# WASHINGTON ECONOMIC WATCH

*A Digest of Development Policy Information*

*A Project of the Overseas Development Council*

**SPRING 1993**
**AFRICA**

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WASHINGTON
ECONOMIC
WATCH

*A Digest of Development Policy Information*

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**AFRICA**

Dear Readers:

Marking our fourth year in production, The Overseas Development Council is pleased to bring you the twelfth issue of the Washington Economic Watch: A Digest of Development Policy Information, a compilation of the recent U.S. policy debate concerning the developing world. ODC wishes to thank the World Bank, the U.S. Agency for International Development, and the Morgan Guaranty Trust Company of New York for their continued interest in this project.

This issue reflects the first 100 days of the new administration, including the debate over President Clinton's economic recovery plan for the United States, testimonies for and against the North American Free Trade Agreement, discussion of Western Aid to the Former Soviet Union, and analysis and commentary on privatization in developing countries and former centrally planned economies, among other issues.

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In the coming weeks you will receive a questionnaire to assess your institution's participation in the reciprocal publications agreement. ODC appreciates your institution's cooperation in this matter. We look forward to your correspondence and hope that you find this edition of the Washington Economic Watch to be a valuable resource for your institution.

Sincerely,

Christine E. Contee

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Director of Public Affairs
& Fellow

O | D | C

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John W. Sewell, President

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# TRADE AND COMMODITIES

## TRADE


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PRESIDENTIAL ADDRESS

# Clinton Outlines Philosophy On Trade, Global Economy

*Saying America must 'reach outward,' the president offers five-step agenda to 'set a new direction for the world'*

*Following are excerpts from the text of President Clinton's address on international economics delivered at The American University in Washington, D.C., Feb. 26:*

Thirty years ago in the last year of his short but brilliant life, John [F.] Kennedy came to this university to address the paramount challenge of that time: the imperative of pursuing peace in the face of nuclear confrontation. Many Americans still believe it was the finest speech he ever delivered.

Today, I come to this same place to deliver an address about what I consider to be the great challenge of this day: the imperative of American leadership in the face of global change. Over the past year I have tried to speak at some length about what we must do to update our definition of national security and to promote it and to protect it, and to foster democracy and human rights around the world.

Today, I want to allude to those matters, but to focus on the economic leadership we must exert at home and abroad as a new global economy unfolds before our eyes.

Twice before in this century, history has asked the United States and other great powers to provide leadership for a world ravaged by war. After World War I that call went unheeded.

Britain was too weakened to lead the world to reconstruction. The United States was too unwilling. The great powers together turned inward as violent, totalitarian power emerged. We raised trade barriers. We sought to humiliate rather than rehabilitate the vanquished. And the result was instability, inflation, then depression, and ultimately a second world war.

After the second war we refused to let history repeat itself. Led by a great American president, Harry [S] Truman, a man of very common roots but uncommon vision, we drew together, with other Western powers, to reshape a new era.

We established NATO to oppose the aggression of communism. We rebuilt the American economy with investments like the GI Bill and a national highway system. We carried out the Marshall Plan to rebuild war-ravaged nations abroad. Gen. [L. Douglas] MacArthur's vision prevailed in Japan, which built a massive economy and a remarkable democracy. We built new institutions to foster peace and prosperity — the United Nations, the International Monetary Fund, the World Bank, the General Agreement on Tariffs and Trade [GATT], and more. These actions helped to usher in four decades of robust economic growth and collective security. Yet the Cold War was a draining time. We devoted trillions of dollars to it, much more than many of our more visionary leaders thought we should have.

We posted our sons and daughters around the world. We lost tens of thousands of them in the defense of freedom and in the pursuit of a containment of communism.

We, my generation, grew up going to school assemblies learning about what we would do in the event a nuclear war broke out. We were taught to practice ducking under our desks and praying that somehow they might shield us from nuclear radiation. We all learned about whether we needed a bomb shelter in our neighborhood to which we could run in the event that the two great superpowers rained nuclear weapons on one another.

And that fate, frankly, seemed still frighteningly possible just months before President Kennedy came here to speak in 1963.

## The Post-Cold War Era

Now, thanks to his leadership and that of every American president since the second world war, from Harry [S] Truman to George Bush, the Cold War is over.

The Soviet Union itself has disintegrated. The nuclear shadow is receding in the face of the START I and START II agreements and others that we have made and others yet to come. Democracy is on the march everywhere in the world. It is a new day and a great moment for America.

Yet across America, I hear people raising central questions about our place and our prospects in this new world we have done so much to make. They ask will we and our children really have good jobs, first-class opportunities, world-class education, quality, affordable health care, safe streets.

After having fully defended freedom's ramparts, they want to know if we will share in freedom's bounty. . . .

Washington can no longer remain caught in the death grip of gridlock, governed by an outmoded ideology that says change is to be resisted, the status quo is to be preserved. Like King Canute ordering the tide to recede, we cannot do that.

And so, my fellow Americans, I submit to you that we stand at the third great moment of decision in the 20th century. Will we repeat the mistakes of the 1920s and the 1930s by turning inward? Or will we repeat the successes of the 1940s and the 1950s by reaching outward and improving ourselves as well?

I say that if we set a new direction at home, we can set a new direction for the world as well.

The change confronting us in the 1990s is, in some ways, more difficult than previous times, because it is less distinct. It is more complex and, in some ways, the path is less clear to most of our people still today, even after 20 years of declining relative productivity and a decade or more of stagnant wages and greater effort.

## Still a Dangerous World

The world clearly remains a dangerous place. Ethnic hatreds, religious strife, the proliferation of weapons of mass destruction, the violation of human rights flagrantly in altogether too many places around the world, still call on us to have a sense of national security in which our national defense is an integral part. And the world still calls on us to promote democracy, for even though democracy is on the march in many places in the world, you and I know that it has been thwarted in many places, too.

And yet we still face, overarching everything else, this amorphous but profound challenge in the way humankind conducts its commerce. We cannot let these changes in the global economy carry us passively toward a future of insecurity and instability. For change is the law of life. Whether you like it or not, the world will change much more rapidly in your lifetime than it has in mine.

It is absolutely astonishing the speed with which the sheer volume of knowledge in the world is doubling every few years. And the critical issue before us, and especially before the young people here in this audience, is whether you will grow up in a world where change is your friend or your enemy.

We must challenge the changes now engulfing our world toward America's enduring objectives of peace and prosperity, of democracy and human dignity, and we



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must work to do it at home and abroad.

It is important to understand the monumental scope of these changes. When I was growing up, business was mostly a local affair. Most farms and firms were owned locally. They borrowed locally. They hired locally. They shipped most of their products to neighboring communities or states within the United States.

It was the same for the country as a whole. By and large we had a domestic economy.

### A World Interwoven

But now we are woven inextricably into the fabric of a global economy. Imports and exports, which accounted for about one in 10 dollars when I was growing up, now represent one dollar in every five. Nearly three-quarters of the things that we make in America are subject to competition at home or abroad from foreign producers and foreign providers of services.

Whether we see it or not, our daily lives are touched everywhere by the flows of commerce that cross national borders as inextricably as the weather. Capital clearly has become global.

Some $3 trillion of capital race around the world every day. And when a firm wants to build a new factory, it can turn to financial markets, now open 24 hours a day, from London to Tokyo, from New York to Singapore. Products have clearly become more global. Now if you buy an American car, it may be an American car built with some parts from Taiwan, designed by Germans, sold with British-made advertisements, or a combination of others in a different mix. Services have become global. The accounting firm that keeps the books for a small business in Wichita may also be helping new entrepreneurs in Warsaw. And the same fast-food restaurant that your family goes to — or at least that I go to — also may well be serving families from Manila to Moscow, and managing its business globally with information, technologies and satellites.

And most important of all, information has become global and has become king of the global economy. In earlier history wealth was measured in land, in gold, in oil, in machines. Today the principal measure of our wealth is information: its quality, its quantity, and the speed with which we acquire it and adapt to it.

We need more than anything else to measure our wealth and our potential by what we know and what we can learn and what we can do with it. The value and volume of information has soared, the half-life of new ideas has trumped. Just a few days ago I was out in Silicon Valley at a remarkable company called Silicon Graphics [Inc.] that has expanded exponentially, partly by developing computer software with a life of 12 to 18 months, knowing that it will be obsolete after that, and always being ready with a new product to replace it.

We are in a constant race toward innovation that will not end in the lifetime of anyone in this room. What all this means is that the best investment we can make today is in the one resource firmly rooted in our own borders — that is, in the education, the skills, the reasoning capacity and the creativity of our own people.

For all the adventure and opportunity in this global economy, an American cannot approach it without mixed feelings. We still sometimes wish wistfully that everything we really want, particularly those things that produce good wages, could be made in America. We recall simpler times when one product line would be made to endure and last for years. We're angry when we see jobs and factories moving overseas or across the borders, or depressing wages here at home when we think there is nothing we can do about it.

We worry about our own prosperity being so dependent on events and forces beyond our shores. Could it be that the world's most powerful nation has also given up a significant measure of its sovereignty and the quest to lift the fortunes of people throughout the world?

It is ironic and even painful that the global village we have worked so hard to create has done so much to be the source of higher unemployment and lower wages for some of our people.

But that is no wonder. For years, our leaders have failed to take the steps that would harness the global economy to the benefit of all of our people. Steps such as investing in our people and their skills, enforcing our trade laws, helping communities hurt by change — in short, putting the American people first without withdrawing from the world and people beyond our borders.

The truth of our age is this, and must be this: open and competitive commerce will enrich us as a nation. It spurs us to innovate. It forces us to compete, it connects us with new customers. It promotes global growth without which no rich country can hope to grow wealthy. It enables our producers, who are themselves consumers of services and raw materials, to prosper. And so I say to you in the face of all the pressures to do the reverse, we must compete, not retreat.

### Importance of Exports

Our exports are especially important to us. As bad as the recent recession was, it would have gone on for twice as long had it not been for what we were able to sell to other nations. Every billion dollars of our exports creates nearly 20,000 jobs here, and we now have over 7 million export-related jobs in America.

They tend to involve better work and better pay. Most are in manufacturing, and, on average, they pay almost $3,500 more per year than the average American job. They are exactly the kind of jobs we need for a new generation of Americans.

American jobs and prosperity are reason enough for us to be working at mastering the essentials of the global economy, but far more is at stake. For this new fabric of commerce will also shape global prosperity or the lack of it, and with it, the prospects of people around the world for democracy, freedom and peace.

We must remember that even with all our problems today, the United States is still the world's strongest engine of growth and progress. We remain the world's largest producer and its largest and most open market. Other nations, such as Germany and Japan, are moving rapidly. They have done better than we have in certain areas. We should respect them for it and, where appropriate, we should learn from that. But we must also say to them you, too, must act as engines of global prosperity.

Nonetheless, the fact is that for now and for the foreseeable future, the world looks to us to be the engine of global growth and to be the leaders. Our leadership is especially important for the world's new and emerging democracies. To grow and deepen their legitimacy, to foster a middle class and a civic culture, they need the ability to tap into a growing global economy. And our security and our prosperity will be greatly affected in the years ahead by how many of these nations can become and stay democracies.

All you have to do to know that is to look at the problems in Somalia, to look at Bosnia, to look at the other trouble spots in the world. If we could make a garden of democracy and prosperity and free enterprise in every part of this globe, the world would be a safer and a better and a more prosperous place for the United States and for all of you to raise your children in.

Let us not minimize the difficulty of this task. Democracy's prospects are dimmed, especially in the developing world, by trade barriers and slow global growth. Even though 60 developing nations have reduced their trade barriers in recent years, when you add up the sum of their collective actions, 20 of the 24 developed nations have actually increased their trade barriers in recent years. This is a powerful testament to the painful difficulty of trying to maintain a high-wage economy in a global economy where production is mobile and can quickly fly to a place with low wages.

We have got to focus on how to help our people adapt to these changes, how to maintain a high-wage economy in the United States without ourselves adding to the protectionist direction that so many of the developed nations have taken in the last few years.

These barriers, in the end, will cost the developing world more in lost exports and incomes than all the foreign assistance that developed nations provide, but after that, they will begin to undermine our economic prosperity, as well.

It's more than a matter of incomes, I remind you. It's a matter of culture and stability.

Trade, of course, cannot ensure the survival of new democracies, and we have seen the enduring power of ethnic hatred, the incredible power of ethnic divisions, even among people literate and allegedly understanding, to splinter democracy and to savage the nation-state. But as philoso-



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phers from Thucydides to Adam Smith have noted, the habits of commerce run counter to the habits of war. Just as neighbors who raise each other's barns are less likely to become arsonists, people who raise each other's living standards through commerce are less likely to become combatants.

So if we believe in the bonds of democracy, we must resolve to strengthen the bonds of commerce.

Our own nation has the greatest potential to benefit from the emerging economy. But to do so, we have to confront the obstacles that stand in our way. Many of our trading partners cling to unfair practices. Protectionist voices here at home and abroad call for new barriers. Indifferent policies have left too many of our workers and communities exposed to the harsh winds of trade without letting them share in the sheltering prosperity trade has also brought. And without helping them in any way to build new ways to work so they can be rewarded for their efforts in global commerce.

Cooperation among the major powers toward world growth is not working well at all today. And most of all, we simply haven't done enough to prepare our own people and to produce our own resources so that we can face with success the rigors of the new world....

## A Five-Step Agenda

I believe there are five steps we can and must take to set a new direction at home and to help create a new direction for the world. First, we simply have to get our own economic house in order. I have outlined a new national economic strategy that will give America the new direction we require to meet our challenges. It seeks to do what no generation of Americans has ever been called upon to do before: to increase investment in our productive future and to reduce our deficit at the same time.

We must do both. A plan that only plays down the deficit without investing in those things that make us more productive will not make us stronger. A plan that only invests more money without bringing down the deficit will weaken the fabric of our overall economy such that even educated and productive people cannot succeed in it.

It is more difficult to do both. The challenges are more bracing.

You have to cut more other spending and raise more other taxes, but it is essential that we do both, invest so that we can compete, bring down the debt so that we can compete....

I think every one of you who is a student at this university has a far bigger stake in the future than I do. I have lived in all probability more than half my life, with benefits far beyond anything I ever dreamed or deserved because my country worked. And I want my country to work for you.

The plan I have offered is assuredly not perfect, but it is an honest and bold attempt to honestly confront the challenges before us, to secure the foundations of our economic growth, to expand the resources, the confidence and the moral suasion we need to continue our global leadership into the next century.

And I plead with all of you to do everything you can to replace the blame game that has dominated this city too long with the bigger game of competing and winning in the global economy.

## An Open Trading System

Second, it is time for us to make trade a priority element of American security. For too long, debates over trade have been dominated by voices from the extremes. One says government should build walls to protect firms from competition. Another says government should do nothing in the face of foreign competition, no matter what the dimension and shape of that competition is, no matter what the consequences are in terms of job losses, trade dislocations or crushed incomes.

Neither view takes on the hard work of creating a more open trading system that enables us and our trading partners to prosper. Neither steps up to the task of empowering our workers to compete or of ensuring that there is some compact of shared responsibility regarding trade's impact on our people or of guaranteeing a continuous flow of investment into emerging areas of new technology which will create the high-wage jobs of the 21st century.

Our administration is now developing a comprehensive trade policy that will step up to those challenges, and I want to describe the principles upon which it will rest.

It will not be a policy of blame but one of responsibility. It will say to our trading partners that we value their business, but none of us should expect something for nothing. We will continue to welcome foreign products and services into our markets, but insist that our products and services be able to enter theirs on equal terms.

We will welcome foreign investment in our businesses, knowing that with it come new ideas, as well as capital, new technologies, new management techniques and new opportunities for us to learn from one another and grow. But as we welcome that investment, we insist that our investors should be equally welcome in other countries.

We welcome the subsidiaries of foreign companies on our soil. We appreciate the jobs they create and the products and services they bring, but we do insist simply that they pay the same taxes on the same income that our companies do for doing the same business.

Our trade policy will be part of an integrated economic program, not just something we use to compensate for the lack of a domestic agenda. We must enforce our trade laws and our agreements with all the tools and energy at our disposal, but there is much about our competitive posture that simply cannot be straightened out by trade retaliation, better educated and trained workers, a lower deficit, stable low interest rates, a reformed health-care system, world-class technologies, revived cities. These must be the steel of our competitive edge.

And there must be a continuing quest by business and labor and, yes, by government for higher and higher and higher levels of productivity. Too many of the chains that have hobbled us in world trade have been made in America.

Our trade policy will also bypass the distracting debates over whether efforts should be multilateral, regional, bilateral, unilateral. The fact is that each of these efforts has its place. Certainly we need to seek to open other nations' markets and to establish clear and enforceable rules on which to expand trade.

That is why I'm committed to a prompt and successful completion of the Uruguay Round of the GATT talks.

That round has dragged on entirely too long. But it still holds the potential if other nations do their share and we do ours to boost American wages and living standards significantly, and to do the same for other nations around the world.

We also know that regional and bilateral agreements provide opportunities to explore new kinds of trade concerns, such as how trade relates to policies affecting the environment and labor standards and the anti-trust laws.

And these agreements, once concluded, can act as a magnet including other countries to drop barriers and open their trading systems.

The North American Free Trade Agreement is a good example. It began as an agreement with Canada, which I strongly supported, which has now led to a pact with Mexico as well. That agreement holds the potential to create many, many jobs in America over the next decade, if it is joined with others to ensure that the environment, that living standards, that working conditions are honored, that we can literally know that we are going to raise the condition of people in America and in Mexico.

We have a vested interest in a wealthier, stronger Mexico. But we need to do it on terms that are good for our people.

And we should work with organizations such as the Asia Pacific Economic Cooperation [Council] forum to liberalize our trade across the Pacific as well.

And let me say just a moment about this, I am proud of the contribution America has made to prosperity in Asia and to the march of democracy. I have seen it in Japan after World War II. I have seen it then in Taiwan as the country became more progressive and less regressive at the same time.

I have seen it in Korea as a country has become more progressive and more open. And we are now making a major contribution to the astonishing revitalization of the Chinese economy, now growing at 10 percent a year with the United States buying a huge percentage of those imports. And I say I want to continue that partnership, but I also think we have a right to expect



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progress in human rights and democracy as we support that progress.

### Global Financial Coordination

Third, it is time for us to do our best to exercise leadership among the major financial powers to improve our coordination on behalf of global economic growth. At a time when capital is mobile and highly fungible, we simply cannot afford to work at cross-purposes with the other major industrial democracies. Our major partners must work harder and more closely with us to reduce interest rates, stimulate investment, reduce structural barriers to trade and to restore robust global growth. And we must look at new institutions we use to chart our way in the global economy and ask whether they are serving our interests in this new world or whether we need to modify them or create others....

You have been saying to us for years we must increase investment in our own education and technology, to improve productivity. We have done it. We have done it for ourselves, we have done it for you, now you must work with us, in Germany, Japan, and in other nations to promote global growth.

We have to work with these nations. None of us are very good at it. America doesn't want to give up its prerogatives. The Japanese don't want to give up theirs; the Germans don't want to give up theirs. They're deep and ingrained traditions in all these nations. But the fact is that the world can't grow if America is in recession. But it will be difficult for us to grow coming out of this recovery unless we can spark a renewed round of growth in Europe and in Japan. We have got to try to work more closely together.

### Promoting Growth

Fourthly, we need to promote the steady expansion of growth in the developing world. Not only because it's in our interest, but because it will help them as well. These nations are a rapidly expanding market for our products. Some 3 million American jobs flow from exports to the developing world.

Indeed, because of unilateral actions taken by Mexico over the last few years, the volume of our trade has increased dramatically and our trade deficit has disappeared.

Our ability to protect the global environment and our ability to combat the flow of illegal narcotics also rest in large measure on the relationships we develop commercially with the developing world.

There is a great deal that we can do to open the flow of goods and services. Our aid policies must do more to address population pressures, to support environmentally responsible sustainable development, to promote more accountable governance, and to foster a fair distribution of the fruits of growth among an increasingly restive world population, where over 1 billion people still exist on barely a dollar a day.

These efforts will reap us dividends of trade, friendship and peace.

### Aid for Russia

The final step we must take, my fellow Americans, is toward the success of democracy in Russia and in the world's other new democracies. The perils facing Russia and other former Soviet republics are especially acute and especially important to our future, for the reductions in our defense spending that are an important part of our economic program over the long run here at home are only tenable as long as Russia and the other nuclear republics pose a diminishing threat to our security and to the security of our allies and the democracies throughout the world.

Most worrisome is Russia's precarious economic condition. If the economic reforms begun by President [Boris N.] Yeltsin are abandoned, if hyperinflation cannot be stemmed, the world will suffer.

Consider the implications for Europe if millions of Russian citizens decide they have no alternative but to flee to the West, where wages are 50 times higher. Consider the implications for the global environment if all the Chernobyl-style nuclear plants are forced to start operating there without spare parts, when we should be in a phased stage of building them and shutting them down — building them down, closing them up, cleaning them up.

