the long run.

Under the current situation, the jungle will not rejuvenate, since both old and young trees are taken and the undergrowth is destroyed in the process, leaving the terrain vulnerable to erosion.

The junta is using profits from lumber concessions in its augmented campaign against the Karen and seems intent on uprooting them in this or the next dry season. Along with a host of other human rights violations, the junta is currently enslaving its own people to carry newly bought munitions to the edges of the Karen conflict.

Whether incidentally or intentionally, the land cleared by lumbering makes movements easier for the military.

The Karen live in southeast Burma along the Thai border. For years they have kept the junta out of the region, which besides being their home is also an area where Thai loggers have easiest access to lush timberland. The Karen "guerrilla camps" that the junta is hoping to overrun consist of schools, temples, homes, and farms as well as base camps and training grounds. The Karen also log teak and sell it to Thailand, but Karen logging practices are reputed to be more protective of forest life than those of the big commercial operators.

Demand in Western markets for teak shows no sign of subsiding, and the market for Burmese teak will only increase now that the Japanese timber industry has deforested Sarawak and Sabah and will need new lands to plunder.

The Burmese teak trade is funding a war and devastating a jungle. At a time when human rights groups and environmentalists are calling for action against Burma, it may be that an embargo by the United Nations on the export of teak from Thailand, in raw or finished form, would be effective in addressing these urgent concerns.

Only concrete action from outside the region will be effective, since the junta in Burma appears immune to foreign opinion and the Thai enforcement system is rife with corruption.

■ *While traveling during the last two months in Southeast Asia, Matthew Burnett investigated deforestation in northern Thailand and Burma.*

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# The Case for the Urban Environment

Ariel Alexandre

***Without a comprehensive urban policy, social, economic and physical deterioration of the kind already suffered by some conurbations will continue, with all the attendant dangers.***

*Everywhere in the world, housing blocks are being put together as if the only consideration were to house completely interchangeable people in sorts of little cages to be destroyed after use.*
*Henri Laborit, L'homme et la ville, Flammarion, Paris, 1971*

Cities are centres of activity and places for exchange. But they also attract disadvantaged groups – ethnic minorities, jobless youngsters, old people – who seek refuge there or cannot move away. The consequent problems and conflicts have to be dealt with through measures based in economic and social policy. But an urban policy, to be effective, should give a spatial dimension to sectoral policies, co-ordinating them and instilling considerations of solidarity and equity. Admittedly, such a policy will be hard to define and harder still to apply, because it calls for an all-encompassing

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approach and for close co-operation among all the parties involved. But it is a challenge that will have to be met by a large number of countries, including those in the East and South of the world. For if cities go on expanding, they will end up suffocating themselves; they are not viable in the long term.

Policies to upgrade the urban environment cannot offer a panacea for all the ills from which cities suffer. Raising the quality of life in towns is only one attribute of a policy for the city that has to include a strong socio-economic component: segregation and pockets of unemployment have to be alleviated, cultural and leisure services that match local requirements have to be provided, delinquency staved off, local enterprise encouraged, run-down cities and neighbourhoods helped.

Nonetheless the improvement of the urban environment and its buildings has become a priority for the 1990s, and there is a growing awareness that a specifically urban strategy is required.[1] There are four reasons.

First, living conditions in cities are steadily worsening. Disamenities – air and water pollution, rubbish, noise, traffic jams, ugliness, dirt, the absence of green spaces, crumbling buildings and infrastructure – are growing. And the problem is by no means confined to northern industrial towns. It is equally serious on the Mediterranean rim,[2] in tourist resorts and rapidly growing conurbations – not to mention the suburbs built quickly and cheaply in the 1950s and '60s.

Second, demand for a high-quality local environment is becoming ever more vociferous and so is taking on a political dimension – witness the success of the 'green' parties in national, regional and local elections in a number of countries and the inclusion of ecological concerns in the manifestoes of other political parties.

Third, many economic activities today, particularly in the service sector, want to set up in business in attractive, unspoiled, unpolluted areas. For younger, lively, well-qualified people the choice of where to move is governed by the quality of their environment, which is therefore of increasing importance to the economic vitality of any town.

Lastly, in the developed countries, three-quarters of the population are city-dwellers. And so failure to improve the urban environment is the equivalent of failing to improve the environment at all.

It may be self-evident to declare that most environmental problems centre on the large cities or can be attributed to them. Yet that statement means that the strategy adopted must be specifically urban and spatial, problems cannot be dealt with piecemeal, sector by sector. Moreover, the concentration of pollution and other disamenities within a small space (cities take up only a tiny proportion of total land area of most countries, often no more than 2 or 3%) has not merely additive but synergetic effects: city-dwellers find themselves exposed, at one and the same time and in one and the same place, to too much insecurity, too much pollution, too much noise, too much stress.

Yet local co-ordination of the anti-pollution measures of different sectors is very weak. And environmental considerations are hardly ever taken into account in non-environmental programmes. As a result urban environment policies are narrow in scope and poorly endowed with resources.

Some towns – or rather, some local authorities, backed up by local people and businesses – have nevertheless done wonders in rehabilitating run-down neighbourhoods and raising the standard of urban transport.

## Rehabilitating Run-down Neighbourhoods

Rehabilitation most often concerns old inner cities. But it is now increasingly being attempted in more recently built disadvantaged suburbs and former industrial zones that have been left to decay.

The experience gained to date shows that, if economic activity is really to be

Silvia Thompson OECD

'The horses of the barbarians are parked in the forum.' Bertrand de Jouvenel, speaking at the OECD in 197?

1 **Environmental Policies for Cities in the 1990s** OECD Publications, Paris, 1990. See also Ariel Alexandre and Eric Oberkampf, 'Funding Urban Infrastructure', **The OECD Observer** No 172, October/November 1991.

2 See Sergio Arzeni, 'Tourism in Mediterranean Cities', **The OECD Observer** No 164, June/July 1990.



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given a new lease of life, a city must not only improve its buildings and infrastructure but also reduce the degree of pollution (rubbish, water pollution, smoke). London, Manchester, Vancouver and Istanbul offer examples of success. New uses have been found for dilapidated buildings and sites, water pollution has been reduced and waterfronts improved. Interestingly, riverside and seaside settings seem to have a distinct advantage here: water is both an environmental and aesthetic asset and a source of leisure pursuits.

The recipe for success in urban rehabilitation programmes includes long-term planning and careful implementation of the plans adopted, diversified funding sources, public/private-sector partnerships, local initiatives with strong public support, the purchase and 'set-aside' of sufficiently large expanses of land. To attract some establishments, moreover, recourse to taxes or tax incentives is often necessary.

There now exists a substantial body of experience in rehabilitating abandoned industrial zones. And the turn will come of the suburbs built in the 1950s and '60s, even of some tourist resorts, though for the time being the focus – especially around the Mediterranean rim – tends to be on improving buildings rather than on reducing pollution and disamenities.

## Improving City Transport

Road traffic – commercial and private – raises huge environmental problems in cities, bringing air pollution, congestion, noise and danger. Local authorities often seem paralysed by the sheer scale of these problems.

Yet some cities – London, Osaka, Munich and Zurich, for instance – have set an example, by restricting motor traffic, upgrading public transport and cutting down nuisance. Now Stockholm is considering making drivers pay to enter the city – as Singapore has been doing for the past fifteen years. The aim is to reduce the number of cars with a single passenger, thus reducing pollution and traffic jams, and to spend the revenue on improving public transport.

Many cities are still hesitant about taxing private car drivers, even though they over-consume limited, valuable urban space. There is also an enormous amount of reluctance to charge city tolls, as there was at the beginning of the 1960s, when parking charges were first introduced. Charging would nevertheless be the most effective and fairest way of reducing traffic noise and pollution and upgrading public transport. It seems likely that, with the passage of time, more and more cities will resort to charges, increasing local taxes on petrol and making drivers pay a toll at city gateways (as, indeed, many countries did in past centuries).

Another step would be for each metropolitan zone to set up a single authority whose powers would cover both privately owned traffic and public transport. Only an authority of that kind would be able to make the necessary trade-offs, 'internalising' more equitably the environmental costs of private motoring and improving the quality of the environment and the public transport system.

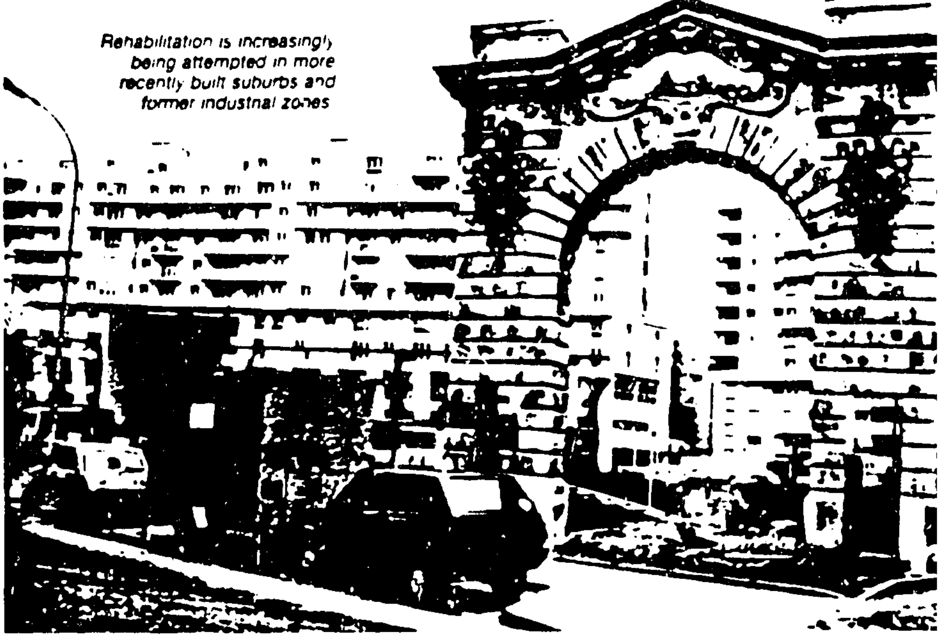
Broadly speaking, it is increasingly realised that demand for transport will have to be contained, restricted or even reduced. There is a physical limit to the growth of motor traffic, set by the limits to the space available and the intensity of congestion and pollution.

Indeed, it is of interest that whereas energy consumption as a proportion of national income has fallen steadily over the past twenty years ('energy intensity' per unit of GDP is down 25% on 1970), transport 'consumption' over the same period has risen constantly: the volume of traffic per unit of GDP is up by 10%. Each dollar produced now involves no less than a 500-metre drive in a car or a lorry. It really is time to make road transport more efficient.

## The Keys to Success

The common element in the success of the most dynamic cities in enhancing their environment is that they have taken action themselves without waiting on other decision-making levels, introducing radical measures that were unpopular at the outset (levies on pollution, restrictions on drivers) to improve the quality of life and at the same time reduce pollution and nuisance. They have taken a broad approach stressing the co-ordination of programmes and their enforcement. Above all, in framing urban policies they have systematically taken aboard environmental considerations

*Rehabilitation is increasingly being attempted in more recently built suburbs and former industrial zones*



Silvia Thompson/OECD



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*Only a single authority responsible for both private and public transport would allow a balance to be developed between them*

and set up private/public-sector partnerships [3]

First and foremost, everything possible must be done to internalise the environmental costs of urban activities – to make polluters pay and to offer incentives not to pollute. Pollution taxes and levies would help here – but such charges are still far too rare and, even where they do exist, they are too low to offer any real incentive.

The reduction of urban congestion and pollution will require a rise in the price not only of driving cars but also of using electricity, local services, and other conveniences. To persuade city-dwellers to use public transport, ride bicycles and to walk, car use will have to be taxed much more heavily than car ownership.

In addition, environmental considerations should be basic to town planning and management. Any large-scale project, public or private, should be subject to evaluation of its impact on the environment. In the same way, those responsible for policies and programmes which also, though less directly, affect the environment (industry, road-building, public housing, and so on) should systematically take into account the possible effects on the environment from the planning stage onwards.

There are many ways to this end. For instance, environmental specialists could be regularly placed at the disposal of services which do not themselves have the necessary expertise. Or official urban-planning institutions could be set up to co-ordinate all local activities concerned with enhancing the environment.

No urban-planning policy can succeed unless local people are actively involved and public- and private-sector projects closely and continuously co-ordinated. Partnerships are an essential key to success in revitalising a city. Partnerships, moreover, unlike economic incentives, are often already in place. A city will often turn to the private sector to carry out its plans, whereas it is still hard, in many cases, to justify recourse to economic incentives.

□ □

There is a wide variety of efforts currently under way to upgrade the urban environment. Yet planners still rarely look at the problem and the city as a whole. Policies are still small-scale, piecemeal, and never all-embracing. They should be much more ambitious and far-reaching than they have been. Central government, in particular, ought to encourage local initiatives by offering incentives and aid, and by running an enlightened information policy through which municipalities can discover experience that has proved pertinent elsewhere.

In short, if a city is to prosper it must care for its environment – and reducing the impact of cities on the global environment, moreover, is going to be a central component of the environmental policy of every country. Indeed, it is now generally accepted that threats to the environment concern the whole planet – global warming is one example. Patently, cities have to set themselves to solving problems for which they are in large measure responsible. ■

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3. See also Christian Huillet and Pieter van Dijk, 'Partnerships for Rural Development', **The OECD Observer**, No. 162, February/March 1990.



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## Environment for the Americas:

# "No Country Will be Able to Enjoy Economic Prosperity Without Protecting the Environment That All Countries Share"

*Robert S. Gelbard, Principal Deputy Assistant Secretary for Inter-American Affairs, discussed the Environment for the Americas component of EAI with delegates to the Globescope Americas Conference in Miami on October 31, 1991. Following are excerpts from his remarks.*

No country will be able to enjoy economic prosperity without protecting the environment that all countries share. The President's Enterprise for the Americas Initiative recognizes that sound environmental practices and sustainable economic progress go hand in hand. . . .

During my time as Ambassador to Bolivia, we forgave 80% of Bolivia's PL 480 debt, reducing this burden from $38 million to $7.7 million. In addition, the Government of Bolivia pledged to provide $20 million over 10 years to support environmental activities. We are now negotiating environmental agreements with Bolivia, Chile, and Jamaica—all beneficiaries of EAI debt reduction.

### Multilateral Lenders Change Focus

To reinforce these EAI environmental initiatives, the United States has encouraged multilateral lenders to increase their focus on the environment. New environmental impact assessment procedures are about to begin at the World Bank and the IDB [Inter-American Development Bank]. The World Bank is reassessing its forest policy and taking a new look at energy efficiency and conservation. The IMF [International Monetary Fund] is seriously discussing establishing a group of economists to advise it on environmental concerns. We are looking for new opportunities to influence energy policy, promote energy efficiency and conservation programs, and secure greater protection for tropical forests.

But neither the United States nor international lenders can single-handedly bring about greater concern for the environment in Latin America. This is why achieving the ultimate goal of EAI—a prosperous, democratic hemisphere, each country trading freely with its neighbors—is so important to the future of our environment.

The experience of the world has shown that prosperous countries pay more attention to the environment than countries where people are more concerned about their next meal. And nations that must worry about where to get resources to pay their international debt will worry less about protecting environmental resources. . . .

### Mexico's Innovative Environmental Progress

Indeed, Mexico, one of the hemisphere's leaders in economic reform and economic growth, is also showing the way with innovative approaches to protect the environment. On October 23, the Mexican Government announced that an Integrated Border Environmental Plan, which Presidents Bush and Salinas set in motion during their November 1990 meeting in Monterrey, Mexico, would be ready by January. Independently, President Salinas pledged $460 million for environmental projects in the border area between 1992 and 1994. These projects would concentrate on water treatment, solid and hazardous wastes, and vehicle pollution. By the end of the year, 200 trained inspectors will monitor the environment along the border. And by 1992, computerized systems will keep strict tabs on border crossings of hazardous wastes.

Mexico has also been active in arranging private debt-for-environment swaps. Last February, the group Conservation International purchased $4 million in Mexican debt in exchange for an increase in the Mexican Government's spending on the environment.

The economic reforms that provide the basis for greater concern for the environment do not come easily. Many countries must pass through difficult periods of adjustment before recovering their economic footing. But the success stories show that countries that want to reform can weather the changes.

Bolivia suffered through years of massive inflation. With the help of the IMF and other multilateral lenders, it undertook sweeping economic reforms. Now, Bolivia has substantially reduced its debt burden through rescheduling, buybacks, and swaps, and is well on the way to economic health. Not surprisingly, Bolivia was one of the first countries to show interest in debt-for-environment swaps.

Venezuela also faced hard times while economic reforms took hold. Today, it enjoys perhaps the highest rate of economic growth in the region—4.4% in 1990 and an expected 5-7% in 1991.

The lesson couldn't be clearer: There can be no economic growth or new investment without economic reform. And without economic growth and new investment, the environment will suffer. . . .

### Improving Living Standards, Protecting the Environment

To sum up, the hemisphere that the President's Enterprise for the Americas Initiative envisions is a hemisphere where the air and water are clean, one where the forests and animals thrive, as well as one where people enjoy the fruits of growing, outward-looking economies. Indeed, the goals of improved living standards and improved environmental protection go hand in hand. For only when people are not overwhelmed by the problems of their own survival can they spare the resources to ensure the survival of the environment. . . . ❑



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PERSPECTIVE ON FREE TRADE

# Who's Afraid of Mexican Trade?


## Bush can have the job-creating pact quickly if he'll take a more vigorous approach to environmental protections.

By BRUCE BABBITT and RON WYDEN

The outline of a North American free-trade agreement that could be consummated this year is at hand. Negotiators from the United States, Mexico and Canada are about to exchange their first drafts. But growing support for protectionism may spook the President from pushing the agreement in an election year.

It need not be such a gamble. It's still possible to write an agreement that would promote job growth and improve the environment more satisfactorily than the quick fixes proposed so far in Washington.

Exports have driven our economic growth in recent years, and without stronger links to the global economy, we will find it difficult to compete with regional trading blocs in Asia and Europe—regardless of tax cuts or Japanese trade concessions.

A successful North American free-trade agreement would immediately expand U.S. access to Mexico, a rapidly growing market. The unilateral reforms that Mexico has undertaken since joining the General Agreement on Tariffs and Trade in 1986 have triggered an investment boom and energized Mexican entrepreneurs. They now have the money to buy American heavy equipment, such as trucks, tractors and earth movers, high-technology products, environmental cleanup services and products, finished paper products and agricultural products, including wheat, fruit, nuts and potatoes.

In addition, a free-trade agreement would enable all North American companies to develop the kind of regional links that help make German and Japanese competitors so formidable. The old model of huge, integrated, monolithic companies launching exports from a single national base no longer reflects reality. Most production now comes from what Harvard Prof. Robert Reich calls a "web" of trade and investment flows, in which products and services are created out of flexible, ever-shifting combinations of joint ventures, target-specific alliances and specialized service providers.

European and Asian companies have already spun such webs in their regions. North American companies should have similar opportunities.