If we're willing to spend trillions of dollars to ensure communism's defeat in the Cold War, surely we should be willing to invest a tiny fraction of that to support democracy's success where communism failed.

To be sure, the former Soviet republics and especially Russia must be willing to assume most of the hard work and high cost of the reconstruction process, but then again, remember that the Marshall Plan itself financed only a small fraction of post-war investments in Europe. It was a magnet, a beginning, a confidence-building measure, a way of starting a process that turned out to produce an economic miracle.

Like Europe then, these republics now have a wealth of resources and talent and potential, and with carefully targeted assistance, conditioned on progress toward reform and arms control and non-proliferation, we can improve our own security and our future prosperity at the same time we extend democracy's reach.

These five steps constitute an agenda for American action and a global economy. As such, they constitute an agenda for our own prosperity as well. Some may wish we could pursue our own domestic effort strictly through domestic policies, as we have understood them in the past.

### Harnessing the Global Economy

But in this global economy, there is no such thing as a purely domestic policy. This thing we call the global economy is unruly, it's a bucking bronco that often lands with its feet on different sides of old lines, and sometimes with its whole body on us. But if we are to ride the bronco into the next century, we must harness the whole horse, not just part of it.

I know there are those in this country in both political parties and all across the land who say that we should not try to take this ride, that these goals are too ambitious, that we should withdraw and focus only on those things which we have to do at home. But I believe that would be a sad mistake and a great loss.

For the new world toward which we are moving actually favors us.

We are better equipped than any other people on earth, by reason of our history, our culture and our disposition, to change, to lead and to prosper. The experience of the last few years where we have stubbornly refused to make the adjustments we need to compete and win are actually atypical and unusual, seen against the backdrop of our nation's history.

Look now at our immigrant nation, and think of the world toward which we are tending. Look at how diverse and multiethnic and multilingual we are, in a world in which the ability to communicate with all kinds of people from all over the world, and to understand them will be critical. Look at our civic habits of tolerance and respect. They are not perfect in our own eyes. It grieved us all when there was so much trouble a year ago in Los Angeles. But Los Angeles is a country with 150 different ethnic groups, of widely differing levels of education and access to capital and income. It is a miracle that we get along as well as we do. And all you have to do is to look at Bosnia, where the differences were not so great, to see how well we have done in spite of all of our difficulties.

And look at the way our culture has merged technology and values. This is an expressive land that produced CNN and MTV. We were all born for the information age. This is a jazzy nation — thank goodness, for my sake — that created bebop and hip-hop and all those other things. We are wired for real time.

And we have always been a nation of pioneers. Consider the astonishing outpouring of support for the challenges I laid down last week, in an economic program that violates every American's narrow special interest if you just take part of it out and look at it. And yet, here we are again, ready to accept a new challenge, ready to seek new change, because we're curious and restless and bold. It flows out of our heritage. It's ingrained in the soul of Americans. It's no accident that our nation has steadily expanded the frontiers of democracy, of religious tolerance, of racial justice, of equality for all people, of environmental protection and technology, and, indeed the cosmos itself. For it is our nature to reach out, and reaching out has served not only ourselves, but the world as well. Now, together, it is time for us to reach out again toward tomorrow's economy, toward a better future, toward a better direction, toward securing for you, the students at American University, the American dream. Thank you very much. ■



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BUSINESS AMERICA
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U.S. DEPARTMENT OF COMMERCE
International Trade Administration

# Secretary Brown: Expanding Exports 'Dramatically' Is Priority for the U.S. Department of Commerce

*In a speech to the California Council for International Trade, March 26, in San Francisco, Calif., Secretary of Commerce Ronald H. Brown described the Clinton Administration's trade objectives and the goals of the U.S. Department of Commerce in helping U.S. companies expand their exports. The Secretary placed those issues in the broader context of President Clinton's economic program to stimulate the economy and develop a long-term investment strategy. He cited the deficit-reduction plan; the program to build the skills and adaptability of the workforce; the proposals for public investment in infrastructure; and the efforts to commercialize technology. Excerpts from Brown's speech follow.*

We have entered a new era of global competition. My purpose today is to outline my vision of the role of the Department of Commerce in helping you compete effectively around the world...

As we work to fashion a more efficient economic engine here at home, we have to work just as hard to expand the markets for American goods overseas. That is why, earlier this month, President Clinton reaffirmed his commitment to an aggressive, expansive American trade policy.

He talked about the growing importance of exports to the American economy, noting that 7 million Americans hold export-related jobs, mostly in manufacturing. And these are high-wage jobs. As the President pointed out, the recent recession would have lasted twice as long, had it not been for the $480 billion in goods we now ship abroad every year.

As Secretary of Commerce, my priority is to help increase and expand American exports. And expand them dramatically.

We have put an end to the idea that industry and government are somehow natural enemies. We have to learn to work together.

We understand that we provide the framework—through export promotion, technological development and information dissemination—that helps you. But we also understand that it is you, the private sector, that will actually create thousands of new export-related jobs.

We propose a new partnership between the public and private sectors, whose centerpiece is a broad, concerted effort to break down barriers American exporters face overseas—so that you really have an opportunity to compete.

Let me outline seven specific areas in which the Department of Commerce intends to promote exports.

• *First,* we will work in concert with the U.S. Trade Representative to conclude multilateral trade agreements, such as GATT and NAFTA, that will provide the foundation for a generation of free trade and economic development for all their signatories. In entering negotiations, we recognize that free trade is moved forward by good agreements, not quick agreements.

Last week, I traveled to Mexico to meet with President Salinas. I used the trip and a speech to the Trilateral Chambers of Commerce to reaffirm the Clinton Administration's commitment to NAFTA and our approach to the supplemental agreements.

I found the quality and sense of purpose of the Mexican leadership to be extraordinary. And I was impressed with the resolve of President Salinas to solidify and strengthen political and economic reforms.

I am also convinced that our exports to Mexico will steadily increase. For example, I met with officials of GE and Bechtel who are part of a consortium that has been hired to build an electric co-generation plant in Mexico. This project alone will result in exports of $675 million worth of U.S. equipment and $70 million annually in U.S. exports of natural gas. And there will be more to come.

• *Second,* the Commerce Department will play an important role in expanding trade as a means of strengthening democracy around the world. No example is more pressing than that of Russia and the rest of the former Soviet Union.

Our policy to Russia must, in the President's words, "support democracy's success." Our reasons are both idealistic—because we support democracy—and pragmatic—because we support a growing world economy.

Earlier this month, Commerce awarded $500,000 grants to four U.S. trade groups as part of a pilot program to help smaller companies establish a commercial presence in the Newly Independent States. I also met with Deputy Prime Minister Alexander Shokhin, who agreed that we would co-chair a U.S.-Russia Business Development Committee. I will be going to Russia this spring for the first meeting. The Committee will work to remove obstacles to bilateral commerce and will seek to build a framework for business. The removal of these obstacles could open the floodgates to literally billions of dollars of U.S. investment, which Russia desperately needs to continue moving toward democracy and a free market economy.

• *Third,* the Department of Commerce will lead the creation and implementation of a dynamic export promotion strategy. As part of the new relationship between government and business, we are adopting a customer service focus. We must make the Department user friendly, to meet *your* needs by providing a one-stop export promotion service that can provide you with everything from exchange rates to local business leads.



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As Secretary of Commerce, I chair the Trade Promotion Coordinating Committee, an organization of 19 government agencies that will undertake a dramatic streamlining of our export services. One of our initiatives will be to shorten the regulatory process. For many small- and medium-sized businesses, overcoming American export obstructions—getting through bureaucracy—may be as great a hurdle as foreign market barriers. Other goals include streamlining overseas promotion efforts, pooling information, increasing our advocacy efforts on behalf of U.S. firms, and ending the duplication of effort that pulls us away from our real mission: helping you.

• *Fourth,* and to paraphrase the President, the Department of Commerce will focus like a laser beam on international trade in high-technology products. The National Institute of Standards and Technology—or NIST—is a linchpin of the Clinton technology policy. The first step in expanding exports is building more competitive products in the United States.

The Commerce Department will expand its Manufacturing Technology Center Program from the current seven facilities to a network that will cover the nation. MTCs assist small- and medium-sized businesses in selecting and applying the latest in cost-saving manufacturing technology to their own operation.

And Commerce's Advanced Technology Program—which provides matching grants to develop precompetitive technologies with broad commercial applicability—will also expand. The ATP is already helping one small company develop superconducting materials for use in cellular phones; and another company to streamline the machine tool manufacturing process.

Let me emphasize that this is an *industry-driven process.* We do not pick winners and losers. ATP projects originate in the private sector, and federal investment is matched dollar-for-dollar by the interested companies.

Japan, of course, is a focal point of our interest in technology and trade. I met this morning with Minister Mori, the MITI Minister, of Japan, and conveyed both my concern ... and my optimism ... that the economic relationship between our two countries can be restructured.

For years, Japan has deflected our concerns over the continuing trade deficit and continuing trade barriers, by pointing to our domestic economic disarray. Well, the Clinton Administration is taking dramatic steps to put our house in order. We expect that our bold actions will be reciprocated by the Japanese government. It is time for free trade to become a reality on both sides of the Pacific.

But opening markets is more than confrontation and belligerency. Indeed, the endless military metaphors, the momentary obsession with charges and countercharges and duties and threats, the phrase "trade war"—all these things ignore the fact that, in the long run, trade is meant to bring us closer.

• *Fifth,* we need to pay attention to markets where we now have a foot in the door, but have not fully entered. In the Pacific Rim, for example, Japan will always present a special challenge, and the sheer size of the potential Chinese market makes it an obvious target. But there are other, growing economies there that also show great promise. Indonesia, Thailand, Taiwan and Korea, to name a few, have huge untapped potential.

And, as we look within our own hemisphere, we should be careful not to focus just on Canada and Mexico. For example, Brazil, Argentina, and Venezuela combined, purchase only half as many U.S. exports as we sold to Mexico alone. Driving a strategy to enter these untapped markets will be a major Commerce Department effort.

• *Sixth,* the Department of Commerce is committed to using its resources to help U.S. companies capture growing markets in environmental technologies.

The American environmental technology industry—a $78 billion industry—has almost limitless growth potential. Not surprisingly, Germany and Japan have also noticed this market and are actively promoting their domestic industries.

Thus, two agencies of the Department of Commerce have joined with the Export-Import Bank in developing a new initiative complete with a long name and catchy acronym; the National Environmental Technologies Trade Initiative, or NETTI.

NETTI successfully combines three elements. By educating developing countries about the need for environmental technologies, arranging for U.S. firms to demonstrate their technologies, and providing methods for financing these exports, we believe NETTI will have a significant impact on international trade.

• *Seventh,* and finally, I intend to be a Secretary of Commerce who will get on a plane to fly to the far reaches of the earth to promote the interests of American firms in competition with their foreign counterparts. I intend to place the influence and power of the American government behind you—just as other nations promote their own domestic products.

Let me conclude by reinforcing what, I hope, is obvious: these Commerce initiatives are part of a larger approach to trade policy that this Administration will initiate—but which private business must, in the end, bring to a successful conclusion. I've come here today in hopes that you, the men and women who really *are* at the heart of America's trade policy, be part of this new partnership. We are committed to being both visionary and coldly pragmatic in fostering true worldwide free trade.

Indeed, free trade can be described as democracy in the marketplace. And just as we have pushed forward on many fronts to nurture and encourage democracy around the world, so we must work to expand economic freedom. We must not settle for an uneven playing field: free trade for some, protection for others. We can do better than that, and with the leadership of President Clinton and your creativity, tenacity and support, we will.



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# President Clinton and the World Trading System

by Gary Clyde Hufbauer

*Clinton faces the immediate task of resolving three key issues: auto quotas, steel imports and a proposed oil import fee. He should resist the lure of special interests. Free trade is the most effective way to boost economic growth and industrial competitiveness.*

President Clinton takes office at an historic juncture for the world trading system. Gone are the days of an insistent march towards multilateral free trade. Now there are forks in the road. Clinton can choose between a multilateral highway and a regional road, or he can travel both. And some would want to lure him on to the unilateral route, in an attempt to revive American industry.

If economists had their say, Clinton would start with a grand trade strategy and then turn to specific cases; but presidents often use cases to formulate strategy. Several hot trade cases await Clinton and his immediate decisions could shape the trading system.

Freer trade is one of the best supply-side programs ever devised. Over the past forty years, trade has expanded two to three percent per year faster than world GDP, providing a major spur to world economic growth. By my estimates, the Europe 1992 program could increase intra-EC commerce by $75 billion; NAFTA could boost North American trade by $25 billion; and a successful Uruguay Round could expand global trade by $250 billion. The ensuing global efficiency gains should amount to $30–40 billion annually. This is equivalent to expanding the global stock of plant and equipment by $300 to $400 billion — not bad for government work.

Freer trade is also a potent weapon against inflation. When markets are open to global competition, domestic producers have far less power to initiate or sustain a price-wage spiral. Another powerful reason for Clinton to maintain an open world trading system.

In recent years, some critics have juxtaposed the rising share of imports in the American economy against the declining level of real wages for low-skilled workers – suggesting cause and effect. If true, this is a serious indictment. But, until a negative link is documented between trade and wages, the world trading system should not be held hostage to theoretical alarms.

**Front Burner Cases.** As soon as he enters the White House, Clinton will face three important trade proposals: an oil import fee; to restrain Japanese autos; and to limit imports of steel. The way these three cases are handled will say much about the Administration's trade priorities.

**Oil.** An oil import charge — either a fixed fee or a variable levy — starting at around $5 per bar-

rel is under active consideration. A fee has two attractions: it could raise Treasury revenues by up to $20 billion annually, both directly and by boosting the profits of US producers; and it could be imposed with the stroke of a presidential pen.

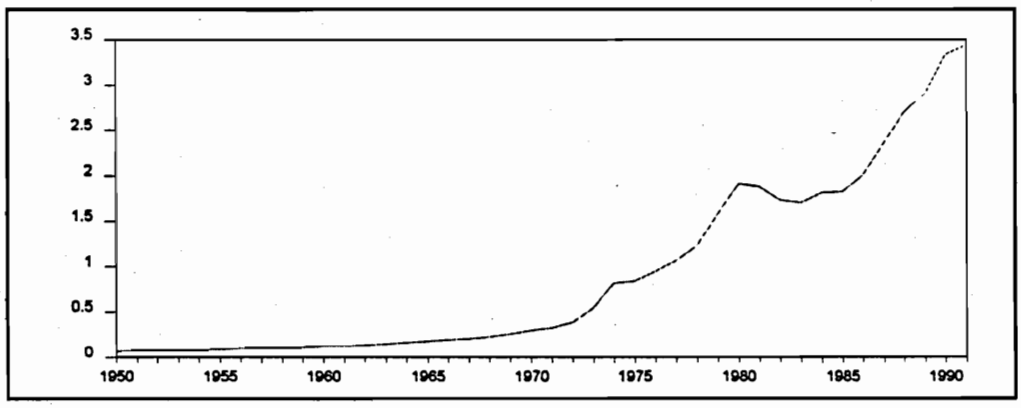
But an import fee imposed *without* commensurate taxes on domestically produced energy (oil, natural gas and coal), would send a powerful message to the world trading system: new border taxes are all right, no matter what economic and environmental distortions they create, such as a substitution of coal for oil. Moreover, if the United States imposes an oil import fee, Canada will insist that its energy exports be exempt (under the US-Canada FTA) and Mexico will seek the same treatment (under the NAFTA). Resolving these issues and others could occupy top trade officials for many months.

*The ensuing global efficiency gains of freer trade should amount to $30-40 billion annually . . . not bad for government work.*

**Autos.** Clinton will face demands for tighter *voluntary* restraints, not only on Japanese car imports but also on autos made by Japanese transplant firms located in the United States (a new twist). While the market share of Japanese imports has stabilized at a figure under 20 percent, Japanese transplants have steadily gained ground on the Big Three (rising from under 1 percent of North American production in 1980 to about 14 percent in 1990). After Bush's visit in January 1992, Japan lowered its voluntary export restraint (VER) ceiling from 2.3 million to 1.65 million cars per year. Congressional bills would lock in the 1.65 million figure until 1999 and raise the tariff on minivans and utility vehicles from 2½ to 25 percent. When the VER comes up for renewal in March 1993, Clinton will be urged to follow Europe's example and negotiate restraints on overall Japanese market penetration, including transplants, as an alternative to new legislation limiting imports.

Restricting the Japanese presence in the US auto market would impose large costs on US consumers and send an unfortunate signal to the world trading system. Depending on the severity of restraints, they could cost US consumers $3 billion or more annually; paradoxically, higher auto prices would enlarge the profits of foreign firms at least as much as the profits of the Big Three. Restraints on imports would show that powerful producers (the Big Three) can go straight to the White House and not follow normal safeguard procedures when they need *breathing room* to cope

**WORLD EXPORTS**
(trillion US$)




*Source: IMF*

with import competition. Restraints on transplants would set an alarming precedent for limiting the output of foreign-owned plants operating in the United States.

**Steel.*** In November 1992, the Department of Commerce announced its preliminary determination that $1.2 billion of steel imports from 12 countries are subsidized by margins between 5–50 percent. This decision will be followed, in January 1993, by preliminary dumping determinations and the margins could be even higher.

These cases have a history. In the 1980s, over $100 billion was spent globally on subsidies to the steel industry, sustaining the current glut of excess capacity. In addition, Europe and Japan tolerate producer cartels that enable their steel firms to sell for high prices at home and low prices abroad – classical dumping. The United States imposed its own *voluntary* import restraints in October 1984, which lasted until March 1992. When the voluntary restraints agreements (VRAs) were allowed to expire, twelve US steel companies filed subsidy and dumping cases against imports from 21 countries. Final administrative determinations will not be made until August 1993; meanwhile bonds must be posted on imports equal to the margins found in the preliminary subsidy and dumping determinations.

Clinton will thus face calls from Europe, Japan and other nations to "cut a deal" to avoid countervailing and antidumping duties. Such a deal could resurrect the VRAs that expired in March 1992. The problem with VRAs is that they limit steel imports that are not subsidized or dumped. By not differentiating between fairly and unfairly traded steel, the VRA system does little to encourage Europe and Japan to stop their subsidy and dumping practices. Over time, however, the VRA system can do a great deal of harm by insulating the US market from fair foreign competition.

**NAFTA.** At about the same time he is addressing these and other cases, Clinton will need to put the North American Free Trade Agreement in place. The NAFTA is a sweeping agreement of historic proportions. For the first time, two industrial nations have embarked on a free market with a large developing country. By 2004, virtually all tariffs will be eliminated; and by 2009, nearly all quotas will be gone. By the year 2020, if Mexico prospers as expected, the number of illegal immigrants entering the United States will be much smaller than the million-plus now apprehended annually.

Clinton is committed to the NAFTA, but important features need to be ironed out before he submits implementing legislation to Congress. He has promised to negotiate supplemental agreements with Canada and Mexico to create effective NAFTA Commissions on the Environment and Labor and to find money for environmental cleanup and labor adjustment. How these issues are handled will say much about Clinton's conditions for entry by other countries and the budget consequences of any future geographic enlargement of the NAFTA.

Assuming that other countries want to join, Clinton will face a major choice by 1994 if not before: whether to view NAFTA as the core of a Western Hemisphere Free Trade Area, as the foundation for a larger Pacific Rim trading group, or simply as a self-contained North American entity.

**The Uruguay Round.** By far the biggest challenge Clinton faces is wrapping up the Uruguay Round package – over the opposition of agricultural, industrial and service lobbies, not only in France and Japan, but also in the United States.

*An oil import charge . . . starting at around $5 per barrel is under active consideration.*

Now, some congressional leaders want to renegotiate this, along with important industry associations and the AFL-CIO. Indeed, they have offered to extend the "fast track" beyond June 1993, to give the President more time.

The President should resist the siren song of open-ended renegotiation. The current package has been a decade in the making (preparatory talks started in 1982); the results inevitably reflect compromise; and an attempt at extensive renego-



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tiation would risk a breakdown not only of the Round but also of the entire GATT system.

The draft Uruguay Round package, circulated in December 1991 by GATT Director General Arthur Dunkel, made great strides. It included a General Agreement on Trade in Services; strict codes on intellectual property protection; a phaseout of the Multi-Fiber Arrangement; and effective dispute settlement procedures. After a high wire act by Ambassador Carla Hills, the EC came to an agreement about oilseed acreage and subsidized grain exports, clearing the path for global agricultural reforms.

*. . . Clinton will be urged to follow Europe's example and negotiate restraints on overall Japanese market penetration.*

The Dunkel package is far from perfect and many issues remain to be resolved. For example, negotiations are still underway on telecommunications, financial services and tariffs.

Clinton will have his hands full finishing the package without reopening settled bargains. When he is ready to make his own mark on the global system, he should organize a ninth GATT round to cover the environment, competition policy and unfinished business from the Uruguay Round.

**Multilateralism, Regionalism and Unilateralism.** Beyond the specifics of NAFTA and the GATT is a raging debate between regionalists and multilateralists. At one extreme, Lester Thurow sees GATT as a toothless tiger ready for early retirement. At the other, Jagdish Bhagwati can find little good to say about regional trade initiatives.

But the real tension facing the Clinton Administration is not between regionalism and multilateralism. Like his predecessor, President Clinton can travel both roads, using whichever route promises the greatest degree of trade expansion for the least expenditure of political effort. If, for example, Japan and Korea want to discuss competition policy within the GATT, then the GATT is the place to do business. If Chile, Singapore, New Zealand and Australia want to join NAFTA and to undertake the far-reaching obligations required, their applications should be carefully considered.

The greater tension is between efforts to enlarge the regional and multilateral trading systems and the lure of unilateralism. It is not just a question of autos, steel, airlines and semiconductors. It is a broader question of the role of trade policy in the revival of American industry and the role of bilateral confrontation in dealing with nations that practice different brands of capitalism, especially Japan, Korea and China. My view is that trade restrictions should play a peripheral role in reviving the fortunes of industries, such as autos or machine tools, that are beset by import competition; and in catapulting new industries, such as HDTV or biogenetics, into the 21st century.

That said, the enduring problems of access to the European airline market, the Japanese semiconductor market or the Chinese chemical market require sustained and subtle diplomacy. The paradox is that the United States must threaten to *restrict* trade in order to *expand* trade. Bluff is part of the game. So is deceit. In this intrigue, there will be those in the United States and abroad who secretly favor trade restricting and market sharing solutions, rather than trade expansion and open competition.

The President's task will be to keep the secret partisans of trade restriction from controlling the play. In the twenty years before World War I, each European power proclaimed that the sole purpose of its diplomatic alliances and vast spending on armaments was to secure the peace of Europe. In the end, all great powers were ensnared by their own tactics. Clinton's challenge is not to repeat this drama in the arena of world trade. ■

**The author has been retained by the US steel industry as an expert witness: these views are not necessarily those of the industry.*

*Dr. Hufbauer is the Reginald Jones senior fellow at the Institute for International Economics. Anup Malani helped write this essay.*



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Research Department

# International Trade, Distortions and Long-Run Economic Growth

Prepared by Jong-Wha Lee 1/

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## Abstract

The links between trade and growth are examined in a neoclassical model of an open economy in which domestic production requires both domestic and imported inputs. The model shows that trade distortions induced by such government policies as tariffs and exchange controls generate cross-country divergences in growth rates and in per capita income over a long transitional period. The empirical results confirm that tariff rates and black market premia, interacting with an estimate of the share of free trade imports, have significant negative effects on the growth rate of per capita income across countries in the orders of magnitude predicted by the model.

JEL Classification Number:
F43, 041



## Summary

How are international trade and trade policy linked to long-run growth? How much can differences in trade policy explain cross-country variations in long-run growth rates? This paper attempts to present new insights into these long-standing questions.

The paper investigates the links between trade and growth in a neoclassical model of an open economy in which domestic production requires both domestic and imported inputs. The model shows that trade distortions induced by such government policies as tariffs and exchange controls generate significant cross-country divergences in growth rates and in per capita income over a long transitional period. An interesting theoretical prediction is that the effects of trade distortions on the growth rate of a country depend on "free trade openness"--the country's share of imports in GDP under a free trade regime. Thus, distortionary trade policies are considered to be more disadvantageous to growth in small, resource-scarce countries, which would be more open in a free trade regime, than in large, resource-abundant countries. The model also explains why capital may flow from low-income to high-income countries: namely, because trade distortions decrease substantially the marginal productivity of capital, they may cause capital to flow from highly distorted low-income countries to high-income countries with low distortions.

The paper presents empirical findings on the links between trade distortions and economic growth by using a cross-section of data on 81 countries from 1960 to 1985. The empirical results confirm that tariff rates on imports of foreign inputs and black market premiums, interacting with an estimate of "free trade openness," have significant negative effects on the growth rate of per capita income. In a typical developing country, whose import share would be 20 percent of GDP in the absence of trade distortions, distortionary trade policies, such as a 25 percent tariff and a 50 percent black market premium, decrease the growth rate by about 1.4 percent a year.

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## EDITORIAL/OPINION

# Clinton's Flexible Trade Policy

By KEVIN G. NEALER

One Washington theory holds that your policy is a success if the editorial boards are unable to pigeonhole it. By that measure, Clinton trade policy is a clear winner. Maybe it deserves to be.

Reporters and editorial writers are struggling to characterize the few trade policy choices made in the first quarter of the new presidency. They do so by reference to a trade theology that assigns everyone a place on a continuum stretching from devout free trader to irredeemable protectionist.

Articles have variously described the Clinton approach as, a) the same as Bush; b) managed trade (meaning Clinton policy-makers are protectionists, but they know better); and c) "two-faced," according to our trading partners. All of these descriptions seem wide of the mark, for at least three reasons.

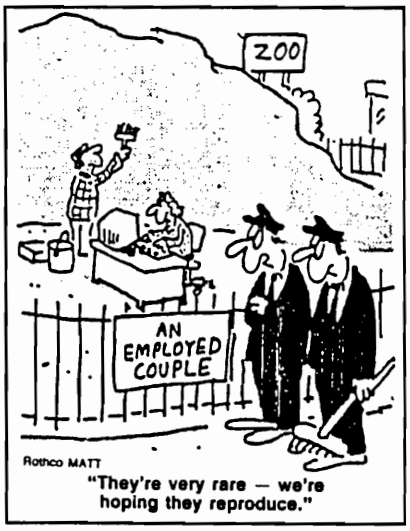
First, they are predicated on the assumption that the United States has something like a national trade policy. It does not. If you want to know about U.S. foreign policy toward Papua New Guinea, there are official State Department papers — couched in suitably vague diplomat-speak — that at least give you the basics. You would search in vain for a similar statement of commercial interests.

Instead of a trade policy, we have trade laws. The process is petition-driven and depends on interested parties filing grievances over import sensitivities or export frustrations. If they have enough money and time, the petitioners might get government to solve their problem, or at least some part of it. In any event, there is no overall statement of interests specific enough to be called a trade policy.

Second, the critics and commentators were encouraged to repeat their free trade/protectionist catechism for 12 years because those terms of debate served the previous administrations well. The media and the financial markets came to believe that Republicans could be counted on to support free and expanding trade, while a Democratic party hostage to labor would reliably act out its worst instincts when dealing with the global economy. Even when faced with the fact that President Reagan instituted more import protection than any president since Herbert Hoover, the caricature proved durable.

Finally, there is a clear reluctance to take the measure of the president by his words and his actions, rather than by theories. Mr. Clinton and his top trade advisers have repeatedly said they see a need for a new trade vocabulary that reflects the current realities of global competition. In his February trade speech at American University, the president said the most important step on the way to a world-class America was to get our own economy in order. In fact, Japanese colleagues who criticize the administration's trade policy to date will do well to remember that a revitalized American economy was the first item on their own wish list in the recent Structural Impediments Initiative trade talks.

The Clinton team is keenly aware of the contribution exports are making to the modest recovery. Likewise, they sense the need to include Congress and the public in the role trade must play in a growing American economy. That seems to mean they are prepared to make certain that any international agreements meet baseline constituent needs. Such a strategy should reassure the financial markets, since the worst setbacks to trade expansion have occurred when the U.S. executive failed to bring along a legislature suspicious of the political cost of progressive trade measures.



"They're very rare — we're hoping they reproduce."

So what can we fairly say about U.S. trade priorities now? If the president gives primacy to the health of the national economy, then it makes sense to assume that export expansion will be more important than import protection. Recent decisions to press Europe on opening its government procurement markets, calls for more open trade in aviation goods and services and continued commitment to the North American free-trade agreement all ratify this thesis.

While import restrictions may not be a favorite tactic, expect maximum use of all available leverage — including U.S. market access. Recent discussion of a tenfold increase in the U.S. tariff on minivans may say less about the administration's susceptibility to domestic auto industry pressure than its political will to use all tools to open Japan to more U.S. and third-country exports.

In addition, there may be a new pragmatism about the package in which export growth is delivered. The administration might be much more ecumenical as to whether multilateral or regional trade liberalization serves as the vehicle for trade growth, as the president hinted in his endorsement of an aggrandized Asia Pacific Economic Cooperation agreement.

All this suggests an approach to trade that is driven much more by the facts of each new policy challenge than by any attempt to manage trade flows. It may be the beginning of a situational trade policy, where the administration's choices are informed by the impact of trade on domestic economic growth and the need to encourage exports. If the lack of predictability frustrates trading partners and editorial writers, that could be a small price to pay for continued U.S. leadership in opening global markets and the honest pursuit of our national interests.

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# New President, Same Trade Plan

WASHINGTON — Whatever happened to the Clinton administration?

Weren't we led to expect a new, hard-headed, worker-environment-human rights-oriented administration? So far, it hasn't seemed all that different.

Take the president's trade policy address three weeks ago at American University.

"We will continue to welcome foreign products and services into our markets, but insist that our

TRADE SCENE

Richard Lawrence

products and services be able to enter theirs on equal terms . . . Certainly we need to seek to open other nations' markets and to establish clear and enforceable rules on which to expand trade . . ."

Mr. Clinton lauded "a more open trading system," linked trade with national security, urged greater policy coordination among economic powers and talked of helping the world's less advanced nations.

Who wrote that speech? George Bush? Ronald Reagan? Lyndon Johnson? Ike?

A few days later, the president's trade representative, Mickey Kantor, went before the Senate Finance Committee to flesh out the administration's trade policy plans. Among other things, he said, "We need to use every tool at our disposal . . . to make sure that other markets are comparably open to our own."

His remark evoked some nostalgia. Four years earlier, before the same committee, Carla Hills, Mr. Kantor's predecessor, vowed to enforce U.S. trade rights with at least one tool — a crowbar. Unless Japan opens its markets wider, she said, the United States will be "forced" to retaliate. She voiced concern over U.S.-Japanese semiconductor trade and European Airbus subsidies, among others.

Still, some things have changed.

Candidate Clinton promised that he would not implement a North American free-trade agreement without tough-worded side agreements on the environment, labor standards and worker rights. He also insisted on protection against sudden, overwhelming import surges.

(Talks on those proposals began Wednesday.)

Mr. Clinton, in a campaign speech Oct. 4 at Raleigh, N.C., laid out those side agreements. He called for a U.S.-Mexican-Canadian environmental commission to "provide remedies, including money damages and the legal power to stop pollution . . . If we don't have the power to enforce the laws that are on the books, what good is the (Nafta)?"

But last week, Mr. Kantor, in congressional testimony, made clear that the commission would have no supranational powers. He avoided saying that it would even have "investigatory" authority. "Review," he suggested, is the better word.

Now, it seems, the kind of environmental commission the Clinton administration envisions does not differ strikingly from one the Bush administration described.

Candidate Clinton also proposed a Nafta commission with "dispute resolution powers and remedies" for worker standards. It looks likely, however, that the administration, awakened to the sensitive matter of "national sovereignty," will drop that notion, too.

As for protecting business against "crippling" import surges, the administration is in a box. Nafta already has reasonably protective tariff provisions dealing with surges. And how, people ask, can the administration substantively add to those provisions without amending the basic Nafta, which President Clinton insists he won't do?

A few months ago, there was much hand-wringing over the possibility that President Clinton would give U.S. automakers their wish for a ten-fold increase in the tariff on minivan and four-door sport utility vehicle imports. Candidate Clinton had attacked the Bush administration for supposedly "reversing the decision of their own government" and unilaterally paring the tariff. That action, he added, gave "the Japanese a $300 million-a-year trade break with no concession in return."

The Treasury Department is said to be reviewing the matter. Will it hike the duty from 2.5% to 25%? Highly unlikely. It would be an action without technical merit, costly to U.S. consumers (Big Three automakers, please note) and likely to trigger foreign reprisals.

If the administration were to raise the tariff, then we'd see a really new trade policy.

To be sure, the Clinton administration is trying to demonstrate it is no pushover. It is about to disqualify some European Community suppliers from some U.S. government contracts — a $50 million-a-year reprisal. U.S.-EC trade runs about $200 billion a year. Might not even the Bush administration have taken similar symbolic action to protest new EC purchasing rules?

Meanwhile, the United States and the EC continue a spat over European oilseed export subsidies. The Bush administration was about to retaliate in December, perhaps against $300 million a year in EC exports. Instead, it negotiated some EC market concessions. Now the Clinton crowd says it doesn't think the concessions go far enough. But there's little talk yet of oilseed reprisals.

So far, there is one clear shift from Bush to Clinton policy. While Mr. Bush steadfastly rejected renewal of "Super 301," the law that directs the president to act against foreign unfair trade practices, Mr. Clinton embraces it. It marks a rare, if not unique, instance of a president encouraging Congress to tell him how to carry out powers he already has.

Drawing once again on the old French saw, the more administrations change, the more U.S. trade policy, save for a dab here or a touch there, stays the same.

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# Deja Vu on Anti-Dumping Laws

By MICHAEL A. MEYER

President Clinton recently outlined a trade policy that seems strikingly similar to that pursued by U.S. presidents for the past 20 years: Fight for open markets abroad while "enforc(ing) our trade laws and our agreements with all the tools and energy at our disposal."

While the benefits of opening foreign markets to U.S. products seem obvious, the value of enforcing U.S. trade laws, as now written and applied, is not as clear. For example, protectionist anti-dumping laws are a big burden on U.S. companies.

As customs tariffs have declined as a result of seven GATT rounds of tariff reductions, many countries have turned to their anti-dumping laws to protect their industries from foreign competition. More than 30 countries have anti-dumping laws on their books and another 12 are in the process of implementing such laws.

During the 1980s, GATT member countries brought 1,456 anti-dumping cases, of which 144 were directed against U.S. exports.

The theory of anti-dumping law, though criticized, can be defended. Theoretical anti-dumping law attempts to prevent foreign companies from stealing market share by subsidizing cheap exports with monopoly profits gained in a protected home market.

In practice, however, the major users of anti-dumping law (the United States, the European Community, Canada, Mexico and Australia) do not require monopoly power to find dumping. For example, Hong Kong sweater makers were found to be dumping in the United States even though Hong Kong prices were set by nearly perfect conditions of competition (hundreds of producers, no subsidies or import barriers).

Anti-dumping law has become, essentially, a legalized price-fixing scheme. Domestic producers are encouraged, and are often required, to take concerted action against foreign competitors by filing anti-dumping petitions on behalf of U.S. industries. The outcome of this concerted effort is often increased prices. The Commerce Department finds dumping in 97% of the cases placed before it.

A determination of dumping by Commerce, and a subsequent injury finding by the International Trade Commission, results in the application of punitive duties on all imports of the merchandise under investigation from the subject countries — in short, a price hike ultimately paid by the consumer.

The price increase on foreign merchandise invites domestic producers to raise their prices as well. If the imported product is subject to a 20% anti-dumping duty, domestic producers know they can raise prices by 19.9% and still win sales.

Anti-dumping investigations have become so burdensome that even the threat of a case causes price increases. For example, in late January, the Big Three automakers threatened to file anti-dumping petitions against car imports. Even though that threat was rescinded in mid-February, Honda, Toyota and Mazda announced 1% to 1.5% price increases on their U.S. exports "to head off protectionism." The Big Three got their price increase without lifting a finger.

Tough anti-dumping laws are beginning to take their toll on the world economy. In 1990, a U.S. association of computer screen manufacturers filed anti-dumping petitions against flat panel display screens from Japan. Anti-dumping duties were ultimately assessed against two types of flat panels, even though there was no domestic producer of one of them.

Since the anti-dumping duties rendered the Japanese screens prohibitively expensive, U.S. computer manufacturers were forced to move their manufacturing operations offshore since there was no domestic supply. U.S. anti-dumping law does not include a provision that requires an assessment of the public interest prior to the imposition of anti-dumping duties, nor does it allow for the suspension of such duties in the event of short supply. The result was a loss of U.S. manufacturing jobs in order to protect a U.S. industry that does not exist — hardly an outcome that would be sought by a president promising to create jobs.

U.S. exporters also suffer from the application of other countries' anti-dumping laws. When U.S. negotiators fight to make tough anti-dumping laws even more protectionist in the GATT world trade talks, they don't realize the protectionist rules they are fighting to preserve and "improve" will be used against U.S. exporters in foreign markets.

A company like Caterpillar is a good example of how a U.S. manufacturer can be hit by anti-dumping laws on both sides of the ocean. Caterpillar is forced to pay higher prices for steel in the United States since almost every steel product is currently subject to or threatened with an anti-dumping investigation. The higher import prices raise Caterpillar's costs and thus make its products less competitive abroad. If Caterpillar happens to sell heavy machinery abroad at prices lower than its U.S. prices, it will be hit with foreign anti-dumping duties even if it is doing nothing that most businesses would consider "unfair."

With a new administration, the time has come to revamp U.S trade laws. The United States should return to the position on anti-dumping laws it adopted during the Kennedy Round of GATT negotiations: Propose a fundamental review of whether the concept of anti-dumping law makes sense economically. The original U.S. request was quashed by the European Community. In 1989, during the Uruguay Round negotiations, the United States joined the EC in squelching similar proposals by Norway, Sweden, Finland and Hong Kong.

In a bold parting move, former United states Trade Representative Carla Hills requested a two-year study by the International Trade Commission analyzing the effect of the U.S. anti-dumping laws on domestic producers, consumers and the U.S. economy. The commission has requested that trade representative Mickey Kantor reaffirm the administration's interest in this request. The administration should seize this opportunity.

In his American University address, Mr. Clinton recognized the value of "open and competitive commerce." Rather than repeating the age-old mantra of "tough enforcement of trade laws," the administration should examine seriously whether these laws actually improve U.S. competitiveness and create jobs.

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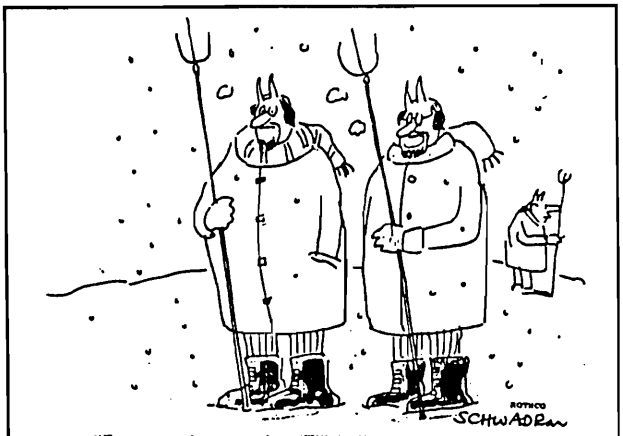


"Everyone kept saying 'Till hell freezes over' like it would never happen."

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*Hobart Rowen*

# Fog Over Free Trade

I desperately wanted to enthuse about President Clinton's speech last Friday at American University broadly endorsing the principles of free trade, rejecting protectionism and pledging that America will lead the way to global economic growth.

Clinton, obviously troubled that his administration was beginning to be seen as tilting toward protectionism, pledged to "compete, not retreat" into isolationism.

"The truth of our age is this, and must be this," he said. "Open and competitive commerce will enrich us as a nation. It spurs us to innovate. It forces us to compete. It connects us with new customers. It promotes global growth without which no rich country can hope to grow wealthier. . . . And so, I say to you, in face of all the pressures to the reverse, we must compete, not retreat."

Could anyone who believes firmly in such principles ask for anything more?

The answer is: Yes.

Free traders would be more assured if somewhat dissonant themes were not being heard from various members of the Clinton administration. Many of its top officials persist in advocating "tough" or "activist" programs to help specific industries at home.

"There still appear to be two tracks," says trade expert Gary Hufbauer of the Institute for International Economics. Clinton confused the issue with recent appearances in Silicon Valley and at the Boeing Seattle plant, where he promised government intervention that seems incompatible with the open trade vision he painted at American University.

At the Boeing plant, he blamed European subsidies for Airbus for the prospective loss of 28,000 Boeing jobs and threatened retaliation, even though the problems faced by Boeing and other aircraft manufacturers relate more to overcapacity and the weakness of their airline customers.

And how about the Bill Clinton who appeared in California's Silicon Valley, where he unveiled a plan for a government partnership with high-tech industries that over four years, will cost Uncle Sam about $17 billion? That fulfills his campaign pledge to create "a civilian technology agency [that] will bring businesses and universities together to develop cutting-edge products and technologies."

But it raises questions about whether such a partnership would go beyond matching, tit for tat, what other nations do, or whether it would supply a crutch to inefficient companies or industries. Author and investment banker Jeffrey E. Garten, who has sympathy for Clinton's general goals of promoting investment, tells me: "I get nervous: Clinton may take industrial policy to a point where it could backfire."