But to be successful, a North American free-trade "web" must include explicit provisions to protect the environment and public health. Without such rules, free-trade pressures would induce companies to cut short-term costs by skirting laws intended to protect health and the environment. And without such protections, long-term economic growth could not be sustained, because business can't operate with a work force suffering the effects of air and water pollution.

This question of negotiating environmental protections has polarized political debate on the free-trade agreement. From the outset, the Bush Administration has seemed to favor an approach that pushes Mexico hard for concessions on intellectual property and investment rules, but backs off when it comes to clean water, clean air and safe food.

**'The thinking of the Administration is that free trade and environmental protection are not related.'**

There has been serious opposition in some quarters to almost any treaty that would expose the U.S. economy to additional competition, even though refusing free trade with Mexico would sacrifice economic growth and leave major existing environmental problems to fester untreated.

The key votes in Congress, however, seem to be held by a group that falls in neither camp. These pro-trade Democrats and pro-environment Republicans suggest another path: Negotiate a job-creating trade agreement but include the cleanup of pollution along the U.S.-Mexico border and require that new investment in Mexico pay up front for basic environmental protection infrastructure.

This swing group of policy-makers wants an environmental protection program built around strong rules, adequate resources and tough enforcement.

Serious environmental protection would require rules to ensure high standards on both sides of the border, with the costs based on the "polluter pays" principle.

Serious environmental protection would provide for a binational bond program to raise the $5 billion to $9 billion needed to clean up existing pollution along the border and a small levy on new investment to be set aside for future environmental protection.

Serious environmental protection would include a mandatory enforcement program, based on a binational enforcement agency that would be supported by a provision to allow citizens of either country access to the other's legal systems.

The current thinking of the Administration, unfortunately, is that free trade and environmental protection are not related and should not be linked. It has asked for less money to protect the border environment than Mexico plans to spend, even though the U.S. economy is 25 times larger than Mexico's. It maintains that free trade will provide resources for environmental protection but will not say when such resources might be available nor commit to actually spending them on the environment.

In fact, the Administration's central position is that it will be enough to rely on voluntary agreements with Mexico and voluntary compliance by the very businesses that created the environmental problems in the first place. It has said only that it will conduct additional regulatory enforcement "as appropriate"—whatever that means.

A North American free-trade agreement built around the principles we advocate would bring this country more jobs and a cleaner environment. Unlike the short-term tax breaks and subsidy programs being bandied about Washington, it would help generate prosperity—even after the election.

*Bruce Babbitt, former governor of Arizona, is president of the League of Conservation Voters. Ron Wyden (D-Ore.) is a member of the House subcommittee on health and the environment.*

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THE WALL STREET JOURNAL February 12, 1992

# Prosperity Could Curb Mexico's Pollution

## Speaking of Business

By Lindley H. Clark Jr.

Anyone who has been in Mexico City lately knows that the city has a fair amount of industrial pollution. Now the talk of including Mexico in a North American Free Trade Agreement has stirred environmentalists' complaints that such an arrangement would export a lot of Mexican pollution north of the border.

U.S. unions also complain about Mexican pollution. They argue further that Mexican plants aren't subject to all of the anti-pollution regulations that apply to U.S. plants. It's easy to guess, though, that their major concern is that NAFTA would send American jobs south of the border – to Mexico and its relatively low-cost labor.

It's impossible to come up with an easy answer. In a National Bureau of Economic Research paper (Working Paper No. 3914), Gene Grossman and Alan Krueger of Princeton seemed for a while to have done so. Their research indicated that air quality measures in a cross-section of countries indicate that economic growth tends to alleviate pollution problems once per capita income reaches $4,000 to $5,000.

Mexico is already at $5,000 and thus possibly at the point where further growth would generate new political pressure for environmental protection and perhaps changes in private consumption. The current Mexican government already has reduced the lead content of gasoline, ordered several power stations to burn natural gas instead of sulfur-generating fuel oil, and shut refineries and private firms found to be major sources of air pollution.

Presumably, Mexico still has a comparative advantage, at least over the U.S., in pollution-control costs. But authors Grossman and Krueger find little evidence that this advantage has drawn much business to Mexico. They speculate further that removal by Mexico of barriers to direct U.S. investment could lead to specialization in low-polluting industries.

If NAFTA works as well as its U.S. labor union critics fear, it is a safe assumption that it will make Mexico more prosperous. A more prosperous Mexico would be better able to afford pollution-control systems and devices. After all, hardly anyone is fond of dirt.

The Princeton authors admit that they haven't offered the last word on this subject. "Our findings must remain tentative until better data become available," they write. "We have been unable to use any information about the pollution situation as it currently stands in Mexico, since environmental monitoring there has been unsystematic at best. Furthermore, the kinds of pollutants that we can examine are limited by data availability."

These are by no means the only obstacles to Mexico's participation in NAFTA. This is an election year in the U.S., and legislators sensitive to union views – particularly legislators based in the South and Southwest – have strongly opposed Mexico's participation in NAFTA.

There is, moreover, an entirely different sort of opposition to NAFTA. There are many economists who believe that free-trade pacts such as NAFTA will steadily undercut international free-trade agreements, such as the General Agreement on Tariffs and Trade. Regional trading blocs have done very well through the 1980s, while GATT seems to have run aground.

The European Community has sailed ahead, adding members and planning to add more. Europe 1992, its expansion plan, is regarded as so sure a thing that U.S. companies are rapidly expanding in Europe to take advantage of it. At the same time, GATT, which was supposed to have completed its Uruguay Round by late 1990, has yet to reach an agreement.

Some trading blocs seem more natural than others. Even without the EC, European countries presumably would be doing the bulk of their trade with one another, and North America also seems a natural area. An agreement between the U.S. and Korea would seem less natural. Even Israel, with its ties to the U.S., would fit better with Europe.

Some economists still see hope that GATT will reach an agreement and, in the meantime, fear that its progress would only be impeded by arrangements such as NAFTA. If GATT does finally settle its differences, they say, NAFTA and similar pacts would fit in quite nicely.

Mexican and U.S. trade officials, however, are unlikely to stand aside cheerfully while GATT tries to solve its problems. The current Mexican government is embarked on economic reform, a program that could be quite beneficial to the U.S. as well as the Mexican economy.

It's a difficult job, particularly when you consider the obstacles. If it succeeds, however, Mexico may be not only more prosperous but cleaner as well.

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RICHARD E. FEINBERG

# *Paltry Aid to Central Europe*

*To what extent has the international community supported the reform process in Central Europe? 1990–91 total net transfers may actually be negative. Is the reason shortsightedness of U.S. leadership, or private markets' aversion to risk?*

The successful reform of economic and political structures in the newly independent Central Euroepan states will require financing. Various sources of external capital—official and private—could contribute to this historic enterprise. Each of these sources is behaving differently, as is evident in this analysis of financial flows to the three countries at the vanguard of reform: Czechoslovakia; Poland; and Hungary (the "CE3").

While the CE3 will finance most of their development through domestic savings, they are in need of external financial support for several reasons. Stabilization funds and capital inflows facilitate the anchoring of exchange rates and the buildup of reserves, thus helping to restore confidence in the currency and to stabilize price levels. In 1991, financial assistance was required especially to offset adverse movements in the region's terms of trade due to the withdrawal of trade subsidies by the Soviet Union, the loss of COMECON markets, and the war in the Persian Gulf. Financial and technical assistance also began to assist in the transformation of productive structures, as these countries moved from socialism to capitalism.

In addition, official capital flows have facilitated the servicing of debts to the private banks, which are retreating from Poland and Hungary. Although much more cautiously than initially imagined by some observers, private foreign investors have also begun to enter the region. Beyond finance, private investors can provide management know-how, technology, and access to external markets. But there needs to be a "baseline" level of satisfactory macroeconomic stability and microeconomic predictability, fostered in part through external finance, before private capital will come with any volume or durability.

## *Financing economic transformation*

In thinking about the relationship between the sources of external finance and the process of economic transformation, it is useful to distinguish three stages:

1. ***Financial stabilization***: During this initial stage, efforts to stabilize prices, make the currency convertible, and liberalize the trade and financial markets, require immediate balance of payments support. The International Monetary Fund, and the quick-disbursing programs of other multilateral and bilateral lenders, are particularly appropriate here.

2. ***Structural adjustment***: In this intermediate stage, the transforming country can gradually move its attention from financial stabilization to structural change, as it seeks to reform the state, decentralize decision-making, build market structures and regulatory regimes, and create social safety nets. External financial and technological needs are increasingly best met through project finance. As the IMF exits, the World Bank and the new European Bank for Reconstruction and Development

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(EBRD) become most relevant, as do the more trade and project-oriented bilateral programs.

3. ***Self-sustained growth***: Finally, as the new market-oriented system emerges, the private sector can become the engine of growth. Official finance may still be needed to build infrastructure and other unprofitable projects, but external financial needs should be filled increasingly by international banks and equity investors.

These stages and sources of finance overlap, of course. The IMF can return in the event of macroeconomic mismanagement at any time, just as some risk-taking private investors are already active during the stabilization phases. But in broad terms, we can expect this evolution of external finance—from immediate balance of payments support, continuing on to official project finance, and concluding with private capital inflows.

## *Flows, disbursements, and net transfers*

Our knowledge of the size and sources of capital flows into Central Europe is less than perfect. Many actors in the process are new, data collection is incipient, and events are moving very fast. Numbers for 1989–90 are in many cases rough estimates, and for 1991 necessarily best-guess projections. Nevertheless, the basic trends are apparent enough to allow a useful picture to emerge, even if the edges of the specific images are blurred.

According to the "Scoreboard" of the European Commission (Table 1), official commitments to the CE3 by the "Group of 24" (G-24)—the twelve EC countries plus Australia, Austria, Canada, Finland, Iceland, Japan, New Zealand, Norway, Sweden, Switzerland, Turkey, and the United States—and multilateral agencies during 1989–90 totaled $16.5 billion. The dates and speed of the reform transitions account for donor differentiation among countries. Poland benefited by taking the lead in implementing a bold stabilization program that needed financial support, while Czechoslovakia started to reform later and under less shaky financial circumstances.

**Table 1 Foreign Assistance Commitments to Central Europe, 1989—90**
(Credits and Grants, $ millions)

| | Czech | Hungary | Poland | Total | % of Total |
|---|---|---|---|---|---|
| EC & Member States* | 572.5 | 3,503.6 | 5,078.8 | 9,155.0 | 55.4 |
| United States | 0.0 | 41.4 | 530.8 | 572.2 | 3.5 |
| Japan | 174.0 | 782.6 | 912.5 | 1,869.1 | 11.3 |
| Other* | 156.7 | 414.6 | 568.9 | 1,140.2 | 6.9 |
| Total Bilateral | 903.2 | 4,742.3 | 7,091.0 | 12,736.5 | 77.1 |
| EBRD | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| IBRD | 400.0 | 883.6 | 1,763.5 | 3,047.0 | 18.4 |
| EIB | 0.0 | 144.0 | 114.0 | 258.0 | 1.6 |
| ECSC | 0.0 | 240.0 | 240.0 | 480.0 | 2.9 |
| Total Multilateral | 400.0 | 1,267.6 | 2,117.5 | 3,785.0 | 22.9 |
| Total | 1,303.2 | 6,009.8 | 9,208.5 | 16,521.5 | 100.0 |

* Includes Australia, Austria, Canada, Finland, Iceland, New Zealand, Norway, Sweden, Switzerland, Turkey.

*Source*: Commission of the European Communities, G-24 Consultation Unit, January 30, 1991.

**Table 2 Grant Commitments to Central Europe, 1989–90**
($ millions)

| | Czech | Hungary | Poland | Total | % of Total |
|---|---|---|---|---|---|
| EC & Member States | 51.1 | 201.6 | 1,641.2 | 1,893.9 | 74.3 |
| United States | 0.0 | 0.1 | 356.8 | 356.9 | 14.0 |
| Japan | 0.0 | 0.0 | 27.0 | 27.0 | 1.1 |
| Other* | 31.7 | 20.2 | 218.2 | 270.0 | 10.6 |
| Total | 82.8 | 221.9 | 2,243.1 | 2,547.8 | 100.0 |

*Source*: Commission of the European Communities, G-24 Consultation Unit, January 30, 1991.

Of the recorded $16.5 billion in assistance, only $2.5 billion were grants (Table 2). The EC Scoreboard does not indicate the terms of the credits, but it is certain that many credits were not "assistance" at all in that they bore near-market terms of interest. According to the Organization for Economic Cooperation and Development (OECD), the grant element of a credit must exceed 25 percent to count as "official development assistance (ODA)," a marker presumably not attained by at least some of the $5 billion in reported export credits (Table 3), among other bilateral commitments.

**Table 3 Foreign Assistance Commitments to Central Europe by Purpose, 1989–90**
($ millions)

| | Czech | Hungary | Poland | Total | % of Total |
|---|---|---|---|---|---|
| Education | 0.0 | 10.2 | 3.4 | 13.6 | 0.1 |
| Transportation & Communication | 0.0 | 226.4 | 190.3 | 416.8 | 2.5 |
| Energy | 0.0 | 47.3 | 277.4 | 324.7 | 2.0 |
| Environment | 38.0 | 34.7 | 183.5 | 256.2 | 1.6 |
| Training | 10.0 | 64.4 | 164.2 | 238.6 | 1.4 |
| Agriculture | 0.2 | 112.7 | 277.3 | 390.2 | 2.4 |
| Industry, Mining & Construction | 0.0 | 30.0 | 230.9 | 260.9 | 1.6 |
| Trade, Banking & Tourism | 0.0 | 65.0 | 40.2 | 105.2 | 0.6 |
| Non-project Assistance | 733.4 | 2,736.6 | 1,266.7 | 4,736.8 | 28.7 |
| Debt Relief | 0.0 | 0.0 | 798.0 | 798.0 | 4.8 |
| Emergency | 0.0 | 0.7 | 477.0 | 477.7 | 2.9 |
| Export Credits | 87.0 | 1,495.8 | 3,367.8 | 4,950.6 | 30.0 |
| Private Investment | 0.5 | 161.8 | 316.0 | 478.2 | 2.9 |
| All Other | 434.0 | 1,024.2 | 1,616.0 | 3,074.3 | 18.6 |
| Total | 1,303.2 | 6,009.8 | 9,208.7 | 16,521.7 | 100.0 |

*Source*: Commission of the European Communities, G-24 Consultation Unit, January 30, 1991.

Table 4

**Gross Disbursements by Source, 1990-91**
($ billions)

| | Multilateral* | | | Bilateral | | | Private | | | Total | | Grand Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | Total | 1990 | 1991 | Total | 1990 | 1991 | Total | 1990 | 1991 | |
| Czechoslovakia | 0.0 | 1.7 | 1.7 | 0.0 | 0.3 | 0.3 | 1.9 | 0.4 | 2.3 | 1.9 | 2.4 | 4.3 |
| Hungary | 0.5 | 2.6 | 3.1 | 0.5 | 0.5 | 1.0 | 1.5 | 0.7 | 2.2 | 2.5 | 3.8 | 6.3 |
| Poland | 0.5 | 2.0 | 2.5 | 0.4 | 0.4 | 0.8 | 0.0 | 0.1 | 0.1 | 0.9 | 2.5 | 3.4 |
| Totals | 1.0 | 6.3 | 7.3 | 0.9 | 1.2 | 2.1 | 3.4 | 1.2 | 4.6 | 5.3 | 8.7 | 14.0 |

* Includes the IMF.

*Source*: Official sources and *Financing Eastern Europe*, Richard A. Debs, Harvey Shapiro, and Charles Taylor, Washington, DC Group of Thirty 1991.

The EC Scoreboard records commitments, some of which will only disburse over many years, others of which—such as the export credit lines—may never be utilized. Actual disbursements to the CE3 by official donors (including in this calculation IMF credits) totaled approximately $2 billion during 1990 and may reach $7.5 billion in 1991 (Table 4). Estimated medium and long-term gross disbursements by private sources (not captured in the EC Scoreboard) add about $4.6 billion during these two years.

Most interesting is the different impressions given by the EC Scoreboard and its recording of commitments, and actual disbursements. Whereas bilateral donors account for three-quarters of commitments, multilaterals in 1990–91 will account for roughly three quarters of official disbursements (Tables 1 and 4). This apparent discrepancy is explained by the rapid-disbursing nature of the stand-by and structural adjustment loans of the IMF and World Bank, which are designed to provide immediate balance of payments support, in contrast to the necessarily slower gestating investment projects and tied export credits of the bilaterals.

Table 5

**Net Financial Transfers 1990**
($ billions)

| | Disbursements | | Amortization | | Interest | | NFT |
|---|---|---|---|---|---|---|---|
| Czech | 1.9 | - | -1.0 | - | -0.8 | = | +0.2 |
| Hungary | 2.5 | - | -2.5 | - | -1.7 | = | -1.7 |
| Poland* | 0.9 | - | -4.6 | - | -3.9 | = | -8.1 |
| Total** | 5.3 | - | -8.1 | - | -6.4 | = | -9.1 |

* Payments due (prior to debt relief)
** Totals may not add due to rounding. Excludes short-term capital movements and direct foreign investment.

*Source*: Official sources and author's calculations

In public pronouncements, lenders naturally emphasize flows (whether at the commitment or disbursement stages), which are their contribution to the recipient economy. But a fuller picture of the *net* contribution of the international financial community (including the IMF) requires that attention also be paid to reflows —to amortization and interest. The resulting "net financial transfer (NFT)" reveals a dramatically more complex story. For the CE3 as a group, scheduled amortizations and interest payments on old debts substantially exceed actual disbursements for 1990–9. But although the NFT was heavily negative in 1990, in 1991 it promises to become positive, if only by a modest margin (Tables 5 and 6).

Reflecting their very distinct external debt profiles, there is considerable differentiation among the three countries. Poland is heavily indebted to bilateral creditors, and would have recorded a massive negative transfer had it been meeting its contractual obligations. Debt relief in the Paris Club will considerably reduce payments due (although actual payments may increase, since Poland has been closing its financial gap through arrears). The combination of increased disbursements and debt relief may allow Poland a small positive financial transfer in 1991. In contrast, Hungary has eschewed debt restructuring, so that payments on its substantial commercial debt contribute to a negative NFT of over $2 billion during 1990–91. Having been largely absent from international financial markets prior to its revolution, Czechoslovakia, for its part, should accumulate a net positive inflow of $1–2 billion during 1990–91.