Then there are the protectionist rumbles one hears from the Clinton trade team. Secretary of Commerce Ron Brown hinted last week that perhaps the administration itself would pursue the suit charging that Japanese auto companies "dump" cars here below cost—even though Detroit has abandoned that lawsuit.

And what does one make of U.S. Trade Representative Mickey Kantor's prickly broadsides against the European Community, talking tough about meeting subsidy with subsidy?

Paula Stern, former chair of the International Trade Commission, and a Clinton adviser during the campaign, thinks it a mistake to label what's going on, as some do, a "good cop, bad cop" approach.

Stern brushes aside the Brown and Kantor comments as irrelevant, part of a leftover agenda. She said in an interview that Clinton had laid down a challenging, non-protectionist blueprint for America's future international economic policy at AU: "Listen to what the president said at American University. That was the true Bill Clinton, a comprehensive summary of his principles."

I hope Stern is right. If she is, some concrete steps should be taken immediately to demonstrate that there was more than fine rhetoric at American University. For example, the auto industry's greedy effort to boost tariffs on mini-vans by 1,000 percent should be rejected, decisively, by Treasury Secretary Lloyd Bentsen.

An even more critical test will be whether the president pursues a "fast track" approach to get the GATT round settled. He mentioned the need only for "prompt" action at AU. But "fast track" is the code word for getting action on GATT in this Congress. Yet Kantor, in discussions with European officials, raises questions on whether new elements should be added to the GATT agenda that could cause delay or even failure.

Finally, it will take time to see whether fears as expressed by Garten on industrial policy are valid. In this area, Clinton is clearly influenced by Economic Council Chairman Laura Tyson's "cautious activism," as outlined in her recently published book, "Who's Bashing Whom?"

Such "cautious activism" would mean tax credits and other government assistance. But a senior Treasury official confides: "We must make sure the private sector puts their money in first, backing their judgment with their own money."

Bottom line: Bill Clinton is not a protectionist. He also rejects laissez-faire. He said at AU that he rejects the advice of those who would "build walls to protect" and those who "would do nothing in the face of foreign competition." Even after the AU speech, we don't know where he draws the line in between.

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UNITED STATES INTERNATIONAL TRADE COMMISSION

# POTENTIAL IMPACT ON THE U.S. ECONOMY AND SELECTED INDUSTRIES OF THE NORTH AMERICAN FREE-TRADE AGREEMENT

# EXECUTIVE SUMMARY

This report examines (1) the overall economic effects of the North American Free-Trade Agreement (NAFTA) on the economies of the United States, Mexico, and Canada; (2) the key NAFTA provisions and related legal changes for the United States, Mexico, and Canada that may significantly affect individual sectors; and (3) the short- and long-term impact of NAFTA on important industrial, energy, agricultural, and service sectors of the U.S. economy. The report also summarizes recent economic developments in Mexico that, in conjunction with NAFTA, are likely to affect the potential for U.S. investment and market access in Mexico.

Since the mid-1980s, Mexico has been opening its economy to foreign competition by liberalizing its trade and investment policies, privatizing many state-owned or -controlled economic sectors, and reducing subsidies. NAFTA will remove many remaining barriers to trade and investment and will help to ensure that Mexico's recent economic reforms remain in place, thus paving the way for greater economic integration among the three countries.

Under NAFTA, the United States and Canada will gain greater access to the Mexican market, which currently is the fastest growing major export market for U.S. goods and services. Second, NAFTA will create investment opportunities that will facilitate trade among the member countries in many sectors and that may reduce impediments to future trade growth. Third, NAFTA will lead to a more predictable business environment, reducing risks associated with investment and other business decisions. Fourth, NAFTA will improve the competitive position of certain U.S. sectors in North American and global markets. Finally, NAFTA is an important step towards free trade throughout the hemisphere. However, as noted below, NAFTA is also likely to affect certain U.S. sectors adversely.

NAFTA incorporates on a trilateral basis most of the provisions of the existing United States-Canada Free-Trade Agreement (CFTA) and in many instances expands upon those provisions. Because both the United States and Canada already have implemented CFTA, the principal effects of NAFTA on U.S. economic sectors will result from changes in United States-Mexico trade and investment. Mexico will be required to make many more legal changes than either the United States or Canada to implement NAFTA.

Trade and investment within North America are important to all these nations. The United States and Canada are each other's major trading partner and Mexico is the United States' third-largest partner after Canada and Japan. In 1991, Canada accounted for 19 percent of U.S. merchandise trade, Japan 15 percent, and Mexico 7 percent. The United States is Mexico's largest trading partner and source of foreign direct investment (FDI), accounting for almost 70 percent of total Mexican trade in 1991 and 61 percent of Mexico's cumulative FDI by value as of June 1992. Mexico is likely to benefit substantially more from NAFTA than either the United States or Canada because its gross domestic product (GDP) is only 5 percent of U.S. GDP, its economy historically has been closed, and trade with the United States is relatively more important to its economy.

## Economic Trends in Mexico

- Mexico's ongoing market-oriented reforms have spurred foreign investment and trade, leading to higher growth for the nation's economy overall. Austerity measures have reduced inflation from triple-digit levels as recently as 1987 to an estimated 11 percent in 1992. Following economic stagnation during 1982-88, the Mexican economy grew by an annual average rate of nearly 4 percent during 1989-91. In 1992, however, economic growth in Mexico is expected to slow to 2.7 percent. FDI in Mexico in 1991 rose by 81 percent over the 1990 level, and foreign portfolio investment roughly quadrupled in both 1990 and 1991. During the first half of 1992, FDI rose by 13 percent over the 1991 period, whereas foreign portfolio investment fell by 3 percent.

## Likely Impact on U.S. Service Sectors

- U.S. services sales to Mexico of approximately $8 billion represent a very small fraction of the industries' $257 billion in worldwide sales. Restrictions prevented U.S. companies in most service sectors from providing services to Mexico directly through a local establishment and in many cases from providing services on a cross-border basis.

- CFTA enabled U.S. service providers to increase their already significant investment and participation in the Canadian services market. U.S.-Canadian services trade and investment are not expected to change appreciably under NAFTA. The principal exception is in construction and related services, for which Canada has agreed to go beyond CFTA obligations to open its federal government procurement of these services to U.S. providers over a 10-year period.

- The benefits and obligations provided to Mexico under NAFTA are similar to those contained in CFTA. NAFTA is expected to create opportunities in Mexico for U.S. service providers, either through increasing cross-border trade or by investing in or establishing Mexican enterprises. U.S. investment is expected to increase by 6 to 15 percent in Mexico's telecommunications and banking services sectors in the long term. A similar increase is expected in U.S. investment in Mexican transportation services in the short term and is likely to exceed 16 percent in the long term. Mexican investment in the transportation services industry is anticipated to increase between 6 and 15 percent, concentrated in the U.S. border States.

- Removal of Mexico's restrictions on foreign equity ownership in the insurance market is likely to result in an expansion of U.S. investment in this market by 16 percent or more in both the short and long term. However, cross-border trade in insurance services will remain small and largely unaffected by NAFTA because of different regulatory practices in each country (at the state or province level) requiring that insurance transactions be conducted only by formally licensed companies or subsidiaries (not branches) within a given jurisdiction.

- U.S. receipts from sales to Mexico of telecommunication, transportation, construction and engineering, and banking services are likely to increase in the long term between 6 and 15 percent as a result of NAFTA. Specialized environmental engineering services will offer potential growth opportunities for U.S. firms. U.S. payments to Mexico for transportation, engineering, and construction services are expected to rise by 5 percent or less in both the short and long term, with the increases accruing primarily to border areas.

- U.S. operations and employment in most services sectors covered in this report are expected to increase relatively little in the short term and by less than 5 percent in the long term as a result of NAFTA. The principal exception is transportation services where U.S. firms are currently unable to provide cross-border services with Mexico. The U.S. sector is expected to show gains of 6 to 15 percent from the opening of Mexico's market for trucking and rail services under NAFTA, expected infrastructure improvements, and an overall increased demand for transportation services generated by NAFTA.

- Greater access to Mexican markets is expected to result in a small but positive increase in the ability of most U.S. services to compete in North America and globally as the result of the experience gained in a developing market and the potential gateway to further trade in Latin America. In addition, the increase in U.S. investment and trade in services in Mexico under NAFTA will benefit other sectors, as better trucking and rail services and increased efficiency of Mexican banks facilitate merchandise trade flows between the United States and Mexico. Such indirect benefits from NAFTA may affect service sectors in the United States more than will direct benefits from tariff removal only.

## Likely Impact on U.S. Agricultural Sectors

- In the agricultural sectors, U.S. trade with Mexico generated a surplus of $53 million in 1991. Currently, about 40 percent of Mexican agricultural goods enter the United States duty-free and the remaining products are dutiable at an average rate of 8 percent ad valorem. U.S. agricultural exports to Mexico are subject to year-round and seasonal tariffs of 10 percent or more. In addition to tariffs, the United States maintains quotas on certain agricultural imports from Mexico, and Mexico requires import licenses for U.S. agricultural products. U.S. health and sanitary requirements reportedly have slowed the trade flow from Mexico in certain products.

- Canada is the only significant agricultural trading partner with which the United States has a trade deficit in the sector. In 1991 the U.S. trade deficit with Canada in the agricultural sector totaled $239 million; in addition, in lumber and wood products the United States posted a much greater trade deficit with Canada of $2.4 billion.

- The most significant NAFTA provisions affecting trade in agriculture relate to market access. In part, these provisions provide for tariffication of nontariff barriers and the subsequent elimination of these and existing tariffs. The agreement provides different arrangements for the treatment of agricultural trade between the United States and Mexico and between Canada and Mexico. Because of these differences and the existence of CFTA, NAFTA has no practical effect on tariffs and on most nontariff barriers applicable to U.S.-Canadian trade in agricultural products.

- U.S. investment in Mexican agriculture is small compared with investment in manufacturing and services. However, it is expected to increase in the long term by 6 to 15 percent for poultry and fish processing; investment is likely to increase between 6 and 15 percent in the short term and by 16 percent or more in the long term for citrus products, grains and oilseeds, and alcoholic beverages. U.S. investment in domestic fresh-cut roses is expected to decline between 6 and 15 percent in both the short and long term as a result of added Mexican investment in its domestic industry and anticipated increases in U.S. imports from Mexico.

- NAFTA's effect on U.S. agricultural trade is likely to be relatively small compared with current sector production. NAFTA is likely to result in long-term increases of 6 to 15 percent in U.S. exports to Mexico of alcoholic beverages and canned sardines and in U.S. imports of Mexican citrus juices (especially frozen concentrated orange juice) and fresh-cut roses. Long-term increases of 16 percent or more are likely in U.S. exports to Mexico of grains and oilseeds, deciduous fruits, poultry, swine and pork, beef offals, fresh citrus, and certain cut flowers (including high-quality roses).

- NAFTA is likely to have little or no impact on most agricultural sectors examined in this report. Sectors likely to experience production and employment gains of 1 to 5 percent in the long term include fisheries and grains and oilseeds. Production and employment losses of less than 5 percent in the short or long term are expected in citrus juice, shrimp, certain fresh and frozen vegetables, peanuts, and fresh-cut flowers (including fresh-cut roses).

- NAFTA is not likely to affect the overall ability of U.S. agriculture to compete globally. Certain U.S. agricultural sectors are likely to be more cost competitive in the North American market over time, including grains and oilseeds, deciduous fruit, poultry, certain livestock and meat, alcoholic beverages, cotton, and dairy products. Removal of U.S. tariffs under NAFTA is expected to result in a slight decline in the U.S. share of the North American market for citrus juice, certain frozen vegetables, noncitrus fruits (e.g., grapes, melons, and strawberries), and fresh-cut roses.

- NAFTA's impact on trade in agricultural goods subject to U.S. quotas will likely vary. U.S. sugar imports from Mexico and sugar exports to Mexico will depend on whether or not Mexico eventually becomes a net surplus producer of sugar. For goods subject to section 22 quotas (cotton, dairy products, peanuts, and sugar-containing articles), NAFTA will likely have little or no effect on the level of U.S. imports from Mexico. For U.S. exports to Mexico, NAFTA will likely result in little or no increase in sugar-containing articles and in long-term gains of 16 percent or more in cotton and dairy products (especially nonfat dry milk), and less than 5 percent in peanuts.

- Many sectors of U.S. industry are much larger and more technologically advanced than their Mexican counterparts, giving U.S. producers a competitive advantage. However, U.S. producers are at a substantial disadvantage with Mexican firms in terms of wage rates, although this disparity is offset in part by lower productivity and rising costs in Mexico associated with financing, transportation, and infrastructure.

- U.S. production and employment gains of between 1 and 5 percent in the long term are likely in industrial machinery, and in computers, computer components, and electronics; gains of less than 1 percent are likely in machine tools, bearings, textiles, pharmaceuticals, steel mill products, and chemicals. The automotive parts industry is expected to gain 6 to 15 percent in production and less than 5 percent in employment in the long term.

- U.S. production and employment losses of less than 5 percent are likely in apparel in both the short and long term. Losses between 6 and 15 percent in the long term could occur in major household appliances, flat glass, and certain segments of household glassware and ceramic tile. Although the automotive products sector is likely to be virtually unaffected by NAFTA in the short term, automobile production and employment likely will decline in the long term by less than 5 percent.

- NAFTA is expected to have a small but positive effect on the ability of many U.S. industrial sectors to compete in both North American and global markets. In particular, the agreement is expected to boost the ability of the U.S. bearings and textile industries to compete in North America, and to benefit certain major U.S. apparel firms in competing with East Asian products in the United States and Mexico. For the majority of U.S. apparel firms, however, and for the household glassware industry, the elimination of quotas and/or duties is likely to generate added competition in the U.S. market by Mexican producers.

## Likely Impact on U.S. Energy Sectors

- U.S. trade with Mexico in energy products covered in this report was marked by a deficit of $4.6 billion in 1991. Currently, the opportunities for U.S. trade and investment in Mexican energy sectors are very limited. Virtually all aspects of investment, production, and distribution are reserved to the State. Although U.S. companies provide a significant amount of the services procured by the Mexican parastatals—Petroleos Mexicanos (PEMEX) and Comision Federal de Electricidad (CFE)—current procurement procedures tend to favor Mexican suppliers.

- The U.S. trade deficit with Canada in energy products covered in this report was $8.6 billion in 1991. The Canadian energy sectors are relatively open to U.S. trade and investment. The energy provisions of NAFTA are virtually identical to those of CFTA and, thus, are not likely to have any added effect on U.S.-Canadian energy trade and investment.

- NAFTA recognizes Mexico's constitutional reservation of State ownership and control of most of its energy industry, including ownership of subsoil resources, investment in exploration and production, control of services related to energy products, and distribution of these products in Mexico. Because Mexico is not bound by most of the energy provisions in NAFTA, there is only minimal potential for increased energy trade and investment between the United States and Mexico as a result of NAFTA. Little or no increase in U.S. production and employment is likely.

- NAFTA does provide, however, some increased opportunities for U.S. service providers to contract with PEMEX and CFE. The agreement's government procurement provisions will permit foreign firms to bid on 50 percent of PEMEX and CFE contracts immediately on a non-discriminatory basis and the percentage will increase to 100 percent of such contracts after 9 years, subject to some specific exceptions.

- NAFTA will also permit private U.S. and Canadian investment in the production of most petrochemicals and in certain electricity generating facilities (self-generation, cogeneration, and independent power plants), although public sale of electricity remains prohibited.

- In most cases NAFTA will require that each country's federal government procurement process for covered goods be opened further on a nondiscriminatory basis to suppliers from the other NAFTA nations. The elimination of most domestic procurement preferences and the requirement for transparent procedures represent the first legal obligations for open competition in the Mexican Government's procurement market, since Mexico, unlike the United States and Canada, is not a signatory to the General Agreement on Tariffs and Trade (GATT) Agreement on Government Procurement.

## Likely Impact on U.S. Industrial Sectors

- The United States in 1991 recorded a favorable balance of trade with Mexico in the industrial sectors covered in this report, with U.S. exports to Mexico of $16.8 billion exceeding U.S. imports from Mexico by $1.1 billion. U.S. tariffs on Mexican goods average 3 percent in nominal terms, whereas Mexican tariffs on U.S. products average 10 percent. However, the effective tariffs for bilateral trade are lower because of the maquiladora arrangement and other special customs programs. In addition to tariffs, restrictions such as U.S. quotas on textiles and apparel and Mexican domestic content and investment requirements have acted as barriers to trade and investment.

- The United States in 1991 posted a trade surplus with Canada in the covered industrial sectors, with U.S. exports to Canada of $46.8 billion exceeding U.S. imports from Canada by $2.8 billion. Tariffs on all products except selected agricultural goods traded between the United States and Canada are already being phased out under CFTA, and no major nontariff restrictions remain.

- The United States accounts for a large portion of total FDI in Mexico's industrial sectors, primarily under the maquiladora program (which involves the processing or assembly of U.S. components in Mexico for export to the United States). Under NAFTA, U.S. investment in Mexico is expected to increase between 6 and 15 percent in major household appliances, and computers, computer components, and electronics in the short term, and in bearings and pharmaceuticals in the long term. Long-term increases in U.S. investment to Mexico of 16 percent or more are anticipated for autos and automotive parts; computers, computer components, and electronics; major household appliances; and apparel. Some of the expected growth in U.S. investment in sectors such as apparel and computers, computer components, and electronic equipment is likely to represent a shift in investment from East Asia and other developing countries to Mexico.

- NAFTA is likely to result in short- and long-term increases in U.S. trade with Mexico in all industrial sectors covered. Long-term increases of between 6 and 15 percent are expected in U.S. trade in the following sectors (in some broad sectors both imports and exports are expected to increase):

| U.S. exports | U.S. imports |
|---|---|
| bearings | bearings |
| machine tools | household glassware |
| steel mill products | steel mill products |
| pharmaceuticals | |
| industrial machinery | |
| chemicals | |
| major household appliances | |

- Long-term increases of 16 percent or more are likely as a result of NAFTA in the following sectors:

| U.S. exports | U.S. imports |
|---|---|
| autos and automotive parts | autos and automotive parts |
| computers, computer components, and electronics | computers, computer components, and electronics |
| textiles and apparel | textiles and apparel |
| ceramic tile | ceramic tile |
| household glassware | major household appliances |

- Based on the sectors covered in this report where regional effects were identified, regions more likely to be affected by long-term production and employment changes as a result of NAFTA are the Midwest, the South, and the West. Industries in these regions likely to experience gains are machine tools, bearings, industrial machinery, steel mill products, pharmaceuticals, textiles, grains and oilseeds, cotton, lumber and wood products, and automotive parts. Industries in these regions likely to experience losses are automobiles, apparel, flat glass, certain household glassware, major household appliances, shrimp, peanuts, certain fresh and frozen vegetables, citrus juice, and fresh-cut roses. Likely production and employment effects for U.S. industries in other regions are noted in chapter 2 of this report.

## Key NAFTA Provisions Affecting U.S. Trade and Investment

- The key NAFTA provisions affecting U.S.-Mexican investment and trade include the removal of tariffs and quotas, the imposition of strict and transparent rules of origin, and the limitation on duty drawback. NAFTA also will require changes in Mexican law or the maintenance of recent Mexican reforms to ensure removal of many restrictions on FDI, stronger intellectual property protection, and a more open services market and government procurement process for U.S. firms.

- NAFTA prohibits the adoption of new customs duties on qualifying goods and contains a schedule of staged duty reductions for each party, divided into four general staging categories plus a category for goods remaining free of duty. The staged duty reductions affecting U.S. trade with Mexico are approximately as follows (based on a percentage distribution of 1990 trade):

| Category | | U.S. imports from Mexico | U.S. exports to Mexico |
|---|---|---|---|
| A | (free on implementation) ..... | 53.8 | 31.0 |
| B | (free within 5 years) ..... | 8.5 | 17.4 |
| C | (free within 10 years) ..... | 23.1 | 31.8 |
| C+ | (free within 15 years) ..... | .7 | 1.4 |
| D | (currently free) ..... | 13.9 | 17.9 |

Note.—U.S. imports from Mexico in category D are principally those imports entered under duty-free most-favored-nation rates. It should be noted that there are duty-free imports from Mexico under other tariff provisions, such as the Generalized System of Preferences and those relating to production sharing programs. In total, about 45 percent of U.S. imports from Mexico enter duty-free. For further discussion of the data, see appendix F of this report.

- NAFTA rules of origin are intended to ensure that the benefits of tariff reductions will accrue principally to the NAFTA parties and to provide incentives for North American production and sourcing. Comparing CFTA to NAFTA, to qualify as a North American product under NAFTA a number of industrial sectors would be subject to stricter and more detailed change in tariff classification rules, higher and more stringent value-content requirements, and rules requiring that certain subassemblies be produced in North America. These sectors include automotive goods, computers and other electronic equipment, machine tools, steel mill products, textiles and apparel, major household appliances, industrial machinery, and bearings.

- The limitation on duty drawback will contribute to the establishment of an integrated North American market by discouraging the creation of "export platforms" in one NAFTA country to serve markets in another NAFTA country. The NAFTA limitation is intended to ensure that when non-North American components and raw materials are imported into North America, they will be subject to ordinary customs duties without regard to whether such imports are consumed in the country of importation or shipped to another NAFTA country.

- Mexican exports grew by 19 percent during 1989-91, and imports rose by 50 percent. During January-July 1992, Mexican exports rose only 1 percent over the 1991 period, whereas imports accelerated 29 percent. The growth in Mexican imports is largely due to increased purchases of capital goods to support Mexico's modernization of its manufacturing base and infrastructure. The United States supplies two-thirds of Mexico's total imports, and capital goods are a leading U.S. export to Mexico. Since 1989 the Mexican trade deficit has widened and reached $11.4 billion in January-July 1992, surpassing the deficit for all of 1991.

- Remaining economic challenges for Mexico include financing its growing trade deficit, alleviating the shortage of highly skilled workers, and expediting improvement of the highway system, electricity, and telecommunications. The Government has recently launched efforts to modernize infrastructure in conjunction with private participation, as well as to improve education, productivity, and product quality.

- Mexico's regulatory reforms have been accompanied by efforts to address environmental issues. While Mexican environmental laws and regulations are in many instances comparable to those in the United States, concern remains about Mexico's enforcement of such laws and regulations. The Mexican Government has stated its commitment to stricter enforcement and has recently taken additional actions toward this end.

## Likely Impact of NAFTA on Member Economies

- Empirical evaluations generally conclude that NAFTA is likely to produce net aggregate gains for each of the member countries in both the short term (within 1 year) and long term (after complete phase-in of NAFTA). Estimated long-term gains in U.S. and Canadian real GDP are 0.5 percent or less. Projected long-term gains in Mexican real GDP range from 0.1 to 11.4 percent.

- Projected long-term gains in aggregate employment are less than 1 percent for the United States and Canada but up to almost 7 percent for Mexico. Expected increases in average real wages are 0.3 percent or less for the United States, 0.5 percent or less for Canada, and 0.7 to 16.2 percent for Mexico. Although the evidence on the direction of real wage effects for low-skilled and high-skilled U.S. workers is mixed, the preponderance of evidence indicates an almost indiscernible effect on U.S. wage rates for both low-skilled and high-skilled workers.

- NAFTA is expected to expand U.S.-Mexican trade substantially. Estimated gains in U.S. exports to Mexico range from 5.2 to 27.1 percent. Projected increases in U.S. imports from Mexico range from 3.4 to 15.4 percent.

- NAFTA is expected to provide further impetus for increased FDI in Mexico. Analysts disagree over the likely origin and magnitude of the expected increase in FDI, but generally agree that such investment flows will provide Mexico with greater benefits than will the reduction in trade barriers.

- NAFTA is expected to have minimal additional effects on trade and investment between the United States and Canada, because the majority of NAFTA's provisions have already been implemented under CFTA. Canadian gains under NAFTA are expected to be small, reflecting the existing CFTA and the low level of trade and investment flows between Mexico and Canada.

- Mexico's improved access to advanced technology could lead to a long-term increase in Mexico's rate of economic growth (i.e., dynamic gains). The United States and Canada, as longstanding participants in a global open trading regime, may not realize substantial dynamic gains from NAFTA, but will most likely benefit from market opportunities created by economic growth in Mexico.

- NAFTA's impact on the United States will vary from region to region. Various economic studies suggest that the border region will benefit substantially under NAFTA. The sector analyses in this report suggest that the effects on U.S. industries in other regions will range from beneficial to adverse.

# IIE Study Assesses Likely Effectiveness of NAFTA

The North American Free Trade Agreement (NAFTA) will create about 170,000 *net* new jobs in the United States by 1995 while reinforcing the fast pace of change in the Mexican economy according to a new study published by the Institute for International Economics (IIE), a Washington-based think tank. The study maintains that the NAFTA will also benefit the third party to this agreement, Canada, by expanding export opportunities for Canadian firms in Mexico in several key sectors while simultaneously reinforcing its free trade preference in the U.S. market. Written by Gary Clyde Hufbauer and Jeffrey J. Schott, of the IIE, *NAFTA: An Assessment* examines the shape, form, and content of the prospective NAFTA, its potential trade and employment effects, the environmental concerns associated with it, and the implications for key sectors of each national economy.

For the NAFTA to succeed, the authors state that all three participants—Canada, Mexico, and the United States—must be prepared to undertake major adjustments in their trade policies. The permanent gains associated with such adjustments far outweigh the temporary costs.

"For Mexico," explain Hufbauer and Schott, "the NAFTA reinforces the extensive market-oriented policy reforms implemented since 1985 that have sharply promoted real annual growth of 3 to 4 percent in recent years, and driven a falling rate of inflation." They further maintain that in implementing this agreement, Mexico will better be able to carry forward long overdue structural changes in its automotive, textiles/apparel, finance, telecommunications, and land transportation sectors. "The prospect of NAFTA implementation," they write, has already generated strong expectations, with capital inflows to Mexico estimated at about $18 billion in 1992 (of which about $5 billion was foreign direct investment).

*Fruit picking in Mexico: Mexico's merchandise exports to the United States and Canada topped $30 billion in 1991.*

Hufbauer and Schott say that successful implementation of the NAFTA will directly benefit the United States by contributing to a stronger Mexican economy, which will, in turn, make it a better customer for U.S. and Canadian goods. "For the United States, the NAFTA reforms will enhance an already-important export market." In support of this claim, the authors point out that U.S. ex-



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ports to Mexico have grown rapidly since 1986, and in 1992 reached an annual rate of about $43 billion. Turning to the sensitive question of whether U.S. jobs will be lost as a result of the NAFTA, Hufbauer and Schott argue that, in fact, "NAFTA will exert a modest but *positive* effect on the U.S. labor market." Acknowledging, nevertheless, that some U.S. workers will lose their jobs, the authors say that in these instances it will be up to the U.S. Government "to assist such workers to make the difficult transition to new jobs."

The third party to the NAFTA negotiations is Canada. In an earlier study of the agreement (*North American Free Trade: Issues and Recommendations*, IIE, 1992), Hufbauer and Schott characterize Canada as a reluctant participant in these discussions. This is because Canada's economic interest remains overwhelmingly in the U.S. market. In *NAFTA: An Assessment*, however, the authors present a strong case for active Canadian participation in the agreement. "For Canada," they write, "the NAFTA reinforces, and in some cases strengthens, its free trade preference in the U.S. market." They further point out that although Mexico is a relatively small export market for Canada (under $1 billion), the NAFTA could expand export opportunities in that country for Canadian firms in the key sectors of financial services, automobiles, and government procurement.

Hufbauer and Schott devote much attention to the NAFTA's place in the global trade system. As the economies of North America restructure and grow in response to the combined stimulus of domestic economic reforms and NAFTA commitments, and thus become more competitive in world markets, the larger global trade system—anchored in the General Agreement on Tariffs and Trade (GATT)—will become more important. The future challenge is to ensure that a successful NAFTA will complement, not weaken, the world trade system. To achieve such a result, Hufbauer and Schott call upon Canada, Mexico, and the United States, to make the agreement a model for regional trade liberalization—one that does not erect higher barriers against third countries and one that willingly subjects its details to the scrutiny of the GATT.

Hufbauer and Schott warn however, that if the Uruguay Round breaks down, "the complementary relationship of multilateral and regional initiatives could be at risk." They say that although GATT rules and obligations would still apply to the NAFTA, "confidence in using the multilateral process to resolve trade problems would ebb and would be hard to reverse."

In the meantime, the NAFTA's ultimate success could well hinge on its capacity to accommodate workers' rights and environmental policy concerns. With respect to the first issue, Schott and Hufbauer have consistently argued for more effective U.S. job retraining and income maintenance programs, while also encouraging private firms to expand apprenticeship and other training programs. On the environmental front, the authors suggest that NAFTA members be allowed to enforce environmental provisions with trade penalties in "carefully controlled circumstances." For example, they suggest that if a NAFTA panel finds that a member country's environmental standards or enforcement rigor distorts intraregional trade flows, the other countries could impose "green fees" on *all* regional exports from the offending country.

In sum, conclude Hufbauer and Schott, while the NAFTA's potential should not be exaggerated, it remains a noteworthy achievement.

John Starrels,
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ESI
Economic Strategy Institute

News and Notes
Forging the New American Agenda

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# Improving the NAFTA

## *New ESI Study Says Treaty Can Be Made Better*

In one of the first private-sector analyses of the *actual* North American Free Trade Agreement (NAFTA), the Economic Strategy Institute predicted that the treaty will bring short-term gains but cause long term losses for the U.S. economy, including significant net job loss. The report, titled *NAFTA: Making It Better* and released December 16, praises many features of NAFTA and urges its ratification. But it calls on the Clinton Administration to secure long-term U.S. economic interests by improving several key provisions.

The report, written by ESI Vice President **Lawrence Chimerine** and Adjunct Fellow **Robert B. Cohen,** notes that the agreement is less a free trade treaty than an investment arrangement for structuring trade and investment in North America. In its present form, NAFTA will stimulate foreign investment in Mexico, largely in export industries. According to Chimerine and Cohen, the agreement will boost U.S. net exports to Mexico by $2.8-5.5 billion in 1994, and between $2.8-8.8 billion in 1998. But by 2002, they project that NAFTA will be boosting U.S. net *imports* from Mexico by $1.3-8.8 billion. These changes translate into a gain of between 70,000 and 137,500 jobs in 1994, a gain of 70,000 to 200,000 jobs in 1998, but a loss of 32,000 to 220,000 jobs in 2002.

To improve the agreement, the report recommends:

·Encouraging Mexico to reduce and eliminate certain tariffs and quotas ahead of schedule. In some sectors Mexico is a world-class competitor and continued protection has no more economic justification;

·Encouraging exports to non-North American destinations by providing Mexico with Export-Import Bank credits and establishing cooperation among the U.S., Canadian and Mexican Foreign Commercial Services;

·Linking Mexican local content requirements in the auto sector to increases in tandem with any increase in their imports of U.S.-built cars into Mexico;

·Moderating job losses in sectors, like textiles and apparel, by shifting to Mexico a portion of the growth in certain quota areas of nations with large textile and apparel surpluses with the United States;

·Adopting a comprehensive, well funded program to create a high-skill, flexible American work force; and

·Clarifying the means of achieving NAFTA's environmental objectives. A specific program with concrete goals, timetables, budgets, and monitoring mechanisms should be created with funding provided by bond issues from the NAFTA governments.

*Making It Better* is distinctive in several ways. Unlike reports done before the negotiations were completed, *Making It Better* examines the final signed agreement. Moreover, the study used an economic model that captures the dynamic, long-term effects of foreign investment in Mexico; other studies simply assumed that such investment would not divert capital from United States and that would be spread uniformly across the Mexican economy.

Finally, Chimerine and Cohen focused on specific sectors (e.g. motor vehicles, auto parts, poultry and meat processing, apparel and textiles, telecommunications, and computers) where foreign investment in Mexico is most likely to occur as a result of the agreement.

*(Copies of the study are available from ESI at a cost of $9.95. Add $2.50 per item for shipping and handling; $5.00 per item for orders outside the United States.)*

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TRADE

# Tougher Safeguards Pushed For NAFTA Accord

As the Clinton administration opened talks with Mexico and Canada on expanding the North American Free Trade Agreement (NAFTA), congressional Democrats warned about a possible revolt within party ranks over the controversial pact unless considerably tougher safeguards are negotiated for U.S. jobs and the environment.

The new round of talks in Washington, which began March 17, is part of an administration strategy to shore up support for NAFTA, which would eliminate trade and investment barriers with Mexico and make some changes to the existing U.S.-Canada Free Trade Agreement, before the pact is submitted to Congress later this year for an approval vote.

U.S. Trade Representative Mickey Kantor has insisted that the basic NAFTA text negotiated by the Bush administration is not open for changes. But the talks are expected to produce supplemental agreements setting forth ways to improve compliance with environmental laws and worker rights statutes in all three countries.

Testifying before several House and Senate committees recently, Kantor has sought to allay congressional concern that NAFTA will encourage U.S. businesses to relocate to Mexico to take advantage of lower wages and lax pollution controls. The administration wants to establish separate tri-national commissions on labor and environmental issues. But Kantor said these panels should not have the power to levy fines or sanctions because this would infringe on national sovereignty.

As a result, many members of Congress remain concerned, either because they oppose the idea of lowering trade barriers with Mexico or because they fear that the additional agreements negotiated by the administration will lack necessary enforcement powers. Mexican officials have insisted that the discussions do not even qualify as negotiations and are merely aimed at improving "cooperation and collaboration."

"If we do not address environmental enforcement, we will have an incomplete agreement, an agreement that I, for one, will not support," said Max Baucus, D-Mont., who chairs the Senate Environment and Public Works Committee and the Finance Committee's Trade Subcommittee.

*By David S. Cloud*

R. MICHAEL JENKINS

**Kantor on March 16 describes plans for negotiations to supplement NAFTA.**

Baucus recommended that Kantor push for a provision permitting NAFTA signatories to impose trade sanctions against one another's products in cases when persistent failure to enforce environmental statutes gives those products a competitive advantage. The idea is being pushed by environmental and citizens' groups as a way to prevent Mexico from becoming a "pollution haven" that would attract U.S. businesses.

Kantor said the idea "bears great possibilities," telling reporters later that he did not believe it would infringe on Mexico's sovereignty.

### Too Early to Judge

It is too early to know whether congressional opposition is substantial enough to kill the pact. Some Democrats who are complaining now say they might well support the final product if the White House addresses their concerns. In addition, President Clinton can expect to win many Republican votes for the free-trade agreement when he sends it to Capitol Hill.

Kantor's position that the treaty itself will not be renegotiated has hardened since he took office. During his confirmation hearing, he indicated that the administration might be willing to reconsider the section of the agreement covering sugar, which the industry has charged will flood the United States with Mexican imports. But Kantor reversed himself in an appearance before the Finance Committee on March 9, saying: "If we reopen the agreement . . . it would become a mess."

In recent weeks, key lawmakers have signaled their opposition to the pact in its present form. House Majority Leader Richard A. Gephardt, D-Mo., said he would oppose the agreement in the absence of measures to ensure that Mexico complies with its environmental and labor laws. Gephardt denied that there was a split between him and the White House, adding that he felt the sovereignty question could be dealt with in a way acceptable to all countries.

Gephardt has expressed concern since the NAFTA negotiations began in 1991 about how Mexico and the United States would pay for cleaning up the heavily polluted border region, where many Mexican factories are located. He called for an "ironclad" funding mechanism, although he seemed to pull back from his own proposal for a border tax, which Clinton has not endorsed. *(1992 Weekly Report, pp. 3710, 2699)*

Gephardt also has insisted on more money for retraining workers who lose their jobs as a result of the agreement. The administration has not addressed either of those issues, although it is expected to propose a new worker retraining program before the agreement is sent to Capitol Hill.

Gephardt said he would "reluctantly support" the tariff and investment provisions in NAFTA if his other concerns were addressed.

With a Democrat in the White House, Sen. Donald W. Riegle Jr., D-Mich., seems to have pulled back from a confrontational approach that last year led him to sponsor a measure that would have allowed Congress to amend NAFTA. Amendments are barred under special "fast-track" procedures. Rather than reintroduce the measure, Riegle sent a letter to Clinton signed by 24 fellow Democrats urging negotiations of tough side agreements.

Kantor has pledged that the administration will walk away from the entire NAFTA agreement if it is unsuccessful in negotiating the side agreements. But the administration also hopes to send the legislation implementing the pact and the supplemental agreements to Capitol Hill by the summer, so that Congress can vote on it by the end of the year. The agreement is scheduled to take effect beginning in 1994. ■



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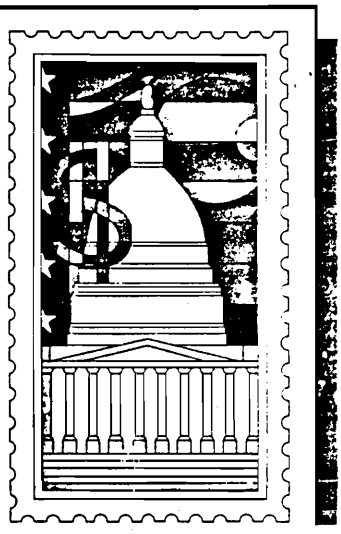
# LETTER FROM WASHINGTON

## *Let Salinas Run World Trade*

*by Harry L. Freeman*



AS WE ENTER THE SEVENTH YEAR OF the on-again-off-again negotiations in the Uruguay Round of the GATT, preceded by over four years of attempts to start this Round, and regardless of the outcome over the next several weeks, one inevitable conclusion is that there must be a better way to conduct future world trade liberalization talks.

What is at stake is the future viability of the world's multilateral trading system. The traditional "Round" approach has clearly run its course. Rumors of its death at the end of the Tokyo Round in 1980 were premature. Now those rumors are reality. Without a clear road to future near-term trade liberalizing talks, the GATT process will stagnate while unfinished business overflows from GATT's in-box.

This issue arises now since the Bush Administration was at least arguably successful in achieving a political breakthrough which would allow most of the Uruguay Round negotiations to be consummated by early 1993. Some major issues would carry over into the first few months of 1993. Presumably the new Administration would notify Congress no later than March 3, 1993, when fast-track authority expires for the Uruguay Round, that it intends to sign the resulting agreement.

The most optimistic scenario from the U.S. (if not the whole world's) perspective would include a four-year run-up period and seven years of negotiations. A pessimistic scenario would be a disastrous collapse of the talks; or, the negotiations continuing well into 1993 with Congress examining the result in 1994, which means a 12-year scenario.

All the possible scenarios in the the Uruguay Round mean that the Clinton Administration, for the sake of the United States and the rest of the world, must face the fact that a traditionally formatted GATT Round no longer cuts the mustard.

Regardless of future bilateral or regional trade agreements, expansion of the NAFTA, or other trade developments, much of U.S. trade policy will still rest on the multilateral trading system now administered by GATT. That system depends on periodic progress in liberalizing trade among an increasing number of countries. But the harsh reality is that the traditional procedure — the trade Round — no longer works.

The Uruguay Round has been extremely ambitious. Many of its critics think it was too ambitious. It not only addressed traditional areas such as market access and tariffs, but it also addressed the so-called "new areas" of services, intellectual property, and trade-related investment measures. It sought to include textiles and agriculture within GATT's structure. There is no doubt that only incremental progress can be made on these issues, and that the Uruguay Round result will not be wholly dispositive of its agenda. Hence, GATT in the near-term future will have its hands full of unfinished business. There is bound to be disappointment in some areas where the progress made does not measure up to the work and years invested. In many areas, the Uruguay Round is now addressing issues framed in the late 1970s.

When the trade negotiators return from the close of the Uruguay Round to their respective constituencies, they will be faced with the question of when and how further progress can be made in many areas which were necessarily compromised. An unacceptable answer would be "Wait until the next Round."

What next Round?

Should we expect a trade Round starting in 1998 with some prospect of ending in 2005? Not a comforting nor reassuring thought. The Round regime worked with a shorter agenda and fewer member countries. Now the GATT faces the prospect of membership of over 125 countries (probably including Russia and the CIS countries and China). New areas

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*Harry Freeman is President of the Freeman Company.*



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of interest will be up for negotiation (such as environmental aspects of trade, competition policy, tax discrimination, fiscal regulation, workers' rights and no doubt many others). A new strong organization that has the capability to do the job for the 1990s and beyond is needed. With members such as Russia and China, a world trade organization would no longer be centered on a U.S.-E.C. dialogue or dispute.

In the past, formally structured Rounds were necessary in order to have sufficient subjects "on the table" to allow possible trade-offs during the negotiation. GATT's future agenda does not lack for subjects, nor lack of areas for compromises or "trade-offs", if that approach is still truly relevant.

Almost a year ago, GATT's Secretary General, Arthur Dunkel, produced a long "draft final text," a document puporting to write out the details and resolution of most of the issues pending in the Uruguay Round, something the trade negotiators had tried but failed to do. Among other provisions, the "Dunkel text" recommended that the GATT be transformed into a new organization, the Multilateral Trade Organization (MTO), under which all of the various GATT Codes negotiated over the years would be aggregated. MTO members would be bound by all codes, a major improvement over past member obligations. It would provide one-stop dispute settlement and provide some needed juridical stature to the GATT.

However, the "MTO" is silent, and therefore flawed, as far as the structure of future negotiations is concerned. It contemplates traditional Rounds. The MTO is important to bring into being as it accomplishes much, but the MTO must be viewed as a transitional organization only because it would perpetuate the now discredited Round system.