The transfer problems of Poland and Hungary are, of course, but a reflection of their debtor-country status. This reverse resource transfer quandary is characteristic

Table 6

**Estimated Net Financial Transfers 1991**
($ billions)

| | Disbursements | | Amortizations | | Interest | | NFT |
|---|---|---|---|---|---|---|---|
| Czech | 3.2 | - | -1.1 | - | -1.0 | = | +1.1 |
| Hungary | 3.8 | - | -2.5 | - | -1.9 | = | -0.6 |
| Poland* | 2.6 | - | -0.5 | - | -1.7 | = | +0.3 |
| Total** | 9.5 | - | -4.1 | - | -4.6 | = | +0.8 |

*after debt reduction
**Totals may not add due to rounding. Excludes short-term capital movements and direct foreign investment

Source: Official sources and author's calculations of middle-income debtors throughout the developing world. It results from the accumulation of substantial debts, high global interest rates, the retreat of commercial lenders in the 1980s following an earlier period of easy credit, and the inability of official lenders to fill fully the resulting gap. Certainly, it is inevitable that borrowers must eventually face repayment on old loans, and interest payments on ballooning debts will consume a rising share of new loans. Ideally, however, the consequent negative transfer occurs when a country has reached a healthy level of sustained growth. For Poland and Hungary, as for other middle-income countries, it is unfortunate that these heavy loan payments coincide with moments of domestic austerity and costly reform, as well as adverse external events beyond their control. Recognizing this contradiction, the international community is providing deep debt relief to Poland.

The foreseeable improvement in the NFT in 1991 coincides with and makes feasible a significant swing in the CE3's trade balance. Whereas the three nations ran a cumulative trade surplus of about $3 billion in 1990, they appear set to run cumulative trade deficits of about the same amount this year. The positive transfers are, in effect, financing this deterioration in trade balances.

## *Role of the Bretton Woods agencies*

The Bretton Woods institutions have been the unsung heroes in the financial transfer game in Eastern Europe generally, and in Central Europe in particular, providing not only significant disbursements but sharply positive net flows as well. The IMF, for its part, has responded with impressive alacrity and creativity; it projects $3.5 billion in disbursements to the CE3 in 1991 (Table 7). Though slower in getting itself off the mark, the World Bank is now engaged as well.

The IMF approach to each of the Central European countries has followed a recognizable pattern. First, the Fund approves a traditional one-year standby to support basic financial stabilization. It then proceeds to approve a three-year Extended Fund Facility (EFF), which is meant to sustain financial stabilization as well as support a series of structural adjustment measures. Furthermore, to cover increased costs of energy imports, additional resources are being made available to each country under the Fund's Compensatory and Contingency Financing Facility.

This most appropriate use of the EFF is to be applauded. The EFF was designed in the late 1970s precisely for circumstances in which countries need large sums of external finance relative to their IMF quotas, necessary reforms cannot reasonably be accomplished during the traditional one-year standby period, and immediate stabilization and longer-term adjustment measures are intimately related. The EFF allows national policy makers to hold IMF financial support over a medium-term period, and stimulates both national policy makers and IMF staff to think beyond the immediate financial crisis, and to focus on the optimal sequencing of reforms over a longer timeframe.

Table 7 **Estimated IMF and World Bank Gross Disbursements, 1991**
($ billions)

| | IMF | World Bank* | Total |
|---|---|---|---|
| Czechoslovakia | 1.4 | 0.5 | 1.9 |
| Hungary | 1.0 | 0.6 | 1.6 |
| Poland | 1.1 | 1.0 | 2.1 |
| Total | 3.5 | 2.1 | 5.6 |

* Includes parallel financing.

*Source*: IMF, World Bank.

## *U.S. as constraining force*

The World Bank responded somewhat more phlegmatically to arising opportunities in Central Europe. This is partly natural, as the Bank's *forte* remains project loans which take longer to design and implement. But more important, the United States, the Bank's major shareholder, offered no leadership vision, and additionally constrained the Bank throughout 1988–89.

Despite its initial hesitancies, the Bank is now engaged in three important ways: balance of payments financing; traditional infrastructure projects; and support for marketization reforms. In tandem with IMF programs, the Bank has signed quick-disbursing Structural Adjustment Loans (SALs) of $300 million for Poland and $200 million for Hungary (with an additional $200 million in cofinancing from the Japanese Exim Bank); a second SAL for an additional $200 million is scheduled for approval during the Bank's fiscal year 1991. As is normal Bank practice, release of the second of the two *tranches* of the signed SALs is conditioned upon the fulfillment of specified conditions. In addition, a SAL of $450 million is also in the works for Czechoslovakia. The approved SALs are intended to support a wide range of reforms, including enterprise reform and privatization, financial sector restructuring, trade liberalization, assistance to unemployed workers, as well as basic balance of payments assistance.

This is not to imply that the Bank has neglected its bread-and-butter projects, however. During 1990 it approved loans for Poland in transportation and energy, and for Hungary in telecommunications. But it is also struggling to be more innovative and to design sector and project loans that directly tackle the daunting problems of marketization. Here, the Bank might assist in enterprise reform by helping with industrial restructuring and competition policy, as well as with trade and financial liberalization.

At the same time, it hopes to promote environmental cleanup, having approved a small loan to Poland to help build the institutional framework for environmental regulation. It also intends to help the formerly socialist nations construct a social safety net consistent with capitalist incentives. Available evidence suggests that in these *terra nova*, the Bank is not yet always on sure footing. This tentativeness is caused in part by confusion in the borrowing nations as well as the state of the art of marketization itself.

Together, the Bretton Woods agencies hope to disburse over $5 billion in 1991 to the CE3 (Table 7). Only Hungary will have to make significant repayments on old loans during 1991, so the net financial transfer could still be in the $5 billion range. If the Bretton Woods agencies make the projected disbursements, they could account for over 60 percent of total loan disbursements in 1991 to the CE3 (Tables 4 and 7). Furthermore, the resulting net transfers would significantly exceed the total transfers anticipated by the region in 1991 (Tables 6 and 7). In effect, much of the net transfers being provided by the Bretton Woods agencies are being recycled to service the debts of other creditors.

It is worth mentioning that the financial contributions of the Bretton Woods institutions to the CE3 need not be at the expense of other developing nations. The IMF is sitting on massive amounts of loanable funds, even prior to activation of the recent quota increase of Special Drawing Rights (SDR) $45 billion. The IMF's outstanding loans have actually declined markedly since the mid-1980s, from SDR 35 billion in 1986 to SDR 23 billion at the end of 1990. The World Bank is also flush with funds, having received a general capital increase of $75 billion in 1988, and has been falling short of its commitment and disbursement targets. Moreover, since the agencies' major shareholders have a strong interest in Eastern Europe, this lending activity increases political support for the IMF and World Bank and actually enhances the prospects for future capital injections.

## *Project finance and technical aid*

As Central Europe stabilizes its macroeconomies, attention will increasingly focus on structural change and project work. During this phase, it will be particularly important for donors and recipients to agree on priorities, for appropriate divisions of labor to be established, and for adequate coordination mechanisms to be at work. The World Bank, the European Commission, and the EBRD will become the central multilateral donors as the IMF exits. Bilateral disbursements will begin to catch up to commitment levels.

The many bilateral programs underway in Central Europe reflect the political priorities as well as existing programmatic capacities of donor agencies. Drawing on their depth of national experience in democratic institutions and private sector organization, they should be able to impart not only capital but also valuable expertise. A cursory review of bilateral and multilateral development assistance suggests that while there is general agreement on overall strategic objectives, there seems to be considerable overlap or duplication among donors, and the wide dispersion of projects suggests inadequate prioritization:

***EC and member countries***: A program to coordinate economic assistance to Eastern Europe was first developed at the July 1989 Paris Summit of the industrialized democracies. The G-7 Summit charged the European Commission (EC) with coordinating assistance from the Group of 24 Western industrialized countries. Known as the "Phare" program, the EC action plan listed five priority areas: (1) improving access to western markets; (2) providing humanitarian and food aid; (3) providing technical training; (4) establishing programs for environmental protection and rehabilitation; and (5) extending loans for economic and investment restructuring. Though originally targeted to Poland and Hungary, the EC Phare program was extended to Czechoslovakia and other Eastern European countries in 1990.

The EC and its member countries have largely prioritized balance of payments support for macroeconomic adjustment—providing important backing to IMF-approved programs—as well as private sector development in their assistance to the CE3, and have also been broadly consistent in providing support to enable East European nations to import agricultural and other Western European products. Yet despite agreement on the strategic thrusts of assistance efforts, on-the-ground aid programs reflect differences of donor comparative advantage as well as priority, as shown in Table 1.



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***The EBRD***: Set up in record time to begin operation on April 15, 1991, the London-based EBRD is distinctive among multilateral development institutions for three principal reasons: its explicit commitment to the political transformation of the former communist countries, its emphasis on private sector development (60 percent of annual lending), and its standing as the first pan-European institution linking the seven Central and Eastern European nations to the West.

With an initial capital base of only $12 billion, the EBRD's role in meeting the financial needs of the CE3 is likely to be modest. Theoretically it could lend as much as $2.5 billion a year, but the Bank's treasury projects that it will lend about $1.3 billion and make equity investments of $140 million for each of its first five years. These lending levels will rank well below those of the World Bank. Nevertheless, EBRD officials believe the Bank can mobilize private investment up to 15 percent of the region's financial needs. Moreover, the EBRD will devote special funds to private technical training.

Particularly at the outset, the EBRD will cooperate with the bilateral donors and existing multilateral development institutions, cofinancing projects already on-line through the World Bank and IFC. Key to the Bank's eventual identity, however, will be its ability to define specific niches among the already existing panoply of international lenders. To date, the Bank has indicated interest in physical infrastructure, small and medium-sized firms, privatization, industrial restructuring, financial sector reform, and environmentalism. But these are wide-ranging, and overlap considerably with World Bank programs. One obvious strategic thread to provide its programs with coherence would be regional integration—between Western and Eastern Europe, and among the Eastern European nations themselves.

***Japan***: Japanese aid flows to Eastern Europe from November 1989 to September 1990 focused primarily on agricultural and other trade credits to Poland and Hungary. To this end, the Japanese government has authorized $175 million for commodity imports to Poland, three-year, $500 million trade credits to both Hungary and Poland, and investment insurance up to $350 million for Poland and $400 million for Hungary.

In addition to these trade measures, Japan has allocated approximately $25 million for a five-year technical assistance program to Poland and Hungary focusing on training, research, and scholarship exchanges. Provision of technical assistance to Czechoslovakia was under consideration in early 1991.

***United States***: The U.S. government authorized $420 million in fiscal year 1990, and $469 million in fiscal year 1991, for foreign assistance and food aid to all of Eastern Europe. An additional $400 million has been requested for 1992. Unfortunately, no country breakdowns of these figures are readily available. But it is clear that U.S. programs for Central Europe have concentrated on balance of payments support and food aid, and assistance to private enterprise and democratization.

The U.S. contributed $200 million to the Polish stabilization fund, and another $100 million of food exports to that country. Of the $95 million authorized in fiscal year 1991 for enterprise funds, Poland has received about $55 million and Hungary about $5 million. Enterprise fund offices support private sector development through loans, grants, equity investments, and technical assistance and training. Additional private sector assistance has been targeted on labor unemployment support and training programs.

The US has also granted roughly $12 million for regional and national democracy-building activities. Channeled chiefly through the National Endowment for Democracy, these funds have served to support the development of trade unions, nongovernmental organizations, the media, political parties, and elections training.

## *Private sector financial flows*

So far, financial flows from the private sector to the CE3 have been disappointing. In reality, it should not be surprising that in light of the historic political and economic uncertainties, coupled with the region's depressed macroeconomic conditions, private investors would take a cautious wait-and-see attitude. In the longer run it is to be hoped that private lenders and equity investors will view the CE3 as significant business opportunities.

Table 8 **Estimated Net Transfers by Commercial Creditors, 1991**
($ billions)

| | Disbursements* | - | Amortizations* | - | Interest* | = | NT |
|---|---|---|---|---|---|---|---|
| Czech | 1.0 | - | 0.9 | - | 0.3 | = | -0.[illegible] |
| Hungary | 1.4 | - | 2.3 | - | 0.9 | = | -1.[illegible] |
| Poland | 0 | - | 0 | - | 0.4 | = | -0.[illegible] |
| Total | 2.4 | - | -3.2 | - | -1.6 | = | -2.[illegible] |

* Interest payments calculated on basis of outstanding medium and long-term commercial debt. Disbursements and amortizations are on medium and long-term debt only.

*Source*: Official sources and author's calculations.

Czechoslovakia and Hungary both successfully tapped international capital markets in 1990, whereas Poland's creditworthiness was undermined by its extensive arrears and requests for debt relief. In 1991, net disbursements to the three countries by commercial lenders may well be negative (Table 8). In the near term, banks are likely to be very cautious, concentrating on trade and project finance, and on servicing the needs of their key corporate clients.

Well-publicized announcements of large investments, such as the Volkswagen investment in Skoda, have left a false impression regarding actual investment flows into the region. In 1990–91, only about $1.5 billion in direct investment appears likely to flow into the three countries (Table 9). In addition to the overall climate of uncertainty and recession, private investors are dissuaded by the absence of clear rules of the game regarding private property and equity investment, as well as the gradual pace of privatization in some sectors. On the other hand, a large number of joint ventures have been signed that may not provide much finance but could bring management skills and technology, as well as access to external markets.

Table 9 **Estimated Direct Foreign Investment, 1990–91** ($ billions)

| | 1990 | 1991 |
|---|---|---|
| Czechoslovakia | 0.1 | 0.4 |
| Hungary | 0.3 | 0.5 |
| Poland | 0.0 | 0.3 |
| Total | 0.4 | 1.2 |

*Source*: World Bank, International Monetary Fund, Group of 30

Assuming reforms proceed and macroeconomies are stabilized, private investment could become much more significant, and gradually replace official flows. But in the short-term it is wishful thinking to imagine that private lenders or investors are likely to fill significant shares of the external financial needs facing Central Europe. Indeed, in 1991 private lenders and investors together are likely to be a net financial drain on the region (Tables 8 and 9).

A critical determinant of investment decisions will be the degree of trade access to the markets of Western Europe, the United States, and Japan. While some trade liberalization steps have been taken recently, significant barriers to the CE3's exports remain. If private flows are to gradually replace official transfers, industrial-country governments will want to continue to lower their barriers to the exports of Central Europe. That is, trade policy will need to be seen as an integral part of financial assistance strategies, if the private sector is to be a principal fulcrum in promoting sustained growth in the CE3 countries.

## *External debt burden*

The current external debt profile of the CE3 differs radically (Table 10). Poland is very heavily indebted, principally to official creditors, and has fallen into arrears to both official and private creditors. Hungary is also struggling under a very heavy debt burden, but its creditors are primarily commercial banks, and Hungarian policy makers have assiduously sought to maintain access to credit markets by remaining current on payments and eschewing restructurings. For its part, pre-1989 Czechoslovak governments avoided foreign financial entanglements, bequeathing to the reform government a relatively light debt burden.

How much interest-bearing external credit can the CE3 prudently acquire? Future debt servicing capacity will be a function of numerous variables, including rates of export and GNP growth, the quality of economic management, and creditworthiness in international financial circles. Given the tremendous uncertainties regarding these critical variables, any estimates of future debt service capacity would suffer from a wide margin for error. But the already difficult debt positions of Poland and Hungary, and the rapidly deteriorating Czechoslovakian circumstances, indicate the universal need for prudent debt management.

In response to its severe debt servicing problems, official creditors have granted significant debt reduction to Poland, and private creditors are expected to follow suit. When the negotiations are finalized, Poland's new debt service position will be greatly improved. Hungary's ability to accumulate more external debt is clearly constrained by its already weighty

Table 10 **External Debt Positions, 1991** ($ billions)

| | Czechoslovakia | Hungary | Poland* |
|---|---|---|---|
| Stock Outstanding | 11.0 | 22.0 | 53.1 |
| Medium-/Long-term | 5.9 | 19.2 | 50.2 |
| IFIs | 1.9 | 4.8 | 5.4 |
| Official/bilateral | 1.2 | 1.8 | 36.6 |
| Commercial | 2.8 | 12.6 | 8.1 |
| Short-term | 5.1 | 2.8 | 2.9 |
| Commercial | 3.0 | 2.3 | 1.8 |
| Official/bilateral | 2.0 | 0.4 | 1.2 |
| Debt Service | 1.4 | 4.4 | 8.3 |
| Debt Service Ratio | 17% | 41% | 60% |

* Prior to debt relief

*Source*: Group of 30

debt service obligations. Indeed, projections suggest that Hungary's debt service ratio (interest and principal payments as a ratio to exports) is likely to remain in the 40 percent range into 1995. If so, debt service obligations will remain a constant concern and will bind macroeconomic policymaking.

The OECD has downgraded Czechoslovakia from a "low-debt" to a "moderately indebted country." Still, compared with Hungary's estimated 1990 ratio of interest payments to hard-currency exports of 35 percent, Czechoslovakia's 10 percent ratio is relatively light. But if Czechoslovakia runs current account deficits as anticipated by some observers, its overall debt service ratio could rise sharply.

Poland and Hungary's ability to borrow abroad is already tightly constrained by existing debt service burdens. Czechoslovakia has more room to maneuver, but its looming trade deficits are causing its debt ratios to deteriorate. Particularly if the external environment is unfavorable in the 1990s—in ways that hamper export growth and make external borrowing costly — debt management requirements could limit external borrowing by the CE3 and thereby stunt growth.

## *Cold reality of support levels*

Looking simply at the flow statistics, it can be concluded that while commitments are impressive and disbursements are significant, net financial transfers are modest at best. This cold reality will disappoint citizens of the industrialized countries who believe that their societies are providing massive assistance to the exciting reform enterprises in Central Europe.

But within this overall landscape, the potential sources of capital are behaving very differently. The multilaterals have taken a strong lead, and bilaterals will play a growing role as disbursements gradually catch up with commitments and new projects break ground. However regrettable, it is predictable that most private risktakers would stay clear of the region's current upheaval. The observed "burden-sharing"—the transfer of relative exposure and risk from private to official lenders—is appropriate to the circumstances. Official institutions exist precisely to act when private enterprise fears to tread. These trends can be observed throughout the debt-ridden developing world today.

At the same time, official lenders, notably the World Bank and the IMF, must watch closely the debt management of recipient nations. In particular, the debt servicing capacities of Poland and Hungary are already strained, and Czechoslovakia's position is worsening. It is in the interests of official lenders for commercial banks to grant debt reduction where they appear unlikely to provide fresh credits in the foreseeable future, as is certainly the case in Poland.

Another advantage to having the Bretton Woods institutions in the lead today is their ability to help design economic reform programs. Drawing on worldwide experience with programs in similar although not identical circumstances, the multilateral agencies also have more political legitimacy than would bilateral governments to attach strong conditions to their credits. This conditionality also provides a macroeconomic umbrella under which other donors can operate. Fortunately, the multilaterals have been pressing against open doors, as national governments are anxious to adopt the preferred market-oriented reforms.

By providing such a heavy share of initial financing, the multilaterals have offered a *de facto* coordination mechanism. In addition, the European Commission has bravely sought to coordinate bilateral programs, but much remains to be done, both at the donor and recipient country levels. Prioritization of financial and technical assistance needs is especially urgent. Such problems are to be expected, given the newness of the experience and the large number of external players.