*Should we expect a trade Round starting in 1998 with some prospect of ending in 2005? Not a comforting nor reassuring thought.*

A new organization, successor to the GATT and the MTO, is needed. It must be stronger both juridically and in stature, in the same class as the World Bank and the IMF. It must have the power and influence to conduct continuous trade liberalizing talks on a very broad range of subjects. It must have a world-class leader at the helm who would credibly exercise that power.

The mechanism for developing the details for the new organization must be started as the last step in the Uruguay Round. It cannot wait until a year or two down the road.

The immediate action steps are these:

1) The MTO, called for in the "Dunkel draft," should be put into place, but with a prescribed life of no more than 18 months, when a successor organization (WTO) would come into being.

2) A very high-level and representative committee charged with the dual responsibility of (1) devising the precise plan for the new World Trade Organization (WTO) after consultation with all MTO member states; and (2) selecting the leader of the new WTO. The WTO would replace the MTO some 18 months after the MTO came into existence.

Selection of the MTO leader is just as important as the constitutional aspects. Ideally, the committee should appoint an individual who has been a head of government of a country that has practiced GATT principles successfully. President Salinas of Mexico might be an ideal choice. With such a leader, the new WTO would achieve its first vital goal: instantaneous status.

But, the real goal is to provide a mechanism which tosses off the shackles of the Round system and begins a new and continuous process of trade liberalizing negotiations. Within a few years the global economic community must have a new and strong World Trade Organization, rallying the more than 125 members into continued liberalization of world trade for the benefit of all. And the United States, as the "rallier of nations", should take the lead in proposing this plan. ◆



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*Max Baucus*

# Freer Trade, a Greener Continent

"Think globally, act locally," the bumper sticker admonishes. The advice is good, and millions have followed it.

When U.S. negotiators returned to the bargaining table with Mexico and Canada yesterday, they began a historic opportunity to extend environmental protections across this continent. For the first time, our trade negotiators can look beyond the technical business questions that have dominated past trade talks and focus on concerns about the environment that are widely shared by Americans.

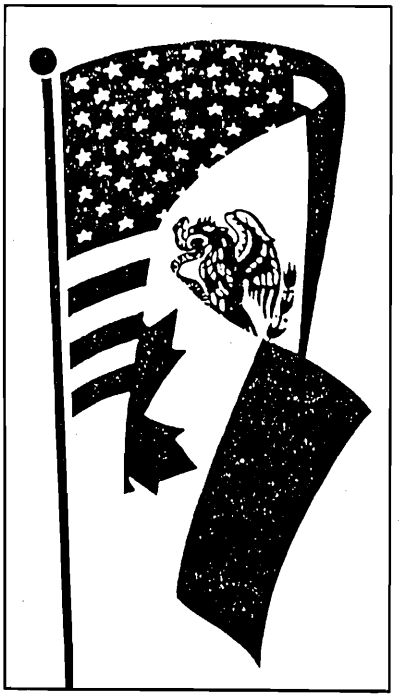
We can best use that opportunity by putting teeth in a key side agreement to the North American Free Trade Agreement. I believe that the North American Commission on the Environment can set a ground-breaking precedent for sustainable development and the best hope for turning the Earth Summit's grand talk about linking environmental goals with economic development into action. And a strong NACE is a fair price to ask for the benefits that NAFTA will bestow on Mexico.

Never before have nations at such different levels of development attempted to negotiate a free trade agreement. The environmental records of the United States and Canada are far from spotless, but we share a long commitment to protecting public health and safety. Our regulators are backed by potent scientific expertise and overseen by a vigilant community of environmental groups. Public opinion has made environmental concerns a driving force of individual, corporate and government decisions; Americans will not settle for backsliding on the progress we have made.

Mexico's environmental protections were modeled on U.S. laws—but comparisons end there. Enforcement is almost nonexistent. Companies there have trouble finding the expertise they need to clean up their operations. And, in the five years since Mexico's key environmental laws were written, public scrutiny has been tentative at best. Despite its recent efforts to enforce its environmental laws, Mexico will be hard-pressed to catch up.

Present plans are to make NACE yet another commission to study problems and write scientific papers. Markets are all-knowing, the argument goes; wait for economic development to take Mexican public opinion down the same path that America traveled.

That approach won't solve the problems, and it won't seize the opportunities NAFTA presents. Even if economic development comes quickly, it won't enlighten companies into changing their ways of operating in Mexico any time soon. It certainly didn't in the United States. Even with a proven record of developing markets for American innovations, our firms traditionally have ignored the carrot of environmental technology until they felt the stick of environmental enforcement.



BY BARRIE MAGUIRE

We cannot ask American companies and their employees to wait patiently while NAFTA works its miracles on Mexico's economy. Instead, we should encourage them to be the innovators that Mexico needs. Creating NACE as an iron fist inside a velvet glove would spur such innovation.

NACE should be empowered to investigate complaints that, because existing environmental laws are being flouted, firms are profiting from an unfair trade advantage—as they do when Mexican authorities look the other way while "maquiladoras" operating on our border illegally dump their toxic waste. Left unchecked by serious enforcement efforts, these practices threaten to multiply with freer trade. Leniency on environmental laws south of the border is nothing less than a trade subsidy if the same laws are enforced north of the border.

If NACE experts find that a persistent pattern of violations has resulted in a trade injury, they should turn their cases over to the authorities of that country for action and stand ready to assist them with technical advice. If violations persist, governments should have the right to cut off the economic benefits of free trade to that firm or impose other sanctions.

To ensure Mexican authorities have the wherewithal to that enforce their environmental laws, a temporary border fee (of no more than one percent of goods traded in the new free-trade zone) should be authorized; our portion might be split between border environmental projects and job retraining for American workers.

The "velvet glove" is a rule for NACE as a consultant as well as an enforcer. Confidential advice would help companies meet environmental standards and match their needs to the environmental technologies available. Like the U.S. Commerce Department's new Manufacturing Outreach Centers do at home, NACE could help U.S. "enviro-tech" companies spot potential customers as they help businesses operating in Mexico.

"The past has left us orphans, as it has the rest of the planet, and we must join together in inventing our common future," Mexican Nobel laureate Octavio Paz wrote. Three decades later, we have an opportunity to do that by more closely linking our environmental and trade policies.

Freer trade is certain to benefit each country, but the United States has more to lose—both economically and environmentally. Mexico is the fastest-growing market for U.S. exports, and we posted a $5.4 billion surplus there last year. To help ensure that NAFTA is a net plus for the United States, we must press our competitive advantages in this market of 360 million consumers—the world's largest. We have just such an advantage in several industries, including the emerging "enviro-tech" industry.

Environmental problems around the globe are increasingly local. Pacts like the North American Free Trade Agreement offer us a way to "act globally" on the environmental issues that spill over our borders. Our responsibility to America's citizens calls for us to evaluate NAFTA not as a way to help a struggling, Third World neighbor—but as an opportunity to improve our own quality of life.

*The writer, a Democratic senator from Montana, is chairman of the Committee on Environment and Public Works.*

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THE WALL STREET JOURNAL THURSDAY, MARCH 18, 1993

# No Rule of Law, No Free Trade

## Counterpoint

By Andrew Reding

Free trade with Mexico is a desirable goal. But as negotiations for supplemental agreements to the North American Free Trade agreement get under way, we should be mindful of serious dangers from the hands-off approach to Nafta advocated by the editorial board of this newspaper. Not the least of these is the fact that the U.S. has never before entered into a free trade agreement with a country that lacks democratic and legal structures comparable to our own.

Despite a division of powers that superficially resembles that of the U.S., Mexico has been run by a single party for more than six decades, through which the country's president has virtually complete control of the Congress and the courts. There are no checks and balances. One will search in vain for a presidential initiative turned down by Congress, or for a decision by the Supreme Court limiting the power of the chief executive. This is no minor point. One simply cannot speak of the rule of law as long as the Mexican presidency retains arbitrary power over the economic and political life of the nation.

Arbitrary executive authority is incompatible with genuinely free markets, which presuppose a level playing field established through the rule of law. That is why the Europeans, faced with a similar problem in dealing with authoritarian institutions in Portugal, Spain and Greece, conditioned those countries' entrance into the European Community on the prior development of genuine democracies.

The Europeans have also taken the lead in developing transnational legal guarantees of human rights and due process. Virtually all European countries, including most of the newly liberated countries of Eastern Europe, have by now ratified the European Convention on Human Rights and accepted the binding jurisdiction of the European Court of Human Rights based in Strasbourg. That means that Europeans can now do business almost anywhere on the continent secure in the knowledge that if they are denied due process at the national level, they may appeal to an international court where they will be assured a fair hearing.

A similar opportunity is at hand in the Americas. The American Convention on Human Rights provides for the observance of basic civil and political rights throughout the hemisphere. It enables any citizen denied due process at the national level to present his or her case to the Inter-American Commission on Human Rights in Washington. Significantly, the convention has already been ratified by Mexico and every other Latin American country except Cuba. The only problem is that the U.S. has not yet ratified the treaty; it has been pending before the Senate since being signed by President Carter in 1979.

There is another treaty mothballed in the Senate that could help level the playing field on the issue of labor rights and standards. The International Covenant on Economic, Social and Cultural Rights was likewise signed by President Carter in 1979. Among other provisions, it guarantees the right to organize, prohibits child labor, sets maximum hours for the work day, and requires attention to occupational health and safety. Furthermore, since it has already been ratified by Mexico, the Mexican government cannot reasonably object to having its provisions apply to trade and investment under Nafta.

Having once settled on common international standards, that still leaves the question of enforcement. Mexico has been very generous in endorsing high standards of human rights both in its domestic legislation and in international treaties. Yet its enforcement has been spotty at best, and subject to wholesale neglect at worst. The culprit, I would suggest, is the lack of institutional checks and balances – including free elections and independent legislatures and courts – so essential to the rule of law.

An inter-American court could help Mexican reformers in their efforts to remedy these problems, by providing recourse where necessary to an international court whose decisions would have the binding force of law. Fortunately, such a court already exists, in the form of the Inter-American Court of Human Rights in San Jose, Costa Rica. Created to help enforce the terms of the American Convention, the court relies for its authority on declarations by member states that they accept its jurisdiction. Most Latin American countries have done so. Mexico has not.

*The Mexican presidency retains arbitrary power over the economic and political life of the nation.*

That fact presents an unusual opportunity. By first asking the Senate to ratify the American Convention, then asking Canada and Mexico to join the U.S. in accepting the jurisdiction of the Inter-American Court, President Clinton could secure a hemispheric system of respect for human rights and due process. That would provide a solid international legal foundation for the supplemental agreements to Nafta now being negotiated, and for the expansion of free trade and investment throughout the Americas.

*Mr. Reding directs the North America Project of the World Policy Institute at the New School for Social Research.*

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# Forging a Trade Pact With Chile

By DON E. NEWQUIST

As President Clinton begins to grapple with his trade policies, he is confronted with the same two long-standing issues that proved so vexing for his predecessor — the faltering Uruguay Round of world trade talks and the successful conclusion and implementation of the North American free-trade agreement with Canada and Mexico.

While both the Uruguay Round and the free-trade pact are immensely important and should be completed as quickly as possible, neither appears any more amenable to a quick resolution now than they were in 1992.

At the same time, however, President Clinton has an opportunity to strike on another front: He should swiftly negotiate a free-trade agreement with Chile, which would advance his campaign pledge to help develop open-market economies and democratic principles throughout the Americas.

As a leading newspaper reported recently, "Chile is quietly completing what is perhaps one of the world's most profound economic transformations."

Emerging as a democracy in 1989 after almost 17 years of repressive military dictatorship, Chile can now justifiably boast an open political and economic system that is a role model for the rest of Latin America.

Entering into a free-trade agreement with Chile would send a strong and vital signal to our Latin American trading partners that Washington is committed to democracy and economic reform throughout the hemisphere.

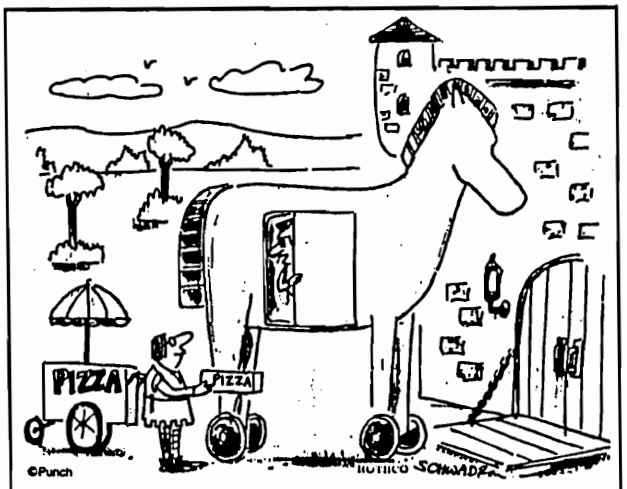
A visit to Chile only reinforces the importance of moving ahead with a Chilean free-trade agreement quickly. Chile's political stability under the freely elected government of Patricio Aylwin stands in sharp contrast to the recent political upheavals elsewhere in Latin America, especially in Peru and Venezuela.

From an economic perspective, Chile's open trade and investment policies are achieving notable results. The Chilean economy grew by almost 10% last year, its best performance in 30 years. In addition, a flat 11% tariff rate on virtually all products and an extensive privatization program have helped bring about steady, balanced growth in trade with the United States, Chile's second largest trading partner after Japan. The United States is also the largest foreign investor in Chile, with over 40% of Chile's total foreign investment since 1982.

Last year, the U.S. International Trade Commission examined U.S. market access in Latin America at the request of the Senate Finance Committee. The committee also asked for a special case study of Chilean trade and investment policies. The commission's report confirmed that Chile is fully integrated into the world economy with sustainable economic growth, generally transparent and non-discriminatory trade and investment regimes and relatively few barriers to outside companies and investors. A U.S.-Chile free-trade agreement can only serve to lock in these valuable market opportunities for U.S. firms and products.

Nonetheless, the report found several areas where Chile still maintains barriers to U.S. goods, services and investment. For example, market access in certain agricultural sectors and in motor vehicles is limited. Moreover, Chile's protection of trademarks, patents and copyrights falls short. A free-trade agreement would address these shortcomings.

A Chilean free-trade pact would present none of the environmental and labor standards problems that will have to be addressed through side agreements in the North American treaty. The Aylwin government has taken significant steps to improve workers' rights and to bring Chile's environmental standards into conformity with international norms. In fact the successful conclusion of a Chilean free-trade deal actually may help spur the completion of the North American side agreements, whose status remains uncertain.



"I don't care if one of the boys did order it. Go away."

The proposal here is not to slow down the Uruguay Round or the North American negotiations, both of which are important U.S. trade priorities. Rather, a free-trade agreement with Chile provides the Clinton administration with the opportunity for an early and notable trade success without unduly hampering progress in the other, more protracted negotiations.

Finally, and at its most basic level, the enactment of U.S.-Chile free-trade agreement will help ensure that Chile remains on the path of reform. As a result, U.S. workers and businesses, still on the rebound from the recession and in search of new export markets, can be sure that Chile will provide an increasingly open and predictable market for their products.

More important, the prompt and successful conclusion of a U.S.-Chile agreement will strengthen Chile's status as a role model for other Latin American countries in areas ranging from liberal foreign investment rules to the improvement of workers' rights and labor standards. Beginning negotiations for a free-trade pact now will set in motion a program of Latin American trade exports — and help preserve U.S. jobs — at a time when our economy so desperately needs both.

*Don E. Newquist, who visited Chile last year, is chairman of the U.S. International Trade Commission. The views expressed here are his own.*

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IMF WORKING PAPER

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JEL Classification Numbers
F14, O13, O55

Summary of
WP/92/55

"The Export Performance of Sub-Saharan Africa, 1970-90: A Survey"
by Roy C. Baban and Joshua E. Greene

The economies of sub-Saharan Africa have lagged significantly behind those of most other developing countries, and the region's poor export performance is a major reason. Total export earnings in 1990 were nearly 20 percent below their nominal level in 1980. Moreover, the "real" value of sub-Saharan African export earnings, measured relative to import unit costs, fell by more than 35 percent between 1980 and 1990. Whereas nominal exports and export volumes from other developing countries rose significantly over this period, the share of developing country exports coming from sub-Saharan Africa fell from 8.5 percent in 1980 to 5.0 percent in 1990.

Although the region has experienced a considerable fall in its terms of trade since 1980, sluggish growth in export volumes attributable to poor domestic policies appears to have been particularly responsible for its weak export performance. Overvalued exchange rates, declining real producer prices, and the failure to maintain and modernize infrastructure have discouraged the maintenance and expansion of existing production facilities. These factors, poor investment codes, and difficult regulatory environments have also discouraged investment from abroad and the transfer of new technology. As a result, sub-Saharan Africa has lagged behind other regions in diversifying its exports and penetrating new markets. Because of preferential trade agreements and the region's concentration in exporting primary, non-fuel commodities, it does not appear to have been significantly hurt by protectionism. At the same time, international responses to the region's export problems have been limited, reflecting the ineffectiveness of international commodity agreements and the limited support available from multilateral facilities, such as the IMF's compensatory and contingency financing facility and the European Community's STABEX and SYSMIN arrangements.

The outlook for sub-Saharan African exports is uncertain. Because of low income elasticities, global demand for the primary, non-fuel commodities that comprise the bulk of the region's exports is expected to rise slowly, on the order of only 1-2 percent a year. For similar reasons, real export prices of these commodities are not expected to show much improvement over the next decade. Although the region could augment growth by diversifying exports toward more rapidly expanding markets in Asia, high cost levels may make it hard to compete effectively with nearby producers of primary commodities. Thus, sub-Saharan Africa's best chance for export growth may lie in augmenting its so-called nontraditional exports, such as floriculture, off-season fruits and vegetables, and light manufactures. Studies indicate considerable untapped demand for these products in the region's traditional markets in Western Europe, which a few countries, notably Kenya and Mauritius, have begun to fill. However, the success of diversification will depend on the region's ability to penetrate marketing networks and supply consistently high-quality and competitively priced items. This is likely to require further structural reforms in many sub-Saharan African countries to create a more attractive investment climate.

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WORLD BANK NEWS

January 22, 1993

# Private Investment Rebounds In the Developing World

Private investment in the developing world has rebounded and reached record highs in some countries, says a new study.

Private investment, which had been declining in the early 1980s, climbed back to the high point reached in the late 1970s. Meanwhile, public investment remains at a 10-year low, says the study, Trends in Private Investment in Developing Countries 1993. The study was prepared by the International Finance Corporation, the World Bank's affiliate that finances private sector projects and advises businesses and governments on investment issues.

Private investment grew by 16.4 percent in 47 developing countries studied during the years 1970 to 1991. A one-third jump in foreign direct investment drove much of the rise.

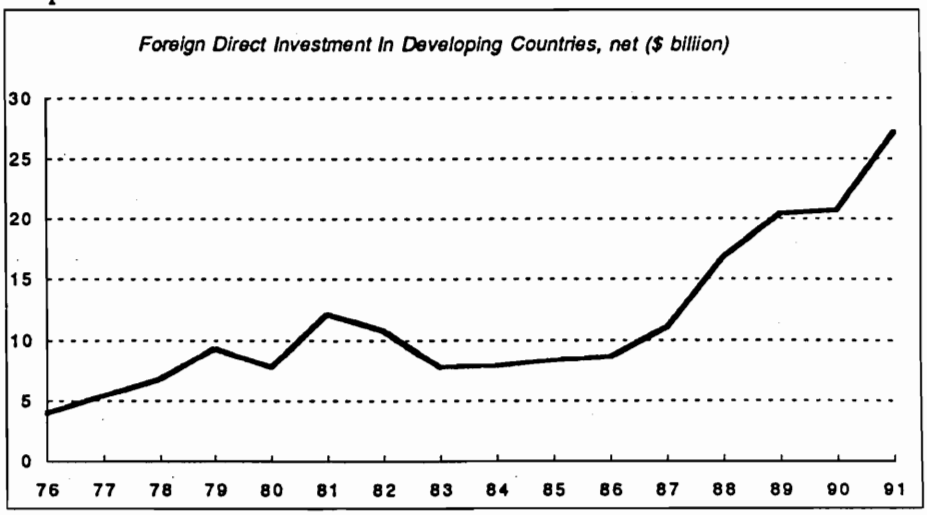
Investment varied across regions, says the study.

Private investment was highest in East Asia, where large amounts of foreign investment added to the rise, especially in Malaysia and Thailand. In sub-Saharan Africa, levels stayed the lowest of any region, despite recoveries in some countries like Malawi and Ghana. Eastern Europe and Latin America witnessed higher levels of investment, particularly in Hungary, former Czechoslovakia and Chile. In South Asia, investment moved up slowly but remained low.