In order to help usher in an epoch of sustained growth, donors must not only strive to foster stable macroeconomic conditions, but will also want to work with governments to develop the "enabling environment" and other indirect incentives that can serve to stimulate private savers and investors. Experience in other developing countries during the 1980s suggests that it cannot be assumed that successful stabilization measures, by themselves, will automatically renew "animal spirits." How best to catalyze the private sector will increasingly become the dominant economic issue in Central Europe. But it would be a grave error to rely on an early response from most large international banks and firms.

Given the mammoth internal tasks facing Central Europe, the difficult external environment that confronts them, and their deteriorating trade and current accounts, official finance will be needed for some time. For multilateral and bilateral donors alike, Central Europe cannot be a short-term matter.

# Aid to Poland: Good News

By Carol Adelman

THIS month's visit to Washington by Poland's new Finance Minister Andrzej Olechowski signals his government's intention to face the serious problems of its rising budget deficit. He took an optimistic tack, calling International Monetary Fund (IMF) budget targets "realistic." The new Polish government is bullish, emphasizing that the private sector has been growing briskly and now accounts for a quarter of industrial production. Foreign-exchange reserves are strong. Inflation is down, as are shortages, hoarding, and long lines. United States foreign assistance has played a critical role in this progress.

American assistance to Poland is designed to help entrepreneurs directly through loans and business advice and encourage the government to create the right climate for trade and investment in the private sector. In 1990 the US granted $200 million to the Polish Stabilization Fund. Our encouragement to other donors helped create a $1 billion Fund. With this support Poland achieved an important base for its new free market economy – currency convertibility. The US also led the way in reducing Poland's official debt by 70 percent and securing a 50 percent reduction from Poland's other creditors.

Using innovative approaches, we set up the Polish-American Enterprise Fund, which operates as a private equity pool that also makes loans. Over $90 million has been committed to equity investments and loans – more than 700 of such loans going to Polish entrepreneurs. One of these was made to "Secura BC Ltd.," a private company that manufactures products such as plastic coverings and disposable gloves. In less than a year, owner-manager Jacek Bodasinski proudly reported that his firm had tripled revenues and doubled employment. Mr. Bodasinski wants to expand his product line and views the European Community as a future marketplace. The Enterprise Fund's investment was the catalyst for Secura's success.

The US pushed a privatization support program by conducting a competition among American accounting and law firms as well as investment banks. We discussed this mechanism with the respective governments as the project developed and since. Three consortia were selected and their assistance is in great demand in Central and Eastern Europe. Governments and managers must first establish priorities for their countries' privatization efforts. An American consortium then provides advisers to help work out laws and regulations, establish enterprise valuations, or sell state-owned companies.

IN one major project, Poland's LOT National Airline and the Ministry of Privatization reviewed the qualifications of several US companies in the consortium and chose a firm to develop a privatization plan for the airline. AID has also helped the Poles privatize their glass products sector and is currently supporting negotiations for a new glass company joint venture.

Other assistance includes:

■ Advisers to the Polish National Bank helping develop regulations for the 80 new private banks and privatization of the remaining commercial banks.

■ A Polish Business Advisory Service which funds advisers for privatizing state-owned firms and helping medium-sized private businesses start up.

■ A long-term adviser to assist the Polish Parliament and several ministries involved in economic restructuring, helping draft laws to facilitate foreign investment.

But citizen volunteers flocking to Poland to help the nation out of its socialist slumber are the secret strength of the US assistance program. The International Executive Service Corps recruits volunteer retired US businesspeople to help Polish companies. They have assisted 60 private companies and several government agencies working on privatization. Over 240 Peace Corps volunteers teach English, assist small business development, and help repair the extensive environmental damage in Poland. With just a bit of the US taxpayer's dollar for airfare and administrative costs, US private voluntary organizations are changing the landscape.

For example, Volunteers in Overseas Cooperative Assistance (VOCA) have helped 180 Polish farm projects by sending US farmers and their spouses to live with Polish farm families. Just one such American volunteer, dairy farmer Damon Szymanski from Pulaski, Wisconsin, has raised enough money from Wisconsin cooperatives to translate and publish a book on private agricultural cooperatives for nationwide distribution in Poland. He was invited to present his views to the Polish Parliament, and these ideas have been incorporated in a new law on private cooperatives.

Imagine the effect of hundreds of Damon Szymanskis throughout Eastern Europe, and it's easy to see why the top Polish foreign aid official has expressed great appreciation for the US assistance program, calling it an "important instrument" to "reshape the socioeconomic system."

The US assistance program has become known for providing assistance quickly and directly to the private sector. Our streamlined procedures have cut delivery time to less than half that of other aid programs. Most importantly, the program is designed to be transitional – to help the Central and Eastern Europeans create jobs for themselves, to stand on their own feet and grow as partners in the vibrant international economic community – becoming a better market for US exports as well.

■ *Carol Adelman is assistant administrator, Bureau for Europe, Agency for International Development.*

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# Quotation of the Month: *"Inspire the Russian people with another unsordid act"*

## Jeffrey Sachs urges international aid

Boris Yeltsin has elevated to power the finest and most market-oriented economists in Russia . . . unified, intellectually and by common bonds of friendship and struggle, behind the new deputy prime minister, Egor Gaidar. . . . This new team has . . . issued a set of remarkable decrees, which within weeks will free prices, make the ruble convertible and aim to get Russia's hyperinflationary budget under control.

If economic transformation were a matter of brilliant ministers and good will, the Russian team would be on its way to success. But life is more tragic than that, particularly in the rubble of a collapsed empire. And the West not only needs to understand the potential tragedy, but find ways to address it sensibly . . . A few best-guess estimates of what is required are:

- Russia now needs international support of about 5 percent of its $300 billion GNP each year for the next four or five years — about $15 billion per year. (The rest of the former Soviet Union, when it gets around to radical reform, might need a like amount.)
- In apportioning aid from the West, a fair U.S. share would be about 20 percent, or $3 billion; the European Community should put in $10 billion and Japan $3 billion. In addition, rather than strong-arming Russia to pay debt service that cannot be afforded, the West should acknowledge that a comprehensive rescheduling of interest and principal payments is needed in the early phase of stabilization. Even heroic measures by the G-7 to "lend" Russia money to pay some of the debts would be misplaced, since that would presume that Russia would have to keep servicing the balance of the debt in the short run.
- Real assistance should be a mix of emergency food aid and balance-of-payments support, not a cosmetic rearrangement of debt servicing. A rough guide for 1992 would be $5 billion in food aid, $6 billion in balance-of-payments loans (to help Russia maintain the flow of crucial imports to keep factories running), and $4 billion for a stabilization fund for the ruble, which the government will make convertible on January 1, 1992.
- All loans should be conditional on the implementation of the radical reforms that Yeltsin and Gaidar have announced. The IMF should immediately be pressed into service to negotiate an "IMF-monitored" program with Russia, exactly as if Russia were an IMF member country. As usual, the IMF would provide strict conditionality, but the money would come from Western governments, not the IMF.
- Next year, Russia should be admitted as a member of the IMF and World Bank. The target date for admission could be the G-7 summit in Germany next summer, after which the financial support would shift, in part, from the U.S. budget to the balance sheets of the IMF and the World Bank. Thus, by the time other Soviet republics become eligible for Western assistance, the overall burden could be borne by a combination of direct budgetary expenditures from Western governments together with funds from international financial institutions.

In no year should direct U.S. budgetary outlays have to exceed $3 billion — which the United States can easily afford. Part can come in the form of food credits, which can be readily financed (and which have already been supported by the administration and Congress). Part, however, must come in the form of cash grants and loans. Since a cash outlay of $2 billion would be considerably less than 1 percent of our annual military spending, the best strategy remains a diversion of up to 1 percent of our military budget to "economic security" spending on behalf of stabilizing the new democracy in Russia and in the other republics in future years.

This is the third time in this century [that] the West must address the vanquished. When the German and Hapsburg empires collapsed after World War I, the result was financial chaos and social dislocation. Keynes predicted in 1919 that this utter collapse in Germany and Austria, combined with a lack of vision from the victors, would conspire to produce a furious backlash toward military dictatorship in Central Europe. Even as brilliant a financial minister as Joseph Schumpeter in Austria could not staunch the torrent toward hyperinflation and hyper-nationalism, while the United States descended into the isolationism of the 1920s under the "leadership" of Warren G. Harding and Henry Cabot Lodge.

After World War II, the victors were smarter. Harry Truman called for U.S. financial support for Germany and Japan, as well as for the rest of Western Europe. The sums involved in the Marshall Plan, equal to a few percent of the recipient countries' GNP, was not enough to actually rebuild Europe. It was, though, a political lifeline to the visionary builders of democratic capitalism in post-War Europe.

Now the Cold War and the collapse of communism have left Russia as prostrate, frightened, and unstable as was Germany after World War I and World War II. Inside Russia, Western aid would have the galvanizing psychological and political effect that the Marshall Plan had for Western Europe. Russia's psyche has been tormented by a thousand years of brutal invasions, stretching from Ghengis Khan to Napoleon and Hitler.

Churchill judged that the Marshall Plan was history's "most unsordid act," and his view was shared by millions of Europeans for whom the aid was the first glimpse of hope in a collapsed world. In a collapsed Soviet Union, we have a remarkable opportunity to raise the hopes of the Russian people through an act of international understanding. The West can now inspire the Russian people with another unsordid act.

*From a recent article in the* Washington Post. *The author is professor of international trade at Harvard and an adviser to the Russian government.*


**"This satellite photo clearly shows nuclear war heads changing hands at a Minsk car-boot sale"**

*from the* Financial Times

The New York Times March 26,1992

# Why Waste Aid on Russia?

By Doug Bandow

## Consider the I.M.F.'s dismal record.

Proposals to aid Russia and other ex-Soviet republics continue to stream forth and most envision a central role for the International Monetary Fund. Not surprisingly, then, many foreign officials, not to mention Richard Nixon, are frustrated by Congress's failure to approve a $12 billion capital contribution to the I.M.F., which the fund claims is necessary for its aid package to Russia.

But legislators shouldn't allow such complaints to shame them into passing the increase. The question is: has the agency, in the four decades it has been making loans, contributed to growth abroad? The answer appears to be no. In some cases, like the Philippines and Zaire, foreign transfers were blatantly looted. In others, the money was wasted on prestige projects. And even what were once thought to be the best investments — docks, factories, roads — are deteriorating and bleeding many poor nations to death.

Of course, some economists say Russia will be different. And the I.M.F. has been surprisingly tough with Poland. But the West provided some $44 billion to Russia last year without obvious results. Moreover, once the I.M.F. begins lending to Moscow it will be under enormous pressure to maintain its lending irrespective of Russia's compliance with its conditions. And the fund's record suggests that it is likely to give in to such pressure.

In contrast to the World Bank, the I.M.F. does not back individual projects, but makes loans to governments, theoretically to assist them in promoting development. Even the organization's friends have trouble pointing to examples of countries that have "graduated" because of its loans. Jeffrey Sachs, the Harvard economist who is advising the Russian Government, has said that most fund agreements "are now honored in the breach." Even the I.M.F. acknowledges declining compliance rates in recent years.

Six nations — Chile, Egypt, India, Sudan, Turkey and Yugoslavia — relied or have relied on I.M.F. aid for more than 30 years; 23 nations have been borrowers for 20 to 29 years. And 46 have been using fund credit for 10 to 19 years.

Since 1957 Egypt has never been off the I.M.F. dole. Yugoslavia, which got its first loan in 1949, was not a borrower in only three of the last 40 years. Bangladesh, Barbados, Gambia, Guinea-Bissau, Pakistan, Uganda, Zaire and Zambia started borrowing in the early 70's and haven't stopped.

I.M.F. lending has many problems, including a lack of effective enforcement. But the main one is that when the borrowers' economic policies remain badly distorted, foreign assistance subsidizes the cause of poor nations' difficulties. For instance, among the fund's biggest clients have been Argentina, Brazil, Mexico and Yugoslavia, all of which persistently promulgated anti-growth policies like price controls and bloated public spending despite I.M.F. loans and conditions.

Some nations, like Argentina, are making progress today, but despite I.M.F. credit, not because of it, since their economic failures left them no other choice. Similarly, Mikhail Gorbachev instituted perestroika only as an act of desperation. Abundant Western aid, by alleviating some symptoms of Russia's economic problems, would encourage even Boris Yeltsin to slow the painful economic reforms that have just begun.

For years, foreign money has helped delay the day of reckoning for many economies. Today the borrowers are left with huge debts and low growth. They need economic reform, not more loans. Once reforms are in place, private credit and investment will follow naturally. The transition will be painful, but the I.M.F. cannot prevent that. Rather, increased lending, whether in the former Soviet Union or the third world, is only likely to waste more money. □

*Doug Bandow is a senior fellow at the Cato Institute.*

REPORT ON RUSSIA

# THE PROSPECTS FOR RUSSIAN REFORM

by John Williamson

The rather big bang introduced by President Yeltsin's government on January 2, 1992 encountered a remarkable degree of skepticism in the West. The *Washington Post* even wrote it off as another perestroika-like reform that changes nothing much, on the ground that the managers of state stores were still phoning higher authority to ask what prices to charge. Another reaction was to assert that nothing had been done except to liberate prices, and that price liberalization in the absence of supply-side reforms like privatization cannot be expected to achieve anything. Other criticisms have been that price liberalization will lead to a widespread breakdown in production as existing supply channels seize up with no alternative market mechanisms to replace them, that social unrest will erupt as living standards are squeezed, and that hyperinflation will develop. Is this pessimism justified?

Perhaps the first thing to note is that the Jeremiahs have already had to change their tune. Until January 2 their main theme had been that President Yeltsin's government would lose its nerve and at the last minute back away from its announced near-comprehensive price liberalization and assault on the budget deficit.

Nor is it true that the package contained nothing except price liberalization. The most conspicuous additional element is a tightening of fiscal policy which is intended to eliminate a deficit of around 20 percent of GDP in one fell swoop. (Can the skeptics recall the fuss the US political system has made about achieving a fiscal adjustment one quarter of that size spread out over five years?) Half of the tightening is supposed to be achieved by the cuts in subsidies resulting from price liberalization, the bulk of the remainder is from an increase in "value-added tax" (really a sales tax) from 5 percent to 28 percent and withdrawal of the many exemptions allowed in the past, and the remainder from economies in spending, notably on procurement of military supplies, which is being cut in half. No one can be sure that in a situation in such flux as prevails in Russia these measures will really succeed in balancing the budget, but they can hardly be dismissed as inconsequential.

It is true that when price liberalization precedes supply-side reforms one should not count on much of a supply response, and a rapid loosening of the supply and distribution network is much to be desired. But to start large privatization before price liberalization is to invite perverse



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supply responses, such as the market closing down socially useful activities where the controlled price is too low to permit profitable operation. Nor is it true that the only objective of liberalizing prices is to bring forth additional supplies. It is also to provide a less wasteful method of rationing limited supplies than the depressing business of standing in endless queues (by far the most visible sign of economic distress in Moscow, as any recent visitor can testify, and one that elicits far more complaints than hunger). Another aim is to replace hoarding by a net release of hoarded supplies onto the market. Price liberalization was the right place to start.

The danger of a total breakdown of production seems exaggerated. Of course, production has already been disrupted and the situation may well get worse rather than better in the first weeks or even months after liberalization. But liberalization will eliminate one of the major sources of past disruption, namely the incentive that enterprises had to fail to deliver contracted supplies in favor of sales on the black market or the commercial exchanges, since supply contracts will be rewritten at market prices. The commercial exchanges (those standing refutations of the charge that Russians lack entrepreneurial instincts) already provide a mechanism for bringing new buyers and sellers together when past relationships break down.

A worrisome source of potential disruption in production is the possibility that inter-republic trade will collapse in the way that intra-CMEA trade did in 1991, either as the republics impose export restrictions to defend their markets against goods being bid away elsewhere or as they impose import restrictions following a move to separate currencies and a general insistence that trade be settled in dollars (see box, page 41). The decision by the other republics to emulate Russian liberalization should keep the first risk at bay. Separate currencies are still at least several months away and so the risk from that source is not immediate. Moreover, it is a danger that is well understood in Moscow and at least some of the other capitals. The potential role of a payments union in keeping trade going is accepted, though qualified by the hope that if the ruble can be stabilized a payments union will prove unnecessary because the other republics will be willing to continue using the Russian ruble at least as a vehicle currency.

The danger of widespread social disruption is perhaps the most difficult thing for an outside observer to assess. One may note that similar predictions in the other economies in transition have so far proved wrong. One reason is doubtless that living standards did not decline as drastically as the official measures suggested, mainly because the enormous waste of standing in queues was eliminated and because goods were previously often unavailable at the prices that enter into the price indices. It is also pertinent to note that the people most likely to suffer by price liberalization, namely those on fixed incomes and with time to stand in line, tend to be the old and weak, who are hardly the social groups most likely to lead social protests. It is when economically powerful groups (like miners) believe that they are not getting a fair deal that social disruption is most likely; hard times produced by general chaos are not necessarily particularly prone to generate social revolt.

Whether the danger of hyperinflation is realized depends primarily on the degree of success that the Russian authorities have in their effort to bring the budget under control. If the budget deficit is close to eliminated, one has to ask from where the monetary expansion needed to support a hyperinflation would come. The only possible answer is that it might come from credits granted automatically to loss-making enterprises. This is a real danger at the moment because the current governor of the Russian central bank, Georgy Matiukhin, tends to regard his prime duty as being to prevent any enterprise going bankrupt. If he can be persuaded to act like a central banker, or if he is replaced by a real central banker, hyperinflation will not happen.

There are nonetheless forces at large that have



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often been instrumental in the development of hyperinflation elsewhere: a high degree of wage indexation, a lack of controls on wages coupled with managers whose position depends on continued goodwill from the workers, the presence of a floating ruble that has sunk to a chronically undervalued level, a cost-plus mentality, and absence of competition. There is no doubt that the initial price increases are substantial: estimates were that the price level would double or triple in the first month. The point is that in the absence of an elastic money supply this inflation will lead to a severe erosion in the real value of money balances; the monetary overhang will not only be inflated away, but be replaced by acute monetary stringency that will induce a recession (as happened in Poland). Whatever its costs, the recession will at least curb further inflation.

At the moment it is fashionable to expect the economy to continue deteriorating indefinitely. It is true that in the short run the situation is bound to be difficult and a further lengthy period of decline cannot be excluded if the initial fiscal package proves to be inadequate. But if it turns out that the tiny group of technocrats currently entrusted with economic policy have done all they tried to do, and if they succeed in following up by imposing hard budget constraints on enterprises so as to establish control over monetary emission, and if they could reach a rather quick agreement with the IMF that would unlock access to Western credit and so permit the exchange rate to be stabilized at a sensible level, it is just conceivable that a virtuous circle could get under way before the end of 1992. It would be a permanent reproach to the West if that outcome were jeopardized for failure of the third "if."

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THE WALL STREET JOURNAL WEDNESDAY, JANUARY 22, 1992

# Reform by the Russians, for the Russians

By David Brooks

Moscow is teeming with brilliant Western economists offering rate fire plans for the reform of the Russian economy. When Yegor Gaidar, Russia's economics minister, had to write the real reform plan he got the hell out of there.