Tight macroeconomic policies proved to be the biggest draw for private investors, says the report. Most of the countries showing the biggest jumps in investment reported improved fiscal balances and increased savings. Most countries with the smallest rises or even declines reported declining savings.

Foreign investors tended to sink much of their money into countries boasting large and expanding markets. Between 1985 and 1991, more than one-half of the foreign direct investment in the developing world went to six of the countries with the largest markets—Mexico, China, Malaysia, Argentina, Brazil and Thailand.

The report was written by Guy Pfeffermann, Director of the IFC's Economics Department and economic adviser to the Corporation, and Andrea Madarassy, a research analyst in the same department. □

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CHOICES
THE HUMAN DEVELOPMENT MAGAZINE
VOL.2. NO. 1

# Privatization: Panacea or Broken Promise?

**Alejandro Rausch,** economic consultant to the Government of Argentina, UNDP and the World Bank:

**"The Argentine experience shows that a privatization programme without strong state regulation is very risky business. An adequate legal and regulatory framework must be in place before the programme begins. If not, the result may be private monopolies with deteriorating standards and rising prices. Thought must also be given to the protection of strategic sectors and to situations where large numbers of workers are dismissed. The state has to form new policies to address these problems."**

**By Christopher McIntosh**

For many economists and politicians in the 1980s, "privatization" was a magic word. Those were the heady days of Margaret Thatcher and Ronald Reagan's ascendancy, when a new era of private enterprise was expected to sweep the world, revitalizing the economies of both North and South. The events in Eastern Europe that began in 1989 appeared to confirm this hope. It seemed that everywhere the government role in industry was on the retreat, and that the future belonged to the private sector. The United Nations Development Programme (UNDP) was one of the international agencies that fully embraced this vision, creating a special division for the private sector and the Interregional Network on Privatization, which aims to assist countries in sharing information and experience in this field.

While the privatization effort is still very much alive, the high expectations of the 1980s are tempered by a new sense of realism. "The initial euphoria has worn off," says Philip Reynolds, a senior programme officer in UNDP. "Creative responses are now necessary to limit potential constraints and negative impacts and to help privatization programmes succeed."

Ironically, developments in Eastern Europe and the former Soviet Union have played a large part in this change of mood. After launching the privatization effort to loud cheers, the countries of the former socialist bloc soon found that the ship was in danger of running aground. John Howell, an economist with the US-based international consulting firm Ernst and Young, blames both Western experts for giving naively optimistic advice, and Eastern European politicians for rushing ahead with privatization for political reasons.

"In the euphoria of the initial political changes," says Mr. Howell, "neither Western advisers and investors, nor the governments and business communities of Central and Eastern Europe conceived of the size of the problems that needed to be overcome."

Obstacles to privatization are many. They include lack of a free market culture, confusion over who owns the enterprises and how much they are worth, poor physical infrastructures which discourage foreign investment, the absence of a legal framework governing the conduct of business, and shortage of investment capital. When privatization is actually implemented, the results can often lead to problems. For example, when a government sells a viable enterprise, the profits go to enrich investors, who tend to be wealthier than the average taxpayer. Thus income disparities are increased. Other consequences can include higher prices for basic goods and services, large-scale layoffs, loss of national assets to foreign buyers and the possible closure of vital

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industries. In a number of countries these effects have led to social unrest.

To examine these problems in depth, UNDP's division for global and interregional programmes called together a distinguished group of economists, politicians and development experts for a seminar at the Palais des Nations in Geneva last August. It was attended by participants from 14 countries, including three of the Eastern European economies in transition: the former Czechoslovakia, Hungary and Poland. The theme was "Privatization: Constraints and Impacts."

Hungary was one of the countries that entered the new era most enthusiastically. The 1990 reopening of the Budapest stock exchange was an exciting occasion: there were speeches lauding the free market system, followed by the dramatic moment when the charter of the new exchange was passed down a long table to be signed by bankers, financiers and political dignitaries. One of the first newly privatized companies to be floated on the new exchange was the Hungarian national travel agency, Ibusz. Today, however, Ibusz shares are languishing at below their original offer price, and the exchange has remained a small operation with only 22 companies being traded.

"Ibusz was floated too early," explains Gusztav Bager, who attended the seminar as director general of economic policy in the Hungarian Ministry of Finance. "It was not in adequate shape at the time, and more restructuring work should have been done. In addition, the tourist industry is not flourishing at the moment because of the recession."

Another recent example of privatization in Hungary is the tobacco industry, but here again the results have been disappointing. Foreign tobacco companies have moved into the Hungarian market but have been unwilling to invest in local firms.

As for the stock exchange, Mr. Bager explains that there is a lack of local capital for investment. For the same reason, most firms that turned into shareholding companies have seen their equity ownership remain in the hands of the State Property Agency. In general, while Hungary has made progress in the development of a market economy, the pace of privatization has been slower than intended.

The same is true in Poland, where a law initiating the privatization programme was passed in July 1990. One of the brightest candidates for transfer to private ownership at the time was the Ursus tractor factory, which had a good product and the prospect of doing well in world markets. Today Ursus, like many other Polish enterprises, is still being restructured and is not yet considered ready for privatization. In Poland, a major constraint has been widespread misunderstanding about the nature of a free market system. In the words of the Polish participant at the seminar, Jerzy Cieslik of Ernst and Young: "For many workers in Poland, the definition of capitalism is socialism plus more money. People want all the benefits of both systems." With rising unemployment, previously unknown in the country, disenchantment with privatization is spreading.

Mr. Cieslik also discussed restitution, a thorny problem in Poland as in other countries. What happens when the buyer of a state enterprise finds that there is a claim on it by the person who owned it before nationalization? In many countries the laws on this issue are hazy or non-existent. Mr. Cieslik reported that a debate is currently raging in the Polish Parliament on this matter. "Politicians are trying to address the questions of who has rights to reprivatized property, what criteria should be used in deciding claims, and how the property should actually change hands."

In contrast to Hungary and Poland, the privatization movement in the Czech and Slovak Republics remains buoyant. This is somewhat paradoxical, considering that before 1989 a massive 97 per cent of the Czechoslovak economy was state-controlled, whereas in both Hungary and Poland there was already a noticeable private sector.

"The privatization programme is very radical in its scope and methods," says Olivier Bouin, a French economist currently advising the Czech government on the programme.

In the Czech and Slovak Republics, 4,200 state-owned enterprises have been earmarked for privatization. To overcome the shortage of local capital and to give as many people as possible the chance to invest, the country embarked on a daring and ingenious voucher scheme. In the first stage, from October 1991 to February 1992, every adult citizen had the right to buy a book of 14 vouchers costing about one week's salary. Each voucher was

**George Mbowe**, chairman, Parastatal Sector Reform Commission, Tanzania

**"The Tanzanian government aims to reduce public sector share in the economy from 95 per cent to five per cent over the next five years. About 250 enterprises have been identified for privatization or commercialization. Since the announcement of the programme there has been some uneasiness about it. In the minds of many people, privatization connotes the sale of public assets to foreigners at give-away prices. The workers are concerned that the new owners may lay them off. It would have been better if the announcement of the policy had been preceded by an information campaign to educate people about privatization and to gain their support."**

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worth between 100 and 1,000 points. These points could then be used to bid for shares in the firms to be privatized. Alternatively they could be used to buy into one of the investment privatization funds that have appeared. The scheme has been a popular success. By January 1992, 8.6 million people, three quarters of those eligible, had participated. It remains to be seen how the firms privatized under the voucher scheme will fare, but a good start has been made.

"Another unconventional feature of the scheme," explains Mr. Bouin, "is that each state-owned firm is asked to draft its own privatization strategy, containing details of output, profit, export performance and value of assets."

These plans, however, sometimes prove unreliable owing to lack of information about possible restitution claims and confusion about the current legal status of the company. Antiquated accounting methods are also a problem, as they are in many former centrally-planned economies. Accounting is so deficient in some cases that it is impossible to draw up balance sheets for interested buyers.

Many of the problems faced by Eastern and Central Europe have also been encountered by developing countries of the South. A case in point is Argentina, where privatization started on a small scale in 1983. In 1990, faced with a soaring deficit and massive losses from its public sector, the Argentine government accelerated the process, selling off some of its largest state-owned enterprises. These included the national telephone company, the national airline and the state railway system.

Economist Alejandro Rausch, an adviser to the Government of Argentina, the World Bank and UNDP, is highly critical of the programme so far. In both the airline and telephone company, he says, the results of privatization have been worsening services and higher prices. He attributes this to the near-monopoly situation in both cases and the lack of government regulation to monitor the industries after privatization and ensure adequate standards and services.

One emerging lesson is that governments must be willing to play a major role both during and after privatization. This is confirmed by the experience of the former German Democratic Republic, one of the few places in the old socialist bloc where large-scale privatization is being carried out on schedule. Since unification with the Federal Republic of Germany in October 1990, over 3,000 enterprises have been privatized by the Treuhandanstalt (often abbreviated Treuhand), the state fiduciary body charged with carrying out the operation.

"No other country ever privatized so many industrial enterprises in such a short time," asserts Dieter Bös, professor of economics at the University of Bonn. Professor Bös points out that Treuhand does not simply hand over a firm to the highest bidder and then forget about it. Prospective buyers are asked to produce a detailed business plan, including commitments to investment and to maintaining as many jobs as possible. These plans are subsequently monitored by Treuhand, and penalties can be levied for non-compliance.

Buyers are chosen carefully, with the wider interests of the region in mind. Treuhand has sold enterprises for as little as one German mark to avoid their falling into the hands of West German entrepreneurs who might want to simply buy up potential rivals and close down their production lines.

"In a post-privatization world, there is still plenty for government bureaucrats to do," says George Yarrow of Oxford University. Professor Yarrow has made a special study of the British privatization programme, which began in 1979 and is generally regarded as a success. "Since privatization, the amount of state regulation in Britain has increased rather than diminished."

Part of the role of government is to ensure that the overall environment is conducive to healthy development of private firms. Too often, the seeds of the private sector were planted in a soil that was unprepared. The legal infrastructure,

Jerzy Cieslik, partner in Ernst and Young and adviser to the Polish government on privatization:

**"Privatization in Poland has been much more complex and difficult than originally envisaged when the privatization law was passed in July 1990. When the law came into effect there was no clear ideological orientation. Some important people saw it as simply a legal transformation of certain enterprises rather than a radical metamorphosis of the entire economy. The law calls for the transformation of enterprises from centrally controlled to market-driven, but builds in the maintenance of certain social goals, for example by requiring that companies offer 20 per cent of their equity to employees at preferential rates. This type of compromise has been confusing to employees and buyers alike."**

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for example, is a key factor. A market economy requires laws governing contracts, financial institutions, foreign exchange, taxation and monopoly practices. The question of intellectual property is also important. Zahir Jamal of the World Intellectual Property Organization suggests that any team advising a government on privatization should include a good patents lawyer. The protection of patents, he points out, is essential to encourage local research and development.

Equally important is the physical infrastructure such as transport, telecommunications, electricity and water supply. If these are inadequate, it will be difficult to woo foreign capital for divestitures or joint ventures. "Foreign capital can choose where to go, and it prefers to go where the infrastructure is well developed," says Vemuri V. Ramanadham, a professor of economics and coordinator of UNDP's Interregional Network on Privatization.

Legal and physical infrastructure tends to be more conducive to privatization in the developed, market economies than in the developing countries or the economies in transition. Nevertheless, some very poor countries have had successes in their privatization programmes.

Despite one of the heaviest debt burdens in the world and high inflation, Guyana has so far carried out a relatively smooth privatization programme, with 56 per cent of its firms going to Guyanese buyers. Guyana is one of the few countries where privatization has not brought high job losses, mainly because of previously under-utilized capacities in the enterprises.

While there is clearly no single formula for success, the Geneva meeting proved that countries have much to gain by sharing their experiences in privatization. One participant who came away with many practical ideas was George Mbowe, chairman of Tanzania's Parastatal Sector Reform Commission.

"This meeting," he says, "has widened my vision and enabled me to identify areas where my technical team could benefit from training." In particular, he was interested in the Czechoslovak voucher scheme. "This is something I had read about, but never understood in detail before. It could be a way for Tanzania to involve citizens who could otherwise not afford to invest."

For any country embarking on the promising but uncertain path of privatization, there are clearly many calculations to be made and choices to consider. As Professor Ramanadham points out, privatization is not an end in itself, nor is divestiture the only option. There is a wide spectrum of possibilities, ranging from full privatization to the restructuring of an enterprise under state ownership. In the future, countries choosing the privatization route will have to define their goals clearly and learn from the process of trial and error that other countries have gone through.■

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The report of the Geneva seminar, *Privatization: Constraints and Impacts*, as well as the *Guidelines on Privatization*, edited by Vemuri V. Ramanadham, can be obtained from Philip Reynolds, Division for Global and Interregional Programmes, United Nations Development Programme, One United Nations Plaza, New York, NY 10017, USA.

*Christopher McIntosh is an information officer with UNDP in New York.*

**Carl B. Greenidge**, former minister of finance in the Government of Guyana

**"Privatization has been a crucial element of Guyana's Economic Recovery Programme, which has been under way since 1989. The privatization effort got off to a slow start, but picked up momentum and is now ahead of schedule. Nineteen enterprises have been either fully or partially privatized. Notwithstanding this success, the experience of Guyana suggests that as far as possible privatization should not be pursued in a situation of economic crisis. Now that the worst of the crisis is behind us, it will be interesting to see how privatization fares in the next phase."**

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COLUMN LEFT/
ALEXANDER COCKBURN

# Privatization: the Engine of Human Misery

■ From Brazil to Russia, people are turning with fury against neo-liberal depredations.

Neo-liberal heroes are beginning to totter from the stage. Brazil's President Ferdinand Collor de Mello jumped before he was pushed, resigning rather than face impeachment on corruption charges. Half a world away, Russian President Boris Yeltsin, shorn of most of the immense power he held a year ago, watches impotently as his knights of the free market—Yegor Gaidar and others—are forced out.

History is changing step. A year ago, the core economic message of the 1980s—the glories of untrammeled "free markets," the evils of state regulation—still seemed to be carrying all before it.

Journalists excitedly chronicled entrepreneurial, privatizing achievements in the former Soviet Union and Eastern Bloc nations. In Latin America, too, they hymned an end to the statism of the past and gave glowing accounts of the triumphs of Collor as he presided over the continent's most significant economy.

Today, frank appraisal discloses a very different story. Shortly before Christmas, one of Brazil's leading newspapers, Jornal do Brasil, gave the true coordinates of what neo-liberal strategies had done to the country. Nearly a third of the population—some 45 million people—now live on as little as $10 to $15 a month.

As acting president since the impeachment process began against Collor, old-line politician Itamar Franco has been wildly popular simply because he rejected the policies imposed by Collor and the Northern bankers.

Asked if he was concerned by falling stock prices, Franco told the Jornal: "I don't worry about the stock market. I'm not here for them. We've had 2½ years of unemployment, high inflation, rigid monetary controls, high interest and a sad and impoverished people. The country has lost 2½ years. . . . I can't wait to act until after the patient has died."

Elsewhere in Latin America, popular hostility toward neo-liberalism is mounting. In a recent referendum on privatization, Uruguayans soundly rejected the sale of government enterprises. In Argentina, recently privatized operations are mired in scandal. In Venezuela, the new mayor of Caracas, Aristobulo Isturiz, is a radical opponent of privatization.

In Eastern Europe and the former Soviet Union, the broad picture is one of economic misery. Most of Poland, outside the capital, is battered by soaring unemployment, with workers organizing in Solidarity-type drives against the government. The people of the former Czechoslovakia now face the glories of private enterprise, specifically the termination of free health care.

**'To most Russians, the "free market" is simply a system by which gangsters and entrepreneurs shamelessly loot public assets.'**

Economic output in Russia fell by 25% in 1992. To most Russians, the "free market" is simply a system by which gangsters and entrepreneurs shamelessly loot public assets. Amid affecting scenes of thousands of homeless crowding Moscow's main railway station, a reporter on ABC's "World News Tonight" intoned that "under communism, this was not meant to happen." Russians at least would recall that under communism, the station was where you went to catch a train.

One portent of the changing mood in the former Soviet Union was so sensational that in the end everyone agreed that somehow it hadn't happened at all. On Dec. 14 in Stockholm, Andrei V. Kozyrev, the Russian foreign minister, rose to his feet in a closed session of the Conference on Security and Cooperation in Europe, and, to a thunderstruck audience, closed the book on post-communist Russia's *entente* with the West. He lashed out at NATO's meddling in the Baltic and in "the internal affairs of Yugoslavia" and proclaimed that "the present government of Serbia can count on the support of Great Russia in its struggle." So astounding were Kozyrev's remarks that the Associated Press and Reuters held back their reports, fearing that the sensational speech would send world financial markets through the floor.

After a private session with U.S. Secretary of State Lawrence Eagleburger, Kozyrev returned to the podium to say that it had all been a joke intended to dramatize what Yeltsin's enemies were saying daily. But can anyone seriously suppose that if Kozyrev intended his remarks as a macabre flight of fancy, he would not, before he stepped off the podium the first time, have said, "It's all right, fellas, only joking"?

But Kozyrev was entirely correct when he said that his first speech had been the rhetorical currency of the opposition to Yeltsin. What he could have added is that Yeltsin is crumbling in the face of that opposition. If we take Kozyrev's first speech as genuinely meant, it was the flag of surrender to that opposition, a declaration that the neo-liberal crusade had indeed failed.

*Alexander Cockburn writes for the Nation and other publications.*

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# The Sustainability Question: Are There Limits to Economic Growth?

By Paul Ekins

For decades, arguments have raged back and forth about the relationship between development and economic growth. Such arguments, as those presented in UNDP's *Human Development Report*, have enriched the concept of development and established that economic growth alone will not guarantee a better quality of life. But the mainstream consensus remains that growth is required for development to occur.

Moreover, there is widespread agreement that economic growth is not only necessary in the South, but also in the North. The justification given for the rich becoming richer is that, in the process, larger markets for Southern goods will be created and encourage development. Lurking behind this, however, is the tacit understanding that Northern business and the Northern public will insist on economic growth whatever the consequences for the Third World and for the global environment. Politically credible scenarios of the future therefore must provide for it.

Thus the *Brundtland Report* contemplates a five to tenfold increase in manufacturing output by the middle of the next century. Similarly, the *World Development Report 1992* of the World Bank envisages that Northern economies will grow by a factor of three, and Southern economies by a factor of five, by 2030, leading to a global economy that is 3.5 times larger than today's. Even with these differential growth rates, this scenario will greatly increase the already enormous inequalities in per capita incomes between North and South. As both reports also acknowledge, if environmental destruction increases at the same rate as GDP, the damage will be appalling. As far as the human species is concerned, it could prove terminal. Hence the call to make growth environmentally "sustainable."

Such a call prompts a number of questions. First, is it realistic to imagine that growth can be made so environmentally benign that 3.5 times today's world product will cause less environmental destruction than occurs today? Second, if not, does humanity really need economic growth of that dimension, even at the risk of its own survival? Third, is there any guarantee that environmental problems will be any easier to solve under conditions of slow or no growth?

The first question re-opens the "limits to growth" debate that burned in the 1970s and has simmered ever since. Those who propose limits maintain that increases in production, as measured by GDP, have been and will always be associated with an increase in environmental destruction. The laws of thermodynamics, they say, maintain that any increases in the economy's throughput of matter and energy (except renewable sources such as solar energy) must be associated with increases in negative environmental impact. The alternative view holds that it is possible to decrease environmental damage at a rate equal to or greater than the rate of GDP growth. In such a view, growth can proceed indefinitely.



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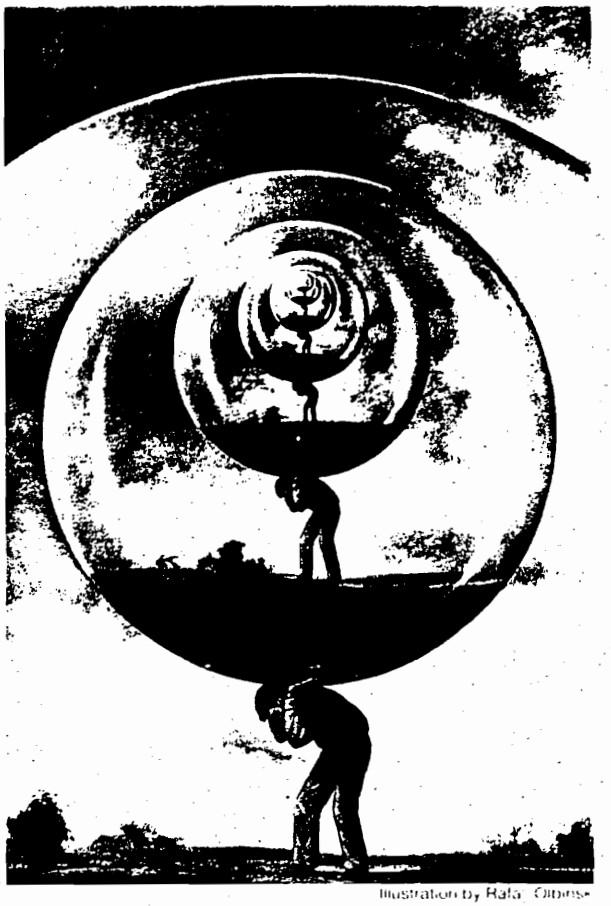

Illustration by Rafa Olbinski

The difference between these positions cannot be resolved theoretically. In theory, either outcome is possible. The crucial question is, what is the relative probability of each?