In October Mr. Gaidar and his team of advisers went to dacha number 17 in the Arkhangelskoe woods, where they isolated for several weeks from all that Western technical assistance, they wrote the strategy that is now being enacted.

The Gaidar team is composed of a few score of men in their 30s. Many of them took their first trip to a foreign economics conference as recently as 1988. But they have since emerged as fearsome economists. "That is the best team that it is possible to collect in Russia," says Polish economist Jan Winiecki. "They educated themselves backwards, seeing the problems and going back to find the right textbooks."

Mr. Gaidar has since called in some outsiders – Polish economists Stanislaw Gomulka and Jacek Rostowski, Richard Layard from the London School of Economics, Anders Aslund from Sweden and at the 11th hour Jeffrey Sachs from Harvard – but they are there merely to detect holes in the Gaidar strategy or to serve as unguided propaganda missiles for the Western market. The whole ethos of the Gaidar approach has been that Russians are going to run this reform themselves. At one point Boris Yeltsin observed that Russians are tired of begging.

## Economics, Not Charity

That's an approach that's looking pretty good as today's humanitarian aid conference convenes on Planet Debbie. It's actually opening in Washington, but it seems out of this world. The conference appears to be an effort to frame the economic crisis as a "We Are the World" charity drive with George Bush in the role of Bob Geldof. But the real issue of the moment is economics, not charity. As important as it is to get the food in Russia distributed properly, if Mr. Gaidar's reforms don't work, a few planeloads of Spam aren't going to help much.

The European delegations who are not entered in the New Hampshire primary are going to want to talk about political and economic aid, notably proposals for a ruble stabilization fund, for aid to balance the budgets, the creation of a payments clearing union and technical assistance.

The danger of the conference is that the West may try to turn Russia's transformation into a global rescue effort, drawing Russia out of its self-reliant posture with billions of aid dollars. Such an economic transformation would be dominated by IMF conditions and timetables. It is perhaps more than symbolic that today's conference is being held in the host city of the IMF and World Bank and that Russia wasn't asked to participate.

At its best the IMF uses its money to induce nations to undertake courageous liberal reforms. But in Russia's case, Boris Yeltsin already has more courage than the IMF. As Mr. Gomulka notes, "Gaidar is too liberal for the IMF."

As it happens Mr. Gaidar and his team modeled their strategy after the Polish reforms, which had IMF guidance. The first steps were to liberalize, or at least raise, prices and let the ruble float on international exchanges, steps that went into effect on Jan. 2. The purpose was to let the marketplace feed real information on the value of things via the price mechanism. Foreign investment would be a step closer and exports would be stimulated.

*At its best, the IMF uses its money to induce nations to undertake courageous liberal reforms. But Boris Yeltsin already has more courage than the IMF.*

The problem is that the ruble has gone crazy, plunging to more than 130 to the dollar as Russians bet against their government by buying dollars. Prices are at surreal levels out of line with senior Russian officials earning the equivalent of a few dollars a month, and ruble-denominated items going for virtually nothing in hard currency. Economist Judy Shelton calls this the ruble gone bungee jumping.

Now, some of the Western experts around Mr. Gaidar are asking for a $5 billion ruble stabilization fund – selling dollars to Russians for rubles to bring down exchange rates. Anders Aslund and Richard Layard argue that Mr. Gaidar's reform cannot succeed without this Western help. If true, this is worse than bungee jumping: it is jumping off a bridge and hoping the West ties on the cord as you fall.

It is possible that the stabilization fund could work as a paper towel to soak up some rubles, if the ruble were to bounce quickly back as Russian exports rose. But the paper towel would be swamped if the monetary spigot weren't turned off. The crucial factor is not Western aid but whether the Russians can find out what their money supply is and control it.

In his 1991 book, "The Order of Economic Liberalization," Ronald McKinnon argues that the first step toward liberalization is control of fiscal policy. In communist economies fiscal and monetary policies are inextricably linked because governments finance deficits by printing money. If governments prematurely decontrol prices, float exchange rates and privatize before controlling budgets and money, then, he writes, "the traditionally passive Soviet monetary system is likely to accommodate explosive, confusing and demoralizing increases in prices without any well-defined upper limits."

Mr. Gaidar's advisers understand that they must control the deficit, which is 10% of gross domestic product. But having raised prices and floated the ruble first, fiscal control becomes exceedingly difficult. With price rises, enterprises face intense pressures to raise wages. These raises are paid for by appealing to the local banker who passively fronts more credits to the enterprise, thus contributing to the next stage in the upward spiral.

The other side of the ledger, revenues, is also a problem. If wages and some welfare payments are allowed to chase the price spiral, government revenues must remain high. The first result is high tax rates, such as Russia's newly enacted 28% VAT.

More important, the government faces the overwhelming temptation to postpone privatization. With the new prices, the government food stores are now sources of much-needed revenue. Mr. Aslund is one of the Western advisers who says that price liberalization must be accompanied by "auctioning off heaps and heaps of enterprises 70%." But so far there's been talk about privatization, but no action.

Failure to privatize then rebounds back and ruins the reason that prices were liberated in the first place. If stores are not driven by profits, if there is no competition among suppliers, then prices aren't really free; they are just set at higher levels. As the American Enterprise Institute's Nicholas Eberstadt says, "You don't negotiate food prices with the checkout girl at the supermarket. Prices have to reflect the factors of production."

This quick and dirty guide through the seeds of Yegor Gaidar's sleepless nights illustrates the central problem facing post-communist reformers. There are dozens of reforms that need to be made, each with interconnecting feedback loops. It's a question of enacting the reforms in the right order. The joke around economic circles is that they all need to be done first. (They're economists, not comedians.) Mr. Gaidar chose to "liberate" prices and float the currency first, so he's got the problems associated with that approach.

He could have chosen the McKinnon approach, which emphasizes fiscal discipline first. There is another approach, which the Russian government seems to be flirting with as a contingency plan. There are about three dozen versions of this, but each involves giving the ruble value by attaching it to some commodity or currency rather than letting it float. Jude Wanniski and Judy Shelton have made the case for such plans on this page.

The major argument against them is that the Russian people are in no mood to try something that seems experimental. "I saw Judy Shelton's Journal piece," Anders Aslund says. "I like Judy Shelton. But it has no relationship to reality."

Regardless of whether Russia continues along its present path or follows the Erhard approach – which has history on its side, having worked in Germany, Mexico and elsewhere – a few metaphors are in order. First, this is a dark and stormy process with visibility restricted to a few feet. The idea that moves can be dictated from afar according to some IMF timetable merely lends rigidities to what is at best a flexible stumble in the dark. Second, the failure rate is high, and the best reform grade even a group as talented as Mr. Gaidar's team is likely to get is "D."

## Panicky Reports

A lot of media reports are panicky, emphasizing the worst complaints and relying on old sources, disgruntled members of the old guard. A lot of aid skeptics are panicked because they think that Jeffrey Sachs is running the reform program. He only talks that way.

The West should do everything possible to foster Russian self-reliance. If Western leaders decide at today's conference that they must give economic aid, what they should do is print up one of those bathtowel-sized cardboard checks that are presented to the winners of the Publisher's Clearing House Sweepstakes. George Bush could then be photographed handing it to Boris Yeltsin with no strings attached. Let Mr. Yeltsin and his team decide whether they want to cash it and how to use it. Russians elected Russians to run Russia.

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*Mr. Brooks is deputy editorial page editor of The Wall Street Journal Europe.*

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## EDITORIAL/OPINION

# Needed: CIS Monetary Policy

By JOHN A. TATOM

The republics of the former Soviet Union confront overwhelming obstacles in their efforts to develop new monetary standards. Unfortunately, recent Commonwealth of Independent States (CIS) actions have been counterproductive, further reducing confidence in official and private CIS commitments.

These actions include imposing new taxes that impose implicit exchange controls, and promoting foreign funding for exchange stabilization. The CIS should quickly reverse these actions and to move toward a convertible hard-currency policy.

There is widespread agreement that the former Soviet Union must find a monetary standard that is acceptable both domestically and internationally. This would restore day-to-day economic transactions, remove the hyperinflation potential, and attract the private foreign financing required for the transition.

A convertible and strong currency, based on credible social commitments, is even more desirable. Commitments are not credible when they are tied to the fancy of a few politicians, especially recent revolutionaries. Institutional arrangements must be altered to remove political discretion and to broaden the commitment to new arrangements.

However, achieving monetary stability is not fostered by government intervention. An effort to prop up the ruble with a foreign-financed exchange stabilization fund would invite speculative attack and would be doomed to failure. A proposed $5 billion to $10 billion fund could not even protect a strong currency when, as in the former Soviet Union, there are ongoing, fundamental changes in the economy's structure, policies and even geography.

Some analysts have recognized the futility of such an effort and have called instead for an open-ended pledge of stabilization by the central banks of the Group of 7 countries. But since the 1970s, periodic attacks on overvalued currencies of up to $1 billion per day have demonstrated the futility of such support, given the greater capacity of agents worldwide to create ruble debt to sell to the banks.

Instead, Russia and the CIS are well positioned to create a commodity-backed ruble with wide appeal to foreign investors. The major producers of internationally traded commodities, especially oil and gold. They appear to have significant reserves of these commodities, which could be committed constitutionally to backing the ruble's value.

A commodity-backed ruble does not guarantee monetary stability, however. When the commodity's price falls relative to other goods and services, the value of the ruble would fall as well.

A more reliable anchor would be a stable currency such as the German deutsche mark. But this choice raises start-up and credibility problems, because the CIS cannot produce deutsche marks or guarantee that it can use that currency to make payments.

New nations, faced with such problems under the gold standard, often put their reserves in the hands of a foreign central bank such as the Bank of England.

The CIS could solve its reserves problem by creating a foreign-based central bank subsidiary with an equity claim on future CIS oil and/or gold. These assets could be sold, via forward contracts running several years, to the German (or other) government for deutsche marks.

The deutsche marks, in turn, would serve as reserves protecting the forward contracts and backing the ruble at the desired fixed rate.

This subsidiary must, in fact, act as the central bank. Its ability to lend or otherwise transfer reserves to the parent must be constrained by its charter, at least over the life of the forward contracts. The reserves and the future value of the ruble would be beyond CIS manipulation, and the commercial integrity of the CIS's contracts and monetary commitment would be subject to the commercial laws of the third-party state of incorporation.


In the unlikely event that the CIS failed to deliver on its commodity contracts to the foreign government, the buyer of the forward contract would be protected by the greater bargaining power of a central government and, ultimately, by access to the reserves. A CIS choice to default on its contracts would be tantamount to a monetary collapse, because of market pressures on remaining reserves. Such an arrangement has many of the benefits of a commodity standard without its potential for price instability.

While recent policy initiatives pose insurmountable roadblocks to convertibility and monetary stability, they can be reversed at little cost if done quickly. Among the other barriers is the inflationary pressure created by a monetary overhang built up by excessive ruble holdings and fast growth in the money supply. This inflationary pressure is not so easily reversed, and poses a major obstacle to investment and to the prospects for a credible hard-currency policy.

A related difficulty is the desire in each republic to develop its own currency. Such moves are understandable, given the history of ruble mismanagement and existing inflationary pressures. The inefficiency of such fragmentation, however, is most apparent in the European Community, where there is a stronger momentum toward a uniform monetary standard. The movement away from the ruble points up the urgency of creating a hard "new ruble" before new, multiple sources of monetary mismanagement are cloned.

The breakdown of the ruble trading area and collapse of ruble confidence can only be reversed by a successful monetary reform more extensive than West Germany's after World War II. The reform must include a once-and-for-all loss in the purchasing power of "old rubles," about as large as that which would otherwise have to occur through inflation. It also must include a non-inflationary pace of expansion of the "new ruble."

Finally, an essential ingredient for a strong currency is the perception that the monetary authorities are competent. The apparent lack of competence recently has worsened the outlook for implementation of credible and effective monetary arrangements. Thus, the former Soviet Union must change course fairly quickly and decisively.

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'ebruary 19,1992

THE WASHINGTON POST

*llis Kirk*

# ıd Russia's Food Crisis—Return the Land to the People

:COW—The food crisis in Russia could be n a single growing season if the land were ıack to the people It continues to be a ıent why Boris Yeltsin hasn't acted to do so. xperience here tells me that the Russian s—given the incentive of owning their vould immediately become productive. :ommunism, 2 percent of the state's land vately farmed in the form of tiny plots of ıxt to dachas. That meager 2 percent :ntly produced one-fourth to one-third of d consumed by the Soviet people It probable that if the government were to its grip on only 50 percent of the land, l crisis would end.

privatization can be done single- y by Yeltsin through a presidential de- he same way the price reforms were . Yeltsin has an appointed presidential ntative plus a governmental representa- :very oblast (region) in Russia whose job ure enforcement of executive orders.

, then, are Yeltsin's excuses for not ıng land? One is that Russia is too big and ıtion can't be done fairly and quickly. Armenian model is convincing proof that ale land privatization can be done both ıd quickly. One year ago this month, ı passed its Law on Peasant and Collec- ısant Farms. Privatization was done re- region in February and March. Each Soviet placed a map of numbered plots on the wall, and all families registered in that oblast could review it In a public drawing one month later, a representative of every family drew a number from a box, and plots were chosen by number—no preferences for anyone (some party leaders ended up with swampland)

The new owners could then sell, farm or do nothing with their land They could farm alone or could form cooperatives and farm collectively. Within one growing season, the cucumber crop has tripled, the vegetable, melon and some wheat production has doubled and herd sizes are increasing for the first time in decades By fall the Armenians announced they had enough potatoes to get through the winter without imports—and this in a country where only 15 percent of the land is arable.

Russia has oblasts just as Armenia does. Russia can privatize the land oblast by oblast, just as Armenia did It is said, however, that Yeltsin feels this step is so important and controversial that the Russian parliament must discuss and legislate it. But since no draft legislation has even appeared yet, it could easily be six months before an act is passed and implemented Any delay now would effectively lose a full year, because the growing season will be over in six months. Privatization must be carried out before spring Otherwise, Russia will face another year of dismal, declining production, and Yeltsin will have to go to the West again next year for food aid.

Many people wonder why Yeltsin should be asking the West to give millions in food aid to a country that could easily feed itself Before the 1917 revolution, Russia and Ukraine were the breadbasket of Europe Seventy-four years later the fertile land is still here and despite (or perhaps because of) three-quarters of a century of destruction inflicted by communism, the Russian people are extremely creative, inventive and resourceful Just as the Armenians do, the Russians will share a tractor to do the planting they cannot do by hand, and they will share the few privately owned cars to get the potatoes to the train station and on their way to Moscow

Many of my Russian friends are embarrassed and angry that they have unnecessarily become the object of world charity. Yeltsin warns the West that unless it pours billions of dollars into the economy of Russia, it may become a fascist state But the agricultural productivity that helps create economic stability can be achieved by Russians themselves—if only they are given the opportunity.

The resistance to land privatization comes from the collective farm managers who stand to lose both their power and their land Their opposition has little to do with the good of the country Besides, Yeltsin would win more votes from the peasants who receive land than he would lose from disgruntled managers. Price reform was just as serious and momentous an issue, and Yeltsin was not afraid to order it by decree.

The only other plausible reason for inacti- on privatization is that Yeltsin does not want t! people to have the land, either because he thin they cannot handle the responsibility or becau the state must control it all Perhaps he is still heart an old-school communist—a closet one, be sure, but a communist nonetheless of wh might be called the "equality in poverty" type.

This is the type portrayed in the "tale Igor's pig" in which a genie appears and offe to fulfill the wish of an Englishwoman, a Frenc man and a Soviet The Englishwoman remar that her friend Daphne has a manor house sl admires, and she requests one like it; she granted it The Frenchman says he'd like vineyard even larger than that of his colleag Jacques, he gets it Then the genie turns to Iv the Soviet "My neighbor Igor has a pig, and don't," says Ivan "I want you to kill Igor's pig"

Where does Boris Yeltsin stand? Is he a tru reformed Communist-turned-capitalist wl seeks a bigger and better vineyard for his peop or a simplistic Ivan who does not want them have to struggle with the troublesome issues ownership? Or is it that deep in his heart, he st hears Stalin whispering "Land is power. Contr the land Never let it go"

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TRANSITION

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Socialist Economies Reform Unit • Country Economic Department • The World Bank

# After the Soviet Breakup: Chaos with Signs of Hope

## Lessons from a colloquium

On February 27-28, the Socialist Economies Reform Unit presented a colloquium on the former Soviet Union for the World Bank's Board of Executive Directors. The session provided an in-depth picture of the current situation, prospects for the future, and the international impact of these developments. Outside experts participating in the program included economists Abel Aganbegyan, Anders Aslund, Jeffrey Sachs, and Norbert Walter; Sovietologists Richard Pipes and Dimitri Simes; and political/military experts Henry Kissinger, Edward Luttwak, Steve Meyer, George Soros, and Strobe Talbott.

The present situation in the former Soviet Union is marked by chaos and extreme fragility — in the words of George Soros, the situation is "not just grim but potentially cataclysmic." On the economic front, output is falling rapidly across the region, with no immediate end in sight. Interrepublican trade is threatened with collapse, with potentially catastrophic effects on the economy of the region. On the political front, a variety of personalities from the former communist party, the military, and national minority groups are emerging in Russia to challenge President Boris Yeltsin. Although they represent potentially antagonistic viewpoints, these groups are beginning to unite in opposition to Yeltsin and thus to pose a growing threat to his already fragmented base of power (itself undermined by competing regional and local power bases within Russia). With regard to the other republics, for the time being only the Baltics and Armenia appear to have relatively well-established democracies with new, reform-minded leaders. Many previous communist party officials are still in charge elsewhere, although with varying degrees of reform attitude. All republics except Russia suffer a severe shortage of economic and legal expertise. Because power in the former Soviet Union was highly centralized in Moscow, the other republics face a vir-

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tual institutional vacuum as they approach the complex task of political and economic transformation.

**Historic legacy**

Previous attempts to create a liberal political environment in Russia have failed. According to historian Richard Pipes, communism gained control in Russia in part because it reinforced certain characteristics of traditional Russian political and economic culture:

- Russian folk culture customarily embraced strong government. (Ivan the Terrible was, in strict translation, Ivan the "Awesome," not considered a particularly bad character in Russian history.)
- Concepts of private property and rule by law had shallow roots even in precommunist times. Until two centuries ago, the omnipotent czars owned both the property and the people of the empire. The concept of private land ownership was unknown in traditional Russian communes; serfs were allotted relatively equal plots of land to use, but ownership and responsibility for paying taxes were communal. The norms of egalitarianism are deeply embedded in the Russian psyche.
- Russian society has been atomized, with poorly developed lateral institutions. Until the late 19th century, Russians were not allowed to form independent organizations such as political parties or trade unions. Thus, the disintegration of the state always meant the disintegration of society. Only the intelligensia has been somewhat united — but only in opposition. Attempts on their part to organize around a common consensus have generally failed.

The current situation carries, nevertheless, some signs of hope. This is the first time in history that Russia has a chance to shed these old political and economic traditions and build a new society from the bottom up. There are signs that the last 70 years have been so traumatic that the population is willing to endure severe hardship if needed to bring fundamental change. The time for change is ripe and should be seized by insiders and supported by the international community. This is certain to be a watershed period — for good or bad — in the region's history.

**Progress of reform**

On the economic front, several republics are indeed taking unprecedented steps toward reform. Russia is the most obvious case, with its dramatic stabilization and price deregulation in January that reduced the budget deficit from 25 to perhaps 5 percent of GDP. Although the enormous price leaps and collapse of the ruble in January led to a corresponding freefall in confidence, the significant appreciation of the ruble on the cash and auction markets in recent weeks is the first sign that stabilization efforts may be taking hold. A large increase in oil prices is planned for April. It will dramatically shift the terms of trade — and possibly the political and economic tide — in favor of Russia against all other republics.

*From the Polish weekly* Polityka.

Although the most visible case, Russia is not the only republic pursuing economic reform. Lithuania is moving vigorously, while Estonia, Latvia, Armenia, Kazakhstan and Kirghizistan are making some (albeit more limited) progress. Conditions in Belorus and Ukraine are amenable to reform, but these republics, in particular, need technical assistance from the international community. The Central Asian Republics, Azerbaijan, Moldova, and Georgia are at present the slowest pursuing reforms.

On the political front, it is striking how political pluralism has flowered in many parts of the region. Several centers of real power are emerging in Russia to challenge the Kremlin. Democracy is well-established in the Baltics and Armenia. This coming of "real politics" would be easier if the economic conditions were not so harsh and thus conducive to the emergence of extremist political groups.

Recent events in the former USSR also bode well for international security. Russia is increasingly looking inward, absorbed by challenges from its own national minorities and economic power centers. Orders for military equipment have fallen 85 percent, leaving military industries in a state of shock and rapid disintegration. Although they are trying to export arms to recoup some of their losses, the level of exports is certain to drop dramatically from that pursued (through sales and military aid) by the former communist regime. Widespread conversion of military industries to civilian uses, however, is not feasible, but some inputs (including labor) can be redirected over time.

In contrast to rather alarmist speculations in the press, the danger of nuclear proliferation is not markedly enhanced by Soviet disintegration. The highly sophisticated and complex controls on Soviet nuclear weapons will continue to prevent unauthorized use, whether by rogue military bands, international terrorists, or indeed republican governments (other then Russia) themselves. Furthermore — as Steve Meyer pointed out — the well-publicized demand from would-be nuclear powers for ex-Soviet scientists has itself been overemphasized as a danger. Even if these scientists wanted to move, they would add little value in other settings, given their specific base of knowledge (generally tied to Soviet weaponry) and the shortage of specialized engineering machinery for making weapons components in most would-be importing countries.

In the nuclear area, however, a major danger is posed by the dozens of Chernobyl-type nuclear plants still in operation. These plants are critical suppliers of electricity that can not realistically be closed in the short-run. Yet their poor design, combined with the difficulty of obtaining spare parts and keeping a skilled and motivated work force for operations and maintenance, make them a global menace.

The only potential major threat to international security, as noted by Henry Kissinger, would be if Russia were to renew its past imperialistic tendencies and attempt to reunite part or all of the empire by force. For this reason the West needs to establish strong links with the other republics and encourage normal Russia-Ukraine relations.

### The West: what role to play?

Few would have predicted a decade ago that a peaceful dissolution of the Soviet empire was possible. This is the third great transformation of the 20th century. The first two (the two world wars) resulted in 60 million deaths, but the CIS is now providing an institutional framework for a peaceful third transformation — a critical role even if the CIS eventually becomes "little more than a footnote in history," in Strobe Talbott's words.

International assistance is critical if the chaotic and fragile situation is to develop into one of hope rather than cataclysm. The exact role for the West is widely debated, however. All experts agree that basic humanitarian assistance, such as emergency imports of food and medicine, is needed. Most also favor Western contributions (perhaps on the order of $5 billion) to a stabilization fund to provide support to the ruble. Some call for additional monetary assistance (with strict conditionality) and debt rescheduling — although many doubt that this money will be forthcoming, given the budgetary and political situation in the U.S. and elsewhere. Although Western technical assistance is also needed, the focus and amount is open to debate. Some experts look to the east German model and call for massive migration of expertise — particularly managerial expertise — "from West to East" to help rebuild public and private institutions. Others take a more cautious approach, calling on the West to help in transferring technical know-how but to leave it to the Russians and other nationalities to rebuild their own indigenous institutions. Although the process could take a generation or two, but this is short given the centuries of Russian history whose legacy needs to be overcome if democracy and a private market economy are to take root and hold.

*Cheryl Gray, CECSE*
*World Bank*

## Larry Summers' observations

Transition's *editor asked Larry Summers, Vice President and Chief Economist of the World Bank and official host of the colloquium, to sum up his comments on the meeting.*

*Q: Abel Aganbegyan described the Russian pessimist as the one who believes things cannot get worse, against the Russian optimist who argues, yes, they can. From an economist's angle, how do you interpret that black joke in the present state of the ex-USSR?*

A: Make no mistake, this is one of the greatest economic challenges in history. However, it's different from most economic reform challenges. The Soviet Union, a staggering economic underachiever, is not lacking in resources. That region is the number one owner of natural resources. Petroleum reserves rival those in the Persian Gulf. It has terrific technological resources; it is third in the world's stock of scientists and engineering. The USSR has devoted as many resources to research and development as has the U.S. or Japan. What ultimately led to the current collapse — the fall of output to the present level — was that incentives were spectacularly misaligned for such a long time. However, I'm cautiously optimistic, and not because I think things could turn even worse. There are tangible signs of progress already: diminishing shortages, an increase of quality of services. If reformers are able to persevere, people for the first time in generations will be able look forward to a brighter future.

*Q: Those who addressed the colloquium, characterized almost in one voice the past autocratic rule of Russia and the Soviet Union as a legacy, a burden, that could determine the future shape of both the "interrepublican" and foreign policy of the successor states. Isn't Japan's post-1945 history a graphic example of how the political framework of a society can radically change, despite adverse traditions?*

A: I think it is difficult for nations to change; prosperity and enlightened external response help though. The contrast in the allies' treatment of Germany after World War I and after World War II had very different consequences. It is full of meaning for Western policy today.

*Q: In your interpretation, what was the message of the discussion on foreign aid to Russia and other states?*

A: I was struck by the consensus of the people — coming from a variety of perspectives: economic, political, conservative, and liberal — in favor of Western engagement, not just standing back. In Russia and the other successor states of the ex-USSR, stabilization, humanitarian aid, and an increase in imports are essential. Therefore, conditional money from the West is urgently required — at a time when Russian imports have fallen by half. Any incentive arrangements, no matter how wonderful, would have limited impact without spare parts furnished from abroad.

Conditionality is important as well: over the years, huge credits have been dumped into the Soviet system without measurable impact. Movements toward a market and movements to create the macroeconomic underpinning for a stable currency are essential. Aid diversion and corruption are more the consequences of distorted prices and perverse incentives than of lying bureaucrats. It is absolutely essential that in the name of targeted aid we do not resurrect socialism.



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# Metamorphosis of the Century: From USSR to CIS

Eleven former Soviet republics — Armenia, Azerbaijan, Belarus, Kazakhstan, Kirgizia, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan — signed protocols on December 22 in Alma-Ata, forming the Commonwealth of Independent States and putting an end to the USSR. A conference of heads of state and government would become the main political institution of the commonwealth, with the chairmanship rotating among the members. Committees have been established to coordinate foreign affairs, defense, economics, transport, and social security. The agreements failed to address economic questions, however. The economic pact recently signed in Minsk by the original *troika* of the CIS — Russia, Belarus and Ukraine — has not been sanctioned yet by the other states. For the record, the text of the Minsk economic pact is as follows:

- to carry out coordinated, radical reforms aimed at creating feasible market mechanisms, transforming property, and ensuring the freedom of entrepreneurship;
- to abstain from any actions economically harmful to one another;
- to develop economic relations and mutual accounts on the basis of the existing currency unit, the ruble;
- to introduce national currencies on the basis of special agreements that will guarantee the preservation of the economic interest of the parties;
- to sign an interbank agreement aimed at curbing monetary emission, providing for effective control of the money supply, and setting up a common accounting system;
- to coordinate policies for reducing the republics' budgetary deficit;
- to coordinate policies for price liberalization and social protection;
- to undertake joint efforts to provide a single economic space;
- to coordinate external economic activities and customs policies, and to provide free transit of goods;
- to regulate by special agreement the question of the debt of the former USSR state enterprises;
- to coordinate the amounts and procedures for financing defense spending for 1992 and for cleaning up the results of the Chernobyl nuclear disaster;
- to ask the Supreme Soviets of the republics to take into account the necessity of coordinating sales taxes while forming tax policy;
- to create joint stock companies;
- to work out a mechanism for implementation of the inter-republic economic agreements.

As a reaction to Russia's move to liberalize prices in early January, 1992, Ukraine has decided to introduce coupons, gradually replacing the ruble, and to free prices partially on January 15. Belarus will free prices for some consumer goods and public services as of January 3. Uzbekistan, according to its president, will not copy Russia's economic reforms and will try to protect its population before freeing prices. Moldova will introduce some price liberalization and a parallel wage indexation on January 2. Moldova's national currency will be introduced beginning in July 1992.

The main elements of Yeltsin's shock therapy-reform program are the following (comments by Oxford Analytica, the London-based research group, appear in brackets):

- *Price liberalization.* With continued controls on the prices of coal, oil, natural gas, bread, milk, salt, baby food, municipal transport, medicines, *inter alia*, up to 70 percent of consumer prices would be freed. [Some compensatory increases in fixed incomes, ahead of the price liberalization, have been announced, along with a minimum monthly wage of 200 rubles, although the degree of income indexation is unknown.]
- *Tax reform.* There would be a shift away from profit taxes to value-added taxes, and a reduction of retail price subsidies and subsidies for enterprises, with the aim of a balanced budget in 1992. [Economic experts have doubts about the feasibility of this goal, especially since, on the expenditure side, an increase in pensions and other low incomes are also promised. Nor is it clear that the Russian central bank is ready and able to impose strict monetary discipline. Effective regulation of commercial banks is still largely lacking.]
- *Rapid privatization.* Yeltsin has suggested privatizing 50 percent of all small and medium-sized enterprises in three months. [However, experience in Eastern Europe suggests that even small-scale privatization cannot be carried through in a matter of months. Meanwhile, the Russian parliament continues to block early introduction of a market for land and, thus, of full private ownership.]
- *Removal of quantitative controls (import and export quotas) and most import/export taxes.* There would be continued import and export licensing, while allowing and encouraging a ruble market for licenses. [As a transparent and accountable alternative to bribes, a market in trade licenses would make sense. But the scope of the remaining controls and the scale of the quantities to be licensed are so far unknown.]
- *Greater freedom in currency conversion.* Foreign firms would be able to invest freely in rubles, including rubles bought at market rates for hard currency. [This would be akin to Poland's move to internal convertibility of the zloty. However, it is doubtful whether budgetary and monetary policy will be strong enough to enable a market exchange rate for the ruble to be sustained at its initial level, or even close to it.]

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FOREIGN POLICY BRIEFING

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# CURRENCY CONVERTIBILITY: A SELF-HELP BLUEPRINT FOR THE COMMONWEALTH OF INDEPENDENT STATES

by Steve H. Hanke and Kurt Schuler

The nations of the Commonwealth of Independent States are gathering in Washington on January 22 and 23, 1992. The U.S. Department of State has called the conference to organize aid for the new nations. Even though the State Department has indicated that the conference will be restricted to discussions about so-called humanitarian aid and self-help programs, it may be politically difficult for Secretary of State James A. Baker III to hold off the foreign aid lobby. Led by Professor Jeffrey Sachs of Harvard University, the aid lobby is in full swing. Sachs claims that the transition from socialism to capitalism in the member states of the CIS will be impossible without significant amounts of foreign aid.[1]

In making his case to limit the scope of the conference, Baker should recall that Sachs and the aid lobby are employing smoke and mirrors, rather than economic analysis, to make their case. The most notable examples of successful transformations from socialism to capitalism are Chile and China's Guangdong province, which is located directly north of Hong Kong. In neither case was aid required.[2] In contrast, the two recipients of the most U.S. largesse, Israel and Egypt, have been unable to transform their largely socialist economies.[3] Foreign aid is not necessary for eco-

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nomic transformation, and the evidence strongly suggests that it is an impediment.

If the West is serious about helping the people of the CIS to help themselves, it should give top priority to seeing that those nations have sound, convertible currencies. As long as they continue to use the inconvertible ruble, or the inconvertible successor currencies now in the works, they will be unable to have true free-market economies. Without free-market economies, they will be unable to produce rapid economic growth.[4]

A sound currency serves as a satisfactory store of value, a medium of exchange, and a unit of account. An unsound currency, such as the ruble, does not serve any of those functions. An unsound currency is not a reliable store of value because inflation makes its value highly unpredictable. As a result, people save by hoarding bricks, timbers, food, and other commodities, which retain value better than money and other financial assets. Although commodity hoarding is rational for people in the CIS at present, it slows economic growth. In addition to hoarding commodities, people in the CIS also use U.S. dollars and German marks as substitute stores of value because the ruble is unsound. Indeed, "dollarization" is significant and accelerating. The Federal Reserve estimates that $10 billion to $15 billion in greenbacks leaked out of the United States last year; most of that money ended up in Eastern Europe and the CIS. Large amounts of German marks have also flowed to Eastern Europe and the CIS.[5] The use of dollar or mark currency is costly. It requires people in the CIS to give up real goods and services to obtain bits of paper that the U.S. and German governments print at almost no cost, generating a perverse form of foreign aid that flows from the CIS to the United States and Germany.

An unsound currency is not a good medium of exchange. The outside world refuses to accept it. That impedes Western investment, which could jump-start the economies of the CIS. Inconvertible currencies also impede foreign trade, which is needed to provide competition for the inefficient monopoly enterprises in the CIS. Even trade within the CIS and the Baltic states is collapsing because the ruble is such a poor medium of exchange. For example, there are reports of urban food shortages because farmers refuse to accept city dwellers' rubles.[6] The purported food shortages do not result from lack of food supplies but from lack of a sound currency.

An unsound currency is not a good unit of account. Inflation distorts prices and makes business calculations

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difficult. Without a reliable unit of account, it is impossible to make meaningful accounting calculations or to write contracts. Even with a reliable unit of account, the CIS will have serious problems training people to perform elementary bookkeeping and accounting according to Western standards. (To give an idea of the magnitude of the task, in Yugoslavia there are 27 accountants trained to Western standards, whereas the economy needs about 6,000.)[7] The additional accounting complications that inflation causes will destroy any possibility of accurately keeping the accounts required in a smooth-running market economy.

In sum, an unsound currency prevents important elements of a market economy from working. If the CIS nations cannot establish sound currencies quickly, the repercussions will be severe both at home and in Western Europe. Inconvertibility will prevent competitive markets from functioning and foreign money from being invested, which would raise living standards. Consequently, hundreds of thousands or perhaps millions of workers in the CIS will emigrate to Western Europe in search of better conditions, thereby aggravating West European unemployment and increasing support for xenophobic political parties.[8]

## Central Banks Will Not Deliver Sound Currencies

Governments in the CIS and the West are pinning their hopes for establishing convertibility on the central banks that have sprung up to replace the USSR State Bank (Gosbank). The Bank of England[9] and the Bank of France are training aspiring central bankers from the CIS and the rest of Eastern Europe. However, Paul Volcker, former chairman of the Federal Reserve, has voiced skepticism about central banks in Eastern Europe.[10] We share his skepticism. There is no reason to expect that the new central banks will be any more successful than the Gosbank was. The Gosbank's legacy is decades of inconvertibility and recent skyrocketing inflation.

Central banking's record in the USSR was in line with the overall record of central banks in socialist countries and the Third World. In the 99 nations that the World Bank classifies as low and middle income, average annual inflation was 16.7 percent from 1965 to 1980 and 53.7 percent from 1980 to 1989.[11]

To establish sound currencies, the new central banks in the CIS must establish credibility. However, that will be a difficult task because years of communist rule have created mistrust at all levels of society. No one believes anyone, particularly not government officials. It is not surprising, therefore, that many people have already conducted their own unofficial monetary reform by substituting Western currencies for the ruble.

In the unlikely event that the new central banks establish and maintain currency stability by adopting fixed rates of exchange with Western currencies, the consequences could be devastating. Because the new central banks lack credibility, people will remain skeptical of them for years. To gain credibility, the central banks must keep real (inflation-adjusted) interest rates high and their currencies overvalued. That will plunge their countries further into depression.

One alternative to a central bank's maintaining a fixed exchange rate is a floating exchange rate. Although a floating exchange rate balances supply and demand for domestic currency against foreign currency, it does not restrain the central bank's power to create credit. Instead, it likely to lead to South American-style hyperinflation. A floating exchange rate does nothing to plug the "soft budget constraint" of government ministries and enterprises. With floating rates, political pressure in the CIS will force central banks to finance "soft budgets."

## An Alternative to Central Banks: Currency Boards

To solve the problem of credibility, the nations of the CIS must replace their central banks. We propose that they do so by establishing currency boards, such as now exist in Hong Kong and (in modified form) Singapore.

A currency board is an institution that issues notes and coins convertible into a foreign "reserve" asset at a fixed rate and on demand. A currency board does not accept deposits. A currency board's reserve asset can be a currency such as the U.S. dollar, the German mark, or the European Currency Unit (ecu) or a commodity such as gold. A currency board's reserves consist of high-quality, interest-bearing securities denominated in the reserve asset.

Reserves are set by law at 100 percent or slightly more of a currency board's notes and coins in circulation. (It is important to note that commercial banks in a currency board system do not hold 100 percent foreign assets against their deposits.) The currency board generates profits (seigniorage) from the difference between the interest earned on the securities that it holds and the expense of maintaining its notes and coins in circulation. It remits

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to the government all profits beyond what it needs to cover its expenses and to maintain its reserves at the level set by law.

By design, a currency board has no discretionary powers. Its monetary policy is completely automatic; it can only exchange its notes and coins for the reserve asset at a fixed rate. Its policy of keeping 100 percent reserves in reserve currency assets ensures that it will always be able to meet demands to exchange its notes and coins for reserve currency. Many currency boards have also held an additional reserve of up to 10 percent to provide against potential losses in the value of the bonds they have held. Because it has no discretionary powers, a currency board cannot act as a tool of inflationary government finance, nor can it offer enterprises a soft budget constraint. The fixed rate of exchange with the reserve asset ensures that if the reserve asset is, say, the German mark, interest rates and inflation in the currency board country will be about the same as in Germany.

## What a Currency Board Is Not

A number of prominent economists have recently voiced support for currency boards in Eastern Europe. Among them are Milton Friedman, Sir Alan Walters (former personal economic adviser to Mrs. Thatcher), and Robert Hetzel of the Federal Reserve Bank of Richmond.[12] However, the currency board system is not yet well known to most economists or the general public. Some monetary systems that in fact are not currency boards have been called currency boards.

A currency board is not a central bank. A central bank that maintains a fixed exchange rate is not a currency board because it lacks the 100 percent foreign asset reserve requirement and because its promise to maintain a fixed exchange rate is not legally binding. Argentina's present monetary system maintains a one-to-one rate of exchange between the peso and the U.S. dollar and requires the central bank to hold at least 80 percent of its assets in dollars. Nevertheless, it is not a currency board system because the government can alter the exchange rate whenever it wishes, and judging from Argentina's monetary history, it will probably do so soon. The central banks that issue the CFA franc in former French African colonies are not currency boards either. Their currencies require French franc reserves of only 25 percent, and on occasion they have gone below that ratio, resulting in bailouts at French taxpayers' expense.

A currency board does not act as a lender of last resort to commercial banks. The currency board system seeks to ensure that the banking system remains solvent by allowing unrestricted branch banking, at home and abroad, and by promoting access to foreign financial markets by means of currency convertibility. The government may act as a lender of last resort by providing deposit insurance, but most currency board countries have not done so. Even so, they have experienced extremely few bank failures. In fact, lack of deposit insurance seems to have made banks in currency board countries more prudent than U.S. banks, which results in more stable financial systems.

## Record and Benefits of Currency Boards

Currency boards exist today most notably in Hong Kong and (in modified form) Singapore. In the past currency boards existed in many nations, including Argentina, the Philippines, Danzig (now the Polish city of Gdansk), and North Russia. The region around Archangel and Murmansk had a currency board in 1918 and 1919, during the life of an anti-Bolshevik government in the region. The board was the idea of John Maynard Keynes. It issued a very successful, stable currency redeemable in pounds sterling. Its currency circulated parallel to the inconvertible, unstable currencies issued by other Russian governments and drove those currencies out of circulation because it was preferred by the inhabitants of the region.[13]

Currency board systems had excellent records. No currency board ever failed to maintain convertibility at the fixed rate of exchange with its reserve asset. Currency boards in North Russia and Burma even managed to maintain fixed rates during civil wars. Most countries enjoyed remarkable economic growth under currency boards. In Singapore average annual growth in real gross domestic product per person was 7.0 percent from 1965 to 1989, and in Hong Kong it was 6.3 percent. Moreover, Hong Kong and Singapore maintained relatively low inflation rates.

## Steps to Establish a Currency Board

The steps for establishing a currency board are simple. We have discussed the details elsewhere,[14] so we shall just sketch the outline here. We assume that the currency issued by the currency board circulates in parallel with the ruble. It seems hopeless to expect to reform the ruble itself, since it is close to utter collapse and CIS members other than Russia have already announced that they intend to issue new currencies.[15] The necessary steps follow.

1. Fix an exchange rate with the reserve asset and issue currency equal to the currency board's reserves. The exchange rate merely determines the units in which the new currency is denominated. It does <u>not</u> have any other effect. The new currency and the ruble will circulate in parallel, at floating exchange rates. It will be up to individuals to decide if they want to continue to use the ruble or switch to the new currency. Presumably, the new currency will eventually drive the ruble out of circulation because the new currency will be more stable, but the pace of change will be determined by the market. People will be able to exchange the two currencies at floating market exchange rates because the next step in the reform, which is simultaneous with the first step, is to

2. Remove all foreign exchange restrictions.

3. Distribute the new currency according to some formula. The new currency could be given to people on a per person or per household basis. Once it has been distributed, people will start depositing it in banks and using it in payments, so there will be a dual system of bank accounts and prices in rubles and in the new currency, with freedom to switch from one currency to the other at market exchange rates. The government may require payment of taxes in the new currency, but it should allow private transactions to occur in whatever currency is agreeable to the parties involved. If the government wishes to switch its own payments and revenues into the new currency, it should make the conversion using the floating exchange rate. For instance, if the new currency--call it the "stabilus"--has a fixed exchange rate equal to 1 German mark and 1 mark trades at a floating exchange rate of 100 rubles on the day that the government makes the conversion, all payments of 100 rubles become payments of 1 stabilus.

It should be possible to establish new currency boards very quickly. Keynes's North Russian currency board opened 11 weeks after it was first proposed, under conditions even more difficult than those the CIS faces today. Most of the delay was due to the fact that the notes had to be printed in England and shipped to North Russia.

Establishing currency boards would not require enormous foreign reserves. To introduce the new currency, for example, the CIS governments could distribute the equivalent of

$15 to each citizen. Although $15 does not appear to be much at first glance, it exceeds a month's wages for the average worker at present market exchange rates. Since there are about 275 million persons in the CIS, the total amount needed to provide 100 percent reserves for new currency boards would be just $4.1 billion. Past currency reforms (such as the German reform of 1948) were able to restart economic activity by using similarly small amounts of new, sound money.

With the rather small amounts of foreign reserves required to establish currency boards, the CIS governments could successfully start currency boards and issue sound, convertible currencies without a dime of Western aid. The CIS governments have some foreign reserves, though the precise amount is hard to determine. The outlawed Communist party may also have several billion dollars stashed in banks abroad.[16] Those funds rightly belong to the people of the CIS, from whom they were extracted. What better way to use those funds than as currency board reserves, which would be distributed "free" as new currency board notes to the citizens of the CIS? If the CIS governments wish to distribute even more new currency board notes initially, they have plenty of state property that they could sell to raise further hard-currency reserves.

It may seem that a currency board system would need to run continual balance-of-payments surpluses to enable the real value of its domestic money supply to grow. However, as the experience of Hong Kong and Singapore shows, surpluses are not necessary. Hong Kong and Singapore have run balance-of-payments deficits for decades at a time yet have been able to increase their domestic money supplies rapidly and to enjoy strong economic growth. The currency board system, coupled with good investment opportunities, has encouraged massive foreign capital flows into Hong Kong and Singapore, which have financed their balance-of-payments deficits.

**Insulating Currency Boards from Political Pressure**

To perfect the restraint that the currency board system imposes on government deficit spending and on inflation, we propose that currency boards in the CIS combine several features of past currency boards.

A majority of the directors of the new currency boards should be foreign nationals, chosen by private institutions in their home countries. Important decisions should require approval of two-thirds or more of the directors. The currency boards should be incorporated and their assets should be held in a safe-haven country such as Switzerland. The boards' assets should belong to the boards themselves, not to the CIS governments. It is important to recall that the assets of the board are offset one-to-one by noteholders' claims.

The new currency boards should earn the trust of citizens of the CIS nations in open competition with foreign currencies. People should be permitted to make contracts in and to use any currency that they find mutually agreeable. That freedom is already enjoyed in many Western nations and under the currency board systems of Hong Kong and Singapore.

A major source of dissatisfaction with past currency boards was that they had no organized procedure for resetting their exchange rates if the reserve asset to which they were tied became unstable. British colonial currency boards devalued their currencies with the pound sterling in 1949, 1967, and 1972 even though devaluation raised the cost of the foreign goods that the colonies needed for economic development. To avoid such problems, a currency board could be allowed to change its reserve asset if annualized inflation, measured by a wholesale price index, fell outside some range or if the reserve asset country changed the value of its currency by more than some specified percentage against third currencies. The procedure for resetting the exchange rate should be known and definite, rather than vague and ad hoc.

The following model currency board law is based on the constitutions of past and existing currency boards.

## A Model Currency Board Law

1. The [name of country] Currency Board is hereby created. The Currency Board's purpose is to issue notes and coins and to exchange them at a fixed exchange rate as specified in paragraphs 5 and 6.

2. The Currency Board shall have its legal seat in Switzerland. The Currency Board shall hold its assets in Switzerland.

3(a) The Currency Board shall be governed by a board of five directors. Two directors, including the chairman, shall be persons chosen by the government of [name of country]. One director shall be a German national chosen by the Deutsche Bank; one director shall be an American national chosen by the Morgan Guaranty Trust; and one director shall

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be a Japanese national chosen by the Dai-Ichi Kangyo Bank.

(b) A quorum shall consist of four members of the board of directors, including the two chosen by the government of [name of country]. The board of directors may meet at the board's legal seat and such other locations as they may designate. Decisions shall be by majority vote, except as specified in paragraph 14.

(c) The first chairman and the first other member of the board of directors chosen by the government of [name of country] shall serve terms of five years and one year, respectively. The first German national shall serve a term of two years. The first American national shall serve a term of three years. The first Japanese national shall serve a term of four years. Later members of the board of directors shall serve terms of five years. Directors may not be re-elected. Should a director resign or die, the appropriate organization as specified in paragraph 3(a) shall choose a successor to fill the remainder of the term.

4. The board of directors shall have the power to hire and dismiss the Currency Board's staff and to fix salaries for itself and the staff.

5. The asset with which the fixed exchange rate is maintained is hereafter called the reserve asset. Initially, the reserve asset shall be the [German mark, for instance] and the fixed exchange rate shall be [1 mark = 1 stabilus, for instance].

6. The Currency Board may set a minimum size for transactions, not to exceed 100,000 units of the reserve asset. It may adjust the size upward in the same proportion as increases in the wholesale price index in the reserve asset. The Currency Board may not charge any commission for transactions of the minimum size or larger.

7. The Currency Board shall begin business with assets equal to at least 100 percent of its notes and coins in circulation. It shall hold those assets in investment-grade securities payable only in the reserve currency. The Currency Board shall not hold any securities issued by the national or local governments of [name of country] or of enterprises owned by those governments.

8. The Currency Board shall pay all net profits into a Surplus Fund until its unborrowed reserves equal 110 percent of its notes and coins in circulation. It shall remit all net profits beyond those necessary to maintain 110 percent reserves to the government of [name of country]. The dis-

tribution of profits shall occur annually.

9. The Currency Board's head office shall be at [name of country's capital]. The Currency Board may establish branches or appoint agents in such other cities as it sees fit.

10. The Currency Board shall publish a financial statement, attested to by the directors, quarterly or more often. The statement shall appraise the Currency Board's securities holdings at their market value.

11. The Currency Board may issue notes and coins in such denominations as it sees fit.

12. Should the change in the wholesale price index in the reserve asset fall outside the range of -5 percent to 25 percent for more than two years or -10 percent to 50 percent for more than six months, within 60 days the Currency Board must either:

(a) Devalue (if the index's change is negative) or revalue (if the index's change is positive) its currency in terms of the reserve asset by no more than the amount of the index's change over the period specified above or

(b) Choose a new reserve asset and fix the exchange rate at the rate then prevailing between that asset and the original reserve asset.

13. If the Currency Board chooses a new reserve asset, within one year all its reserve assets must be denominated in the new reserve asset.

14. The Currency Board may not be dissolved or its assets transferred to a successor organization except by unanimous vote of the board of directors.

## Notes

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14. Steve H. Hanke and Kurt Schuler, "Currency Boards for Eastern Europe," Heritage Lecture no. 355, Heritage Foundation, Washington, 1991. We have written specific proposals for parts of the former USSR in Kurt Schuler, George Selgin, and Joseph Sinkey, Jr., "Replacing the Ruble in Lithuania: Real Change versus Pseudoreform," Cato Institute Policy Analysis no. 163, October 28, 1991, and in Steve H. Hanke, Lars Jonung, and Kurt Schuler, Monetary Reform for a Free Estonia: The Currency Board System (forthcoming). See also Steve H. Hanke and Kurt Schuler, Monetary Reform and the Development of a Yugoslav Market Economy (London: Centre for Research into Communist Economies, 1991).

15. In "Currency Boards for Eastern Europe," which was written before many of the CIS members announced their intention to establish new currencies, we also discuss how a currency board could make existing rubles convertible. David Goldman, "Why a 'Currency Board' Would Be a Mistake for Russia," Polyconomics, Inc., Morristown, N.J., January 2, 1992, criticizes the idea of parallel currencies issued by currency boards, but that is not a criticism of the currency board system itself.

16. John Lloyd, "Hunt for the Missing Roubles," Financial Times, September 11, 1991.

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WORLD BANK NEWS

Volume XI, No. 2

# Governments Move Ahead with Privatizations

Formal barriers to private enterprise have been removed in all countries in Eastern and Central Europe, and new privately owned businesses are growing rapidly throughout the region, says World Bank official Alan Gelb.

Czechoslovakia, Hungary and Poland have made rapid progress and developed private sectors of considerable size, says Mr. Gelb, who heads the World Bank's Socialist Economic Reform Unit. Most of the advances have been in new service-sector firms and in privatizing small firms, such as retail outlets. Divesting larger enterprises has fallen short of initial expectations.

The area that used to be East Germany has surpassed other countries in the region in transferring ownership to private hands. A holding company, Treuhandanstalt, was established to manage privatization operations and completes over 300 larger privatization transactions each month. But East Germany's experience is a special case, with much of the success attributed to merging with a richer and more productive country.

Each country is taking a different approach to privatization, notes World Bank senior economist Branko Milanovic. "By 1989, when political reform swept through

*See* PRIVATIZATION, *page 2*

*PRIVATIZATION continued from page 1.*
countries, and in most cases at least half of the housing in major cities, mostly in the form of large apartment blocks that are often in poor condition.

Under central planning, housing was almost completely isolated from market forces. Through massive subsidies that in the past amounted to 6%-7% of the national gross domestic product, most renters in Eastern Europe have paid no more than 5% of their incomes for housing. That is considerably less than the amount needed to simply maintain their dwellings, and often less than budgets for cigarettes and alcohol.

In the past two years, as economies in the region contracted, underinvestment in the housing sector has grown more acute, and housing stock has been neglected. The transfer of housing from federal to local control this year throughout the region has also led to a management crisis in publicly-owned rental housing. Local authorities are looking for efficient ways to manage the gigantic stock of housing now under their control, and are preparing policy measures which will involve some combination of sale to private buyers and tenants, transfer to private management, and rent increases. A.I.D.'s housing program for the region is providing advice on the timing and mix of these measures.

In Poland, a small number of the best rental units have already been sold, but the bulk of the country's rental housing is still publicly-owned, and is now in the hands of over 2,000 *gminas* or municipalities. Most of the laws necessary to privatize single units are in place. But many of the rights of ownership, such as the power to raise rents, are still in national government hands. A.I.D.'s housing program is designing technical training programs to help the *gminas* develop their own working privatization programs, concentrating on the array of new responsibilities of local governments. *Gmina* officials are expected to be managers, sellers, developers, and planners of rental housing, all at the same time.

An unresolved problem is the extreme shortage of capital in the country, despite a burgeoning private sector. Many rental units require renovation before they can be sold to private buyers, but financing is nearly impossible for local authorities to obtain. The lack of a workable banking system in Poland is one of the key reasons. A.I.D. is working in conjunction with The World Bank to help Poland develop housing finance markets and systems to support housing construction and to help the housing privatization process along.

Some of the first housing units in Eastern Europe expected to be privatized with A.I.D. assistance are in Czechoslovakia, where Deputy Prime Minister Pavel Rychetsky has given housing privatization a high priority. The region's A.I.D. housing program has developed a technical assistance program involving training modules to give hands-on training for the privatization of housing management services and the units themselves. Computer-based data management systems will institutionalize the methods explained in seminars and remain behind as a permanent resource.

There is already some evidence that entrepreneurs are stepping in to fill the vacuum left by the shift to local control. When a district in Prague recently dismantled the state-owned housing management company and advertised for private service contractors, it received 24 proposals.

IMF WORKING PAPER





WP/92/9

INTERNATIONAL MONETARY FUND

European Department

# Bank Insolvency and Stabilization in Eastern Europe

Prepared by Daniel C. Hardy and Ashok Kumar Lahiri 1/

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January 1992

## Summary

The formerly socialist countries of Eastern Europe face the double challenge of implementing profound structural change and achieving macroeconomic stability. These goals may conflict insofar as the proposed reforms may jeopardize the financial sector and thereby threaten the stability of the whole economy.

Under the traditional socialist financial system, credit allocation was a by-product of the central plan, and solvency was guaranteed through (more or less explicit) subsidies and distorted prices. Although the reforming countries of Eastern Europe have made progress in dismantling this monolithic structure, they have not yet had time to develop a complete market-based financial system. More immediately, banks inherited loan portfolios have been significantly impaired by the growing insolvency of their borrowers, and their liabilities have been inflated.

In this paper, a model is developed that clarifies the role of banking in centrally planned and emerging market economies, and the nature of the problem associated with bank insolvency in these economies. In an overlapping generations model with long-term investments, the sudden withdrawal of subsidies and the liberalization of prices lead to a brief consumption surge, bank runs, and the premature liquidation of investment. The decapitalization of the economy results in a low level of output and investment for a prolonged period. Similarly, an anticipated decline in returns on existing capital, despite an increase in the return of prospective investments, leads to bank runs, erosion of the capital stock, and persistently low and fluctuating output. In either case, banks individually act in a rational manner in restricting lending and calling in loans, but the aggregate outcome is negative net investment, which perpetuates the disruption. The problem is compounded when each household tries to be the first to withdraw its deposits from the loss-making banks.

The real costs of the reform effort will be increased and perpetuated by failure to mobilize resources to cover the costs of restructuring the banking sector. If higher inflation is to be avoided, these resources can be generated in the short term only by reducing government expenditure and raising taxes, in particular by lowering subsidies to enterprises and imposing consumption taxes.

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# ›using Privatization a Priority in .stern Europe

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lected governments have
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:or, one of the most crucial
and difficult transformations will be the privatization of large amounts of publicly-owned and -managed housing.

A.I.D.'s housing program for Eastern Europe has developed a diverse array of technical assistance programs to aid privatization in Poland, Hungary, Czechoslovakia, and Bulgaria.

Policy-makers in governments in these four countries have identified privatization of state-owned rental housing and of housing management services as top priorities in the development of market-driven economies. Rental housing accounts for up to a fifth of all housing in these

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The main obstacle to large-scale privatization of housing in Czechoslovakia is not lack of capital but an appropriate legal framework, according to Petr Tajcman, a Czech consultant who works with A.I.D.-supported programs in the country through The Urban Institute, an A.I.D. contractor. A potential step in the right direction is a condominium law for Czechoslovakia, based on the U.S. model, that A.I.D. housing contractors helped Czech lawyers draft. "We hope that the bill may be approved by the government sometime in December, 1991 and considered in Parliament by early next year," reported Tajcman.

By then, technical assistance projects beginning this winter in two districts in Prague may be helping officials all over the country transfer their housing stock through a developing market. "Our message is: privatize, privatize, privatize, but do it intelligently," Tajcman said.

A.I.D.'s housing assistance efforts in Hungary have concentrated on two programs in inner city districts in Budapest. Contractors are helping Budapest District II bring some of its buildings under private management by gathering data on the district's housing stock and identifying a list of

Close-up of existing residential living units in Warsaw. Poland in desperate need of restoration and upgrading

candidate buildings to be privately managed.

A.I.D's housing program is also involved in devising privatization strategies for Budapest's inner city areas, Districts V and VIII. The technical assistance programs involve identifying initial candidates for privatization and crafting financing packages that would maximize return to the districts while remaining affordable.

A.I.D.'s newest housing assistance program in Eastern Europe is in Bulgaria. Here, many people own their housing (in Sofia, 90% of the apartment units are owner-occupied), but not the land it sits on, creating some unique problems for future housing management. The change of government this fall has brought many more members of the free-market-minded opposition into the cabinet, improving the prospects for key reforms to address some of these problems. The new minister of housing has worked closely with A.I.D. housing officials and contractors in the past.

East Europeans have considered housing their birthright for decades. It will be one of the hardest aspects of life in the region to transform; however, there is some cause for cautious optimism. Through prompt and appropriate policy action, the crushing burden of housing subsidies can be greatly reduced. The gains from greater efficiency and from privatization of some state housing should eventually provide ample resources for sensible housing allowance programs for those with no hope of being able to immediately afford housing at market prices.

*William Maggs contributed to this article.*

IMF

SURVEY

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# IMF Seminar Assesses Tax and Safety Net Issues in Eastern Europe

To raise the public's awareness of the role and the impact of technical assistance, Vito Tanzi, Director of the IMF's Fiscal Affairs Department, asked a panel of economists to distill their recent experience with fiscal reform in Eastern Europe and to identify the lessons that could be drawn from it.

The seminar, which was part of the IMF's Economic Forum series and took place at the IMF Visitors' Center on February 13, drew on the broad examination of the topic found in the recently released book, *Fiscal Policies in Economies in Transition*. The panel, however, concentrated on the IMF's experience with tax reform in Eastern Europe, noting that similar issues are now also part of the IMF's work in republics of the former Soviet Union.

*Vito Tanzi: chairing a seminar on fiscal policies in economies in transition.*

Participants Ved Gandhi, Assistant Director of the Fiscal Affairs Department; Milka Casanegra de Jantscher, Chief of the Tax Administration Division; and Ke-young Chu, Chief of the Expenditure Policy Division, reviewed, respectively, tax policy, tax administration, and social safety nets.

### Tax Policy

"Socialist tax systems are irrelevant to market economies," Gandhi observed. In a command economy, everyone receives wages from the socialized sector, and private business has few employees. Personal income taxes thus have a very peculiar base, limited to nonwage incomes. Whereas wages in the socialized sector are not taxed, wages that exceed the plan's norm are, and the enterprise pays (Please turn to page 72)

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# Seminar on Fiscal Reform in Eastern Europe

(continued from front page) the tax. Socialized tax systems also feature, Gandhi noted, a turnover tax that is, in effect, not so much a tax as a device used to mop up the difference between the price charged to consumers and the manufacturing cost.

Likewise, in command economies, Gandhi explained, tax systems rely heavily on enterprise taxes. These systems are characterized by extreme differentiation by sector, lack of concern over incentive effects, ad hoc implementation, and a depreciation system in which funds belong to the state and have little impact on investment or capital replacement decisions.

Given the state's monopoly over foreign trade, the tax system also has few trade-related taxes, which apply generally only to private sector imports; consequently, customs administration is relatively weak.

"Once economic reforms get under way," Gandhi remarked, "you must create a new tax system." When a country embarks on enterprise reform, for example, enterprises can no longer function as "milking cows for revenue." And once prices are liberalized, turnover taxes have to go.

Foreign trade reform, Gandhi observed, requires greater use of foreign trade taxes to "capture" windfalls on exports and to protect industries during the transition. As the banking sector is reformed, it will cease to supply the government with free or cheap credit, and the tax system have to generate much of the needed revenue.

Gandhi enumerated five goals for tax reform over the medium term: generation of sufficient revenue to run the government; allocative efficiency; equity; simplicity; and international compatibility with other tax systems. To these goals, Gandhi added ending discrimination against the private sector, generating sufficient resources initially to provide social protection and respond to infrastructure needs, and protecting revenue from inflation.

Gandhi was careful not to underestimate the obstacles new tax systems would face. "These countries are going to have to create a new tax administration and customs machinery. They are going to have policymakers who, by training and natural inclination, are interventionists. They don't have an appropriate accounting system or an appropriate legal framework within which enterprises, and therefore a tax system, can readily operate. Finally, of course, they must make trade-offs among efficiency, revenue needs, equity, and other goals."

To cope with these concerns, Gandhi counseled countries to observe five principles:

- Limit the goals to be achieved through the tax system. An overly ambitious or complicated set of goals is likely to accomplish nothing.
- Avoid an excessive tax-to-GNP ratio. While in most of Europe the ratio goes up to 50 percent, "in the medium term," he advised, "after the appropiate role of government has been sorted out and public expenditure needs have been established, aim at a tax ratio no higher than 30 percent." If government needs remain unmet, additional money should be raised through benefit taxes, user charges, and nontax revenues.
- Establish an appropriate mix of taxes. "For revenue," Gandhi advised, "rely more heavily on value-added tax, excise duties, and other commodity taxes, such as import and export duties, in the short term; for equity, rely on personal income and property taxes, without excessive progressivity and with reasonably high personal exemptions."
- Keep rates as low as possible. They should be consistent with growth, equity, and revenue need.
- Make taxes as broadly based as possible to reduce distortions and keep tax rates low.

Gandhi: once reform gets under way, you must create a new tax system.

### Tax Administration

Effective tax administration is the key to implementing the new laws, noted Casanegra. The stakes are high for economies in transition, she added, because ineffective enforcement quickly translates into major revenue shortfalls. "If the administration cannot enforce the taxes on the private sector, we are in big trouble, both for macroeconomic stabilization and for equity. If taxes are enforced chiefly on, let's say, wage earners, and private business doesn't pay its share, we reduce whatever equity effects were sought under the new tax system."

Casanegra found three common traits in the past tax administration experience of these economies. First, tax departments had functioned essentially



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as points of transfer for funds from one part of the economy to another; they had little experience with the customary adversarial relationship between tax departments and private business that exists in most market economies.

Second, at the central level, taxes were traditionally administered by departments responsible for performing financial and economic audits of the state-owned enterprises to determine whether they had met the objectives of the plan. Taxes were collected from such enterprises as a by-product of these audits.

Casanegra noted that "the collection of taxes at local levels from the small private sector was considered a menial task. Highfliers in the tax administration were the ones charged with seeing whether these enterprises complied with the state plan."

And, third, tax administration employed antiquated manual procedures, which, given the relatively small numbers of taxpayers, were not inappropriate but were incapable of handling the increased number of taxpayers expected under the new tax systems.

Casanegra found redeeming features as well, citing several aspects of existing systems that should be retained. First, in several countries, taxes are paid through banks or post offices. "That's good," she explained, "because if you are going to implement broad-based taxes and have a lot of taxpayers, you don't now want, with limited resources, to act as a cashier."

"Another good feature," she said, "was that whatever taxes they had on individuals, they were quite adept at withholding them. That element can be retained. We don't want to flood these countries with large- scale filings and the processing of refunds."

"Finally, we have found that many countries had very good staffs—very highly educated, very able with computers, once they were given computers—and very dedicated. The problem is that they have lacked appropriate direction until now."

What strategy would the IMF propose for economies in transition seeking to develop a reasonably effective tax administration? Casanegra cited a two-pronged approach, which would begin with the design and implementation of a simple tax system.

"By simple," she said, "we mean a system that will reduce unproductive tasks and filing requirements. I'm afraid that the pure concept of a global income tax cannot be adopted in the first stage. We have to go with an income tax that allows withholding to be final on wages, interest, and dividend. On the VAT [value-added tax], we would want one or at most two rates, a broad base, and few exemptions. We are stressing simplicity not for its own sake but because only a simple tax system can actually be implemented."

The second element in the strategy, she noted, was actually to set up a tax department "unmixed with notions of financial controls of the state-owned enterprises and controls of subsidies." This will have to mean, she said, that tax administration must no longer be looked upon as a menial task.

### Social Safety Nets

The discussants agreed that designing effective and efficient social safety nets is an important prerequisite to reform. Chu examined the broad public expenditure issues that economies in transition must grapple with, especially the role of the state and of price controls. Transition economies must tailor the traditionally dominant role of the state to suit a market-oriented environment. They must also reform the pricing system, which is a source of distortion, allocative inefficiency, and large budgetary and implicit subsidies.

Chu pointed out that fiscal adjustment involves changes in relative prices and in employment opportunities. An increase in the prices of foodstuffs and other essential commodities is particularly burdensome for pensioners and other low-income groups. Financial discipline for state enterprises and the conversion of military industries increase transitory unemployment. Thus, the state needs to protect these vulnerable groups. Chu noted that limited commodity subsidies could be combined with cash transfer schemes for the elderly, handicapped, and unemployed.

Focusing on the widespread commodity subsidies in transition economies, Chu stressed that although these subsidies should be phased out, it may not be feasible to dismantle them overnight. While targeting subsidies to the poor would be ideal, refined targeting through means testing is often not feasible, particularly during the transition when income and prices fluctuate rapidly, private sector activities emerge, and the administrative capacity to monitor household income is limited. In this situation, transitory subsidies for a limited number of essential goods could provide equal benefits to the whole population or to well-defined groups. Such a scheme

***Casanegra: without effective taxation of the private sector we are in big trouble.***

*Chu: social safety nets raise issues of administrative feasibility and of cost.*

could limit subsidized consumption to the actual consumption level of the poorest. Such a system would be more equitable, Chu explained, than current generalized subsidies, which tend to benefit the nonpoor more than the poor. These subsidies could be designed to coexist with liberalized markets, he suggested, and the nonpoor could buy additional needed goods at market prices.

Chu pointed out that the implementation of social safety nets raises issues of administrative feasibility and of cost. While quantity coupons and food stamps are possible transitory vehicles, the administrative feasibility of using them must be assessed. He also stressed the possibility of targeting certain goods for urban residents who would be particularly hard hit by food price increases, and of targeting subsidies on certain products, such as milk, at the most vulnerable and needy segments of society (for instance, children and lactating mothers).

*Fiscal Policies in Economies in Transition*, which was edited by Vito Tanzi, contains 16 papers written specifically for this book. Copies, which are US$24.50, can be obtained from Publication Services, Box S-344, International Monetary Fund, Washington, D.C. 20431, U.S.A.

## SELECTED TOPICS

# IMF Seminar Participants Examine Bulgaria's Economic Reforms

Ognian Pishev, Bulgaria's Ambassador to the United States, and Lubomir Christov, Chief Economist of the Bulgarian National Bank, offered a frank and detailed examination of the nature and scope of Bulgaria's economic transition in a March 11 Economic Forum seminar held at the IMF Visitors' Center. The discussion, which was chaired by Anoop Singh, an Assistant Director in the IMF's European I Department, provided Pishev with the opportunity to detail the chronology of Bulgaria's reform efforts and outline its long-term goals, while Christov concentrated on the issues, pace, and direction of Bulgaria's stabilization program.

*Pishev: the fate of Bulgaria's reforms depended on its success in transforming itself into a market economy.*

### Background

Pishev, who helped fashion Bulgaria's new economic program, reviewed the steps leading to, and the policy discussions underlying, the country's economic reform process. Recalling the "intensive economic debate" that stirred the country in late 1989 and early 1990, Pishev identified several early and important themes in that debate, including an awareness that the fate of Bulgaria's reforms depended on its success in transforming itself into a market economy and that a potential link existed between stabilization and the transformation of the economy.

"The initial reaction of the then ruling Communist party was to fight the economic crisis and then think about changing the economy," Pishev observed. "But the democratic economists believed that stabilization should be the first step of economic transition. One of the major accomplishments of the last few years was that we did not remain at the *perestroika* phase, but moved resolutely to stabilization as a significant change in the economy."

Efforts to achieve a national consensus preoccupied these early discussions, he noted. But bipartisan cooperation ended when the Communist-led Government published a jointly drafted reform document as its own. "All of a sudden, we discovered we could not think of the economy in neutral technical terms," he said. "It became obvious that political factors would always prevail over rational economic thinking."

By June 1990, the seemingly stark choice between shock therapy and a gradual approach to economic reform had become a major theme in the country's first election. But Pishev, and many of Bulgaria's reformers, rejected this choice, arguing that it simply created a false dilemma. Both methods could, and should, be pursued, he said. "Obviously when we talk about qualitative changes in the character of the economic system," he noted, "some elements can be introduced only gradually. We cannot, for example, create a new entrepreneurial class overnight. On the other hand, there are elements that should be introduced immediately."

By the fall of 1990, however, it was clear that the country's economy was in serious difficulty. Living standards had fallen dramatically, and domestic supplies and foreign currency reserves had been exhausted—the latter in a vain effort to meet debt obligations and attract new capital flows. What Pishev termed "the deepest forms of social unrest" brought down the last Communist-dominated Government and prompted a broad and serious discussion of market-based reforms. By February 1991, all the essential elements of the reforms had been introduced. For a country like Bulgaria, Pishev said, "price liberalization was extremely important if we wanted to achieve some form of balance between supply and demand, given the existing level of inventories and demand in the economy." It had also become clear to the reformers, he added, that introducing a market-based exchange rate was the only means of compensating for a lack of external financial support for Bulgaria, and opening the economy was the major instrument of restructuring the national economy.

**Stabilization Program**

To prevent a "total collapse of the Bulgarian economy and society," Christov said, the Government launched a stabilization program backed by a one-year stand-by arrangement with the IMF. The broad aims of the program were similar to those of other Eastern European countries: a restoration of macroeconomic stability and the beginning of comprehensive structural reforms.

"What distinguishes the Bulgarian case," Christov observed, "is the extent of the initial price shock and the drop in output associated with the first steps of reform." The cost, in terms of lost GDP and employment, proved significantly greater than anyone had anticipated and was, in fact, greater than that experienced by other Eastern European countries. Bulgaria's 308 percent increase in the consumer price index, recorded in February–March 1991, has been exceeded only by the former Soviet Union's recent experience. Bulgaria also recorded a 23 percent drop in its real product and saw its GDP approach 68 percent of its 1988 level.

How could this performance be explained? Christov cited three factors: large internal imbalances, several external shocks that coincided with the beginning of the reform process, and shortfalls and delays in foreign financing. Internally, the country was coping with shortages of energy, raw materials, and consumer goods, and an enormous monetary overhang. "The whole Bulgarian population could have stopped working," Christov said, attempting to give tangible dimension to the overhang, "and preserved the level of their consumption for a whole year, relying only on savings."

The external shocks were multiple and severe. Intra-CMEA trade collapsed, and the Middle East crisis disrupted Bulgaria's trade with the region, its second most important market. A March 1990 moratorium on the servicing of foreign debt had also effectively cut Bulgaria off from international financial markets.

The stabilization program that Bulgaria undertook sustained a number of major reforms: it completely freed prices, entailing a sharp drop in subsidies; liberalized the trade regime; and took several decisive steps toward the reform of the banking and tax systems. Major issues still to be addressed, Christov said, were large-scale privatization and the remainder of the banking reforms.

*Lubomir Christov: Bulgaria's economic reform efforts "must be gauged by what could have happened, but did not."*

Was the 1991 stabilization program effective? Christov first responded with an anecdote. "One no longer has to get up at 4 or 5 a.m.," he said, "to line up for bread and milk. Items that in the past might not even be available when one finally reached the counter—now are available, but at ten times higher prices."

To measure the program's real effectiveness, however, he argued that Bulgaria's economic reform efforts "must be gauged by what could have happened, but did not. And what could have happened is clear now from the experience of Poland and Russia." Achieving rapid success for an orthodox stabilization program in former socialist countries was, he said, "very difficult, if not impossible." He did note, however, that broad structural reforms are essential to achieve sustained macroeconomic balances and noninflationary growth, and consistent structural reform takes time.

Were Bulgaria's structural reforms undertaken too slowly? Timing and complementarity are often critical in a stabilization program, and some observers argued that faster structural reform in Bulgaria might have blunted the severity of the losses the country experienced in production and employment. Christov noted that the short-term orientation of the previous Government and the short-term nature of the stabilization program both worked against longer-term perspectives. The wise advice of what might have been, he argued, simply did not match Bulgaria's political reality.

Christov also expressed disappointment that the IMF and the World Bank had referred to Bulgaria's structural reforms as being delayed. He believed the evidence on hand and international comparisons both contradicted this assessment. He expressed concern that such an assessment "tends to be interpreted not as advice to accelerate reforms which is necessary and important, but as something that casts doubt on the commitment of the Bulgarian Government to economic reform. The final results might only give greater support to the Communist opposition in Bulgaria and divert the attention of the present Government away from designing and implementing necessary reforms."

Singh noted that Christov had "gently reminded us that we shouldn't be impatient." But Singh also cited the very heavy cost that Bulgaria had borne in terms of sharply reduced output and employment; he suggested



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that perhaps future costs might be mitigated by privatizing enterprises and agricultural land as rapidly as possible.

As Christov looked to the future, he noted two elements—access to industrial country markets and debt relief—that would be critical to Bulgaria's success. Labeling Bulgaria's external debt an enormous problem, he stressed the "very ridiculous structure of our debt" (80 percent owed to private commercial banks and 40 percent representing short-term debt). Rescheduling is urgently needed, he added; debt cannot be serviced from negative growth and declining exports.

*Anoop Singh: future costs might be mitigated by privatizing enterprises and agricultural land as rapidly as possible.*

Foreign assistance is needed, Christov argued, particularly at this juncture. "The country combined rapid liberalization with virtual isolation from the international financial markets and fast and peaceful democratization. Please don't ask me how. I don't know. What I know is this infeasible combination cannot last forever."

**Reintegration in World Economy**

Echoing Christov's call for both greater foreign assistance and wider access to industrial country markets, Pishev stressed the importance of reintegrating Bulgaria into the world economy. "After four decades of self-imposed isolation, Bulgaria was initially not ready to face international competition," he said. An overindustrialized country geared to the needs of the Soviet market, Bulgaria's economy was vulnerable to disruptions in energy supplies and in traditional international markets. Compounding these problems, he noted, was the fact that problems associated with Bulgaria's transition had led to additional declines in GNP, production, and living standards.

Over the past two years, Bulgaria has gained admission to the IMF and World Bank, participated in the European Bank for Reconstruction and Development, and pursued negotiations with the General Agreement on Tariffs and Trade. It has also intensified its contacts with other countries. Pishev noted that Bulgaria has been granted most-favored-nation status by the United States, concluded an agreement with the U.S. Overseas Private Investment Corporation on direct investment, and had coverage for short-term trade credits extended by the U.S. Export-Import Bank. Negotiations with other countries, particularly with Europe's major industrial countries, have not yet yielded similar results, he said, reiterating a concern that Christov had raised.

What Pishev hoped to see for Bulgaria over the long term, he said, was something akin to the successes achieved by countries like Belgium and Denmark in affecting a "seamless integration with the world economy." Regional integration held less appeal for him. "I don't believe, as some have argued, that the future of Eastern Europe lies in merging the economies of Central and East European economies into the European Community. Regional integration is the second best solution to free trade. I believe in comparative advantage. I believe in free trade."

**Photo credits**: Denio Zara and Padraic Hughes, IMF. World Bank, page 121.



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