In support of the "no limits" thesis, statistics can be produced which show falling energy intensities (energy consumption per unit of GDP) and declines of certain air emissions, even as economic growth is proceeding; for the future, practically unlimited technological opportunity is supposed. Proponents of "limits" point out that the absolute use of energy has increased even in countries with falling energy intensities, and is projected to go on doing so. They also regard achievements in environmental quality as relatively trivial compared to the ongoing trends of environmental deterioration. It is certainly difficult to argue that, in the 20 years since the "limits to growth" debate began, environmental conditions or their future prospects have generally improved.

The jury is still out on both the "limits to growth" hypothesis and its converse, "environmentally sustainable growth." Conclusions reached on this question over the last 20 years can be summarized as follows:

- The economic growth that has taken place during this period has not been environmentally sustainable. The negative environmental impact of growing economies has continued to increase. The theoretical possibility of environmentally sustainable growth has not been achieved.
- Even if possible, achieving environmentally sustainable growth will be formidably difficult in practice. The *Brundtland Report* and the *1992 World Development Report* both call for unprecedented changes in patterns of production and institutional reform, threatening to significantly reduce the power of now dominant vested interests.

These conclusions provide a useful context for considering the second question: does humanity really need a gross world product that is more than tripled by 2030? Or, to be more specific, must the Southern economy grow fivefold, and the Northern economy threefold, over the next three and a half decades?

**IT MAY BE THAT THE PRESSURES TOWARD GROWTH IN THE NORTH ARE SIMPLY TOO GREAT FOR CURRENT POLITICAL INSTITUTIONS TO STRIKE OUT ON A SUSTAINABLE PATH.**

It is difficult for a Northerner to quarrel with the aspirations of the South to grow fivefold, especially bearing in mind that per capita incomes in low-income countries then would still be less than 10 per cent of present incomes in high-income countries. Such growth in the developing countries, which represent 75 per cent of the global population, would mean "only" a doubling of today's world product.

The question about Northern growth, however, is a different matter altogether. It is impossible to argue that such growth is necessary to meet basic material needs, because in rich countries, this has more to do with social policy than with growth itself. In the United States and the United Kingdom in the 1980s, for example, growth co-existed with deepening poverty and material deprivation.

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# Liberalization of the Capital Account
## Experiences and Issues

INTERNATIONAL MONETARY FUND
Washington DC
March 1993

Donald J. Mathieson and Liliana Rojas-Suárez

# I Introduction

The growing integration of financial markets located in the industrial countries and major offshore centers represents a fundamental structural change in the world economy during the past two decades. This increased integration has been fostered by the relaxation of capital controls and broader financial liberalization in the industrial countries as well as by new telecommunications and computer technologies that have facilitated the cross-border transfer of funds. The liberalization of restrictions on external and domestic financial transactions was motivated in part by the desire to improve financial efficiency by increasing competition in domestic financial systems and to reduce financial risks by allowing domestic residents to hold internationally diversified portfolios.

Although such efficiency and risk-diversification gains could accrue to any country with capital account convertibility—that is, one that has eliminated capital controls—complete convertibility has been established only in a number of industrial countries and in relatively few developing countries. Indeed, analyses of the sequencing of structural reforms and stabilization policies for developing economies have traditionally argued that capital controls or dual exchange rates are necessary to prevent capital flows that would undermine the reform program. These policy recommendations, however, stand in sharp contrast to a growing body of empirical evidence that suggests that capital controls have often been evaded. This paper reviews the experiences of industrial and developing countries with capital controls, considers some of the key policy issues raised by the diminished effectiveness of capital controls, examines the potential medium-term benefits and costs of an open capital account, and analyzes the policy measures that could help sustain capital account convertibility. Because the liberalizations of capital account restrictions have typically taken place in the context of broader economic programs, which have included extensive stabilization efforts and structural reforms, the implications of opening the capital accounts need to be analyzed against the background of these other policy changes.

Section II examines the *types of capital controls* employed by countries and the rationales put forth to justify their use. Most restrictions on capital account convertibility have been motivated by four principal considerations. First, quantitative capital controls and transaction taxes have been seen as a means of limiting volatile, short-term capital flows that induce exchange rate volatility or sharp changes in foreign exchange reserves and thereby force the authorities to abandon their medium-term macroeconomic policy objectives. Second, capital controls have been credited with ensuring that the domestic savings of developing countries are used to finance domestic investment rather than the acquisition of foreign assets and with limiting foreign ownership of domestic factors of production. Third, restrictions on capital movements have been seen as strengthening the authorities' ability to tax financial activities, income, and wealth. Finally, it has been argued that opening the capital account should occur late in any stabilization and structural reform program to prevent capital flows from destabilizing efforts to control inflation or to sustain a trade reform.

Section III examines the *effectiveness of capital controls* in industrial and developing countries in terms of their ability to insulate domestic financial conditions from external financial developments and to prevent the cross-border movement of funds by residents and nonresidents. Empirical studies point to four key conclusions. First, capital controls were typically most effective when they were combined with exchange and trade controls to restrict both current and capital account convertibility. However, the introduction of current account convertibility created a variety of channels for disguised capital flows. Second, whereas capital controls in the industrial countries effectively limited their residents' net foreign asset or liability positions during much of the 1950s and 1960s, the collapse of the Bretton Woods system in the early 1970s created the expectation of large exchange rate adjustments and was accompanied by large-scale (often illegal) capital flows that overwhelmed

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even the most comprehensive capital control systems. Third, when macroeconomic and financial conditions created substantial incentives for moving funds abroad, capital controls in many developing countries were often of limited effectiveness in stemming capital flight during the 1970s and 1980s. Fourth, recent studies suggest that the effectiveness of capital controls eroded more rapidly during the 1980s than during the 1960s and 1970s.

Section IV considers some of the *implications of the reduced effectiveness of capital controls*, caused in part by structural changes in the international financial system and other factors, which may also have raised the explicit and implicit costs of using such controls. Among these costs are the higher costs of enforcing controls and the resources used in the rent-seeking activities involved in obtaining licenses for restricted capital flows and the evasion of capital controls. New constraints can be placed on the formulation of stabilization policies and structural reforms when the effectiveness of capital controls diminishes. Unsustainable monetary and financial policies will have greater adverse effects on the domestic financial system and on the tax base as capital flight and a growing "dollarization" of the economy take place. The fiscal authorities will also face greater difficulties in taxing income from financial assets, financial transactions, and wealth; moreover, the revenues that can be obtained from an inflation tax will also diminish.

During the early stages of stabilization and structural reform programs, residents often have strong incentives to repatriate external assets even when the sustainability of the program is uncertain. The resulting capital inflows can cause the real exchange rate to appreciate. Although sterilization has been used to limit the inflationary impact of these inflows, it can increase the outstanding stock of government debt and drive up government borrowing costs. Some countries have therefore tightened capital controls to limit capital inflows. Historical experience, however, suggests that whenever there are large incentives for capital flows, residents often find ways to evade the new controls. Moreover, a severe tightening of capital controls could interfere with normal trade financing and thereby vitiate any trade reform as effectively as a real exchange rate appreciation. The potentially adverse effects of a tightening of capital controls raise the issues of what the potential benefits of a more open capital account are and whether there are fiscal, financial, and structural policies that would allow a country initially to "live with" the capital inflows and eventually to achieve and sustain an open capital account.

When accompanied by appropriate macroeconomic and financial policies, a more open capital account may give rise to four efficiency gains: (1) unrestricted capital flows benefit the international economy by facilitating specialization in the production of financial services; (2) capital account convertibility creates dynamic efficiency by introducing competition in the financial industry from abroad and stimulating innovation; (3) if international financial markets price the risks and returns inherent in financial claims appropriately, global savings can be allocated to the most productive investments; and (4) for countries with limited access to private external finance, freedom of capital inflows and outflows may facilitate renewed access to international financial markets.

Section V examines the experiences of industrial and developing countries with *capital account liberalization* in order to identify the asset price movements and capital flows that have been associated with removing capital controls and the macroeconomic, financial, and risk-management policies that can help sustain an open capital account. A common pattern of asset price movements and capital flows has often emerged after the opening of the capital account in both industrial and developing countries. Since the opening of the capital account has historically occurred in conjunction with extensive stabilization and structural reform programs, the accompanying asset price changes and capital flows have reflected the removal of capital controls as well as perceptions about the likely outcomes of the reforms. The resulting portfolio adjustments have typically led to large private sector *gross* capital inflows and outflows, often a *net* capital inflow, and a real exchange rate appreciation. In some developing countries, moreover, high ex post real domestic interest rates and an initially large spread between ex post domestic interest rates (adjusted for exchange rate changes) and international interest rates have also occurred.

Experience suggests that the implementation of certain policies designed to mitigate these asset price movements and capital flows can help to sustain capital account convertibility and reduce the financial risks created by an open capital account. These include macroeconomic and financial policies that minimize the differences between domestic and external financial market conditions before liberalization; avoiding taxes on financial income, wealth, and transactions that create strong incentives to move funds abroad; strengthening the safety and soundness of the domestic financial system; and removing or reducing restrictions that inhibit the flexibility of wages and the prices of goods and assets. Moreover, countries can manage the financial risks created by an open capital account by allowing residents to hold internationally diversified portfolios, by using markets for trading risks (particularly the markets for commodity and financial futures, options, and swaps), and by designing external contracts and debts better. The speed with which a country can move to full capital account convertibility appears to depend on both how far it has proceeded in implementing the policies that are preconditions for such convertibility and its willingness to take further measures that credibly establish that it will implement the remaining policy steps.

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JEL Classification Numbers
G21, G28, E44, E52, O16, P52

Summary of
WP/92/82

"Issues in Managing and Sequencing Financial Sector Reforms: Lessons from Experiences in Five Developing Countries"
by Amer Bisat, R. Barry Johnston, and V. Sundararajan

This paper reviews the experiences of five developing countries in reforming their financial systems, illustrating the benefits and risks and examining the factors that contribute to successful financial liberalization. Although financial reform generally led to significant financial deepening, several countries also experienced some loss of monetary control. Inappropriately sequenced reforms, combined with inadequate prudential supervision and unstable macroeconomic conditions resulted, in some cases, in financial crisis.

Liberalizing interest rates and removing direct credit controls can improve financial sector competition and efficiency in the allocation of financial resources. However, to avoid loss of control, financial sector reform needs to be supported by active monetary policy and flexible and effective monetary control procedures. In some cases, financial sector reform was accompanied by an initial, more rapid growth of credit, which needed to be constrained by high positive real interest rates, with possible adverse effects on the real sector (through appreciation of the real exchange rate and the revaluation of assets). To minimize these effects, the sequencing of reforms should be consistent with a broader program of macroeconomic adjustment. In addition, the pace of the liberalization of interest rates and credit should take account of the solvency of financial and nonfinancial firms and their ability to respond to the new financial environment. In certain cases, countries may benefit from liberalizing interest rates and credit more gradually while pushing ahead with industrial sector restructuring and the recapitalization of banks.

A minimal system of prudential regulation must be in place if financial sector reform is to succeed. Too rapid liberalization can strain banks' credit approval process and may not give them time to develop sound banking techniques and supervisory procedures.

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WORLD BANK NEWS

January 22, 1993

IFC NEWS

# Reforms Lead to Greater Investment

*Many developing countries are luring more investment than at any time in the past, says a new study.*

*Private investors, both local and foreign, are sinking more funds into Eastern Europe, Latin America and especially East Asia, says the study by the International Finance Corporation. The IFC is the World Bank affiliate that finances private sector projects and advises businesses and governments on investment issues.*

*In recent years, tempting new trade reforms and a sense of government continuity have attracted investors, says Guy Pfeffermann, co-author of* Trends In Private Investment In Developing Countries, 1993. *Pfeffermann is Director of the IFC's Economics Department. Pfeffermann, who is also an IFC economic adviser, spoke with* World Bank News *about recent investment trends. Excerpts follow:*

Guy Pfeffermann

WBN: Why is private and foreign direct investment rising in the developing world?

Mr. Pfeffermann: There are a lot of factors behind the jump. But basically, it has been caused by recent reforms in the

*See* INTERVIEW, *page 2*

INTERVIEW, *from page 1*

developing world. More and more countries are increasingly stable, liberalizing trade and capital flows and creating a better business climate.

As countries make these changes, they naturally become more attractive to foreign investors. In India, for example, the government has made considerable efforts to liberalize investment policies. Because of these policy changes, many large enterprises are now thinking about investing more, often in joint ventures with foreign companies.

Today, investing in developing countries can be more advantageous than investing in industrialized countries. Developing countries offer lower production costs and allow investors to create competitive operations.

A factory built in Indonesia, Malaysia or even in a low-income country today, will often be nearly as advanced and state-of-the-art as one built it in Germany, Switzerland or the United States—but cheaper to run.

WBN: East Asia attracted the most private investment of any developing region. Why?

Mr. Pfeffermann: That's very hard to answer. Many economists are still studying the so-called Asian miracle countries.

I can only say that the governments in East Asia, besides having first-rate macromanagement, have made very great, effective efforts to create incentives for private investors. Singapore, for example, now has probably the most efficient port in the world. The bureaucracy is computerized. A ship at sea signals what it needs, and within 20 to 30 minutes, all the permits and bureaucratic requirements are complete. This is beamed back to the ship, and the job is done.

It's extraordinarily efficient, and this i the kind of thing that will attract privat investors. In a place like Singapore, yo don't become mired in bureaucrati hassles.

WBN: What kind of lessons can othe developing countries in Africa, Lati America or elsewhere draw from Eas Asia's success?

Mr. Pfeffermann: Besides the need fo sound macroeconomic policies, it is ab solutely necessary to have good govern ment institutions and minimal red tape

Investors want continuity, which is a large part of East Asia's success. Wher people invest, they want to be sure tha 10 years down the line, the business cli mate is not going to be any worse than i is today.

Also, the structures of communication between the government and the private sector are very important. In some of the

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most successful countries, governments and private companies work together to promote investment. This doesn't mean subsidies, but for example, appropriate infrastructure investment.

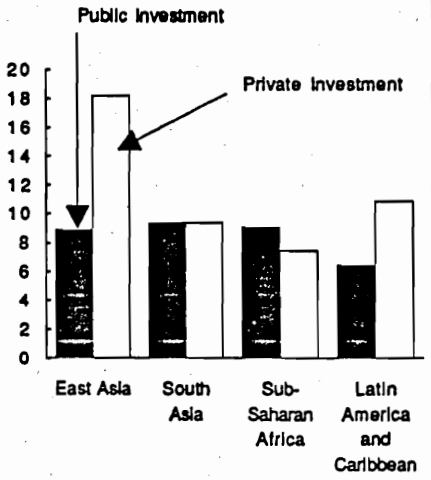
**WBN:** In your report, you say the structural adjustment policies pursued by some developing countries in the 1980s will help them to use investment more efficiently. Why?

**Mr. Pfeffermann:** If you produce matches in a developing country, there are two ways for you to make a lot of money. First, you can make money by being an efficient producer of matches. Or second, you can make a lot of money if the government protects you from foreign competition.

Structural adjustment means that these government subsidies are gradually coming down to a point where they are not very important. Today, if you invest in a country that has liberalized, you know that you will not have to compete against firms that are receiving heavy government subsidies.

As a country opens up, it weeds out inefficient enterprises which rely on so-called economic distortions like subsidies to make profits. That makes it possible to export.

**Public and Private Investment, 1980-90**
**(percent of GDP)**




**WBN:** Will the new investment spur economic growth in developing countries?

**Mr. Pfeffermann:** Yes. Investment activities create jobs—now and in the future—because you are building up the long-term capacity to produce goods. It also generates tax revenues for the developing country's government. Investment is part of an upward spiral of incomes, production, employment and government revenues. If investment goes down, you get a downward spiral of all of these things.

**WBN:** While private and foreign direct investment is rising, public investment is falling. Why?

**Mr. Pfeffermann:** Public investment is dropping, partly because of the after-effects of the debt crisis. In Latin America, especially, governments are still putting the brakes on public spending. When governments cut spending, they tend to cut investment first before wages and current expenses.

Also, governments in many countries are allowing the private sector to invest in infrastructure which used to be a government monopoly. In telecommunications, for example, many countries simply do not have the money to modernize and expand telephone systems. So, they bring in private companies.

Governments are also turning to the private sector for help in roads and ports. In Argentina, railroads are being privatized.

**WBN:** Many economists claim that public investment slows growth. In your study, you disagree.

**Mr. Pfeffermann:** You could argue that public spending is too low in some countries. Schools and hospitals are deteriorating, for example.

By and large, it stands to reason that if you don't have good infrastructure, your country is not going to be very efficient and will not attract investment. It's true that governments have invested in frivolous things like superhighways between the capital city and the nearest beach. But where governments invest in things that make sense and in which the private sector won't take part, then public investment helps development. □

## IMF ACTIVITIES

# Sharp Changes in Global Balance of Payments Picture Occurred During 1991, Says IMF Report

The current account deficit of the industrial countries dropped sharply to $18.5 billion in 1991, from $108.2 billion in 1990, while the deficit of the developing countries widened to $81.0 billion in 1991 compared with $12.0 billion the previous year, according to the IMF's 1992 *Balance of Payments Statistics Yearbook* (*BOPSY*). Among the developing countries, the oil exporting nations recorded a deficit of $51.8 billion in 1991 compared with a surplus of $10.0 billion in 1990. Meanwhile, the deficit of the non-oil developing countries increased slightly, to $29.2 billion in 1991 from $22.0 billion in 1990.

### Industrial Countries

The reduction in the current account deficit of $89.7 billion in 1991 was mainly the result of an improvement in the merchandise account of $46.4 billion (to a surplus of $9.0 billion) and a reduction of $31.2 billion in the unrequited transfer deficit, most of which was due to official transfers. The improvement in the merchandise account was caused largely by the substantial increase in Japan's trade surplus, to $103.1 billion in 1991 from $63.6 billion in 1990, and by a substantial decrease in the U.S. deficit, to $73.4 billion from $108.8 billion. The improvement would have been larger but for a marked reduction in Germany's surplus to $23.5 billion in 1991 from $71.7 billion in 1990.

The deficit on official transfers was reduced significantly during 1991 to $30.8 billion, from $62.7 billion the previous year, as a result of transfer credits almost doubling to $115.3 billion while debits increased by 18 percent to $146.1 billion. The increase in credits was due mainly to receipts by the United States of $42.5 billion of nonrecurring cash contributions from its coalition partners in Operation Desert Storm. The increase in debits reflected both the payments to the United States by its coalition partners and debt forgiveness by a number of industrial nations.

Relative to current payments, the current account deficit of the industrial countries dropped sharply to 0.5 percent in 1991, from 2.7 percent in 1990. These levels contrast with the previous lowest ratio of 1.3 percent in 1986 and a peak of 3.1 percent in 1985.

The reduced current account deficit in 1991 was accompanied by a large inflow of long-term capital of $90.0 billion compared with an outflow of $12.0 billion in 1990. However, owing to short-term capital outflows of $79.7 billion in 1991, compared with an inflow of $110.7 billion in 1990, the overall balance, excluding the items "exceptional financing" and "liabilities constituting foreign authorities' reserves," swung into a deficit of $11.7 billion in 1991 from a surplus of $21.9 billion in 1990. The deficit in 1991 was financed primarily by a reduction in reserves of $10.9 billion, compared with an increase in reserves of $57.3 billion the year before.

Net capital inflows, including changes in reserves, declined to $21.9 billion in 1991 from $76.8 billion in

**Summary of Global Current Account Balances**

(billion U.S. dollars)

| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|
| Current account, n.i.e | -80.2 | -66.2 | -48.6 | -59.5 | -75.9 | -112.5 | -91.1 |
| Merchandise f.o.b. | 6.6 | 0.2 | 22.6 | 30.0 | 17.5 | 19.7 | 20.8 |
| Shipment | -24.6 | -25.6 | -30.2 | -31.8 | -33.1 | -35.7 | -41.6 |
| Other transportation | -0.7 | 1.3 | 0.3 | -0.5 | -2.9 | -2.8 | -1.4 |
| Travel | 2.9 | 3.4 | 1.4 | -3.8 | — | 0.4 | 3.5 |
| Reinvested earnings on direct investment | 15.6 | 16.8 | 27.8 | 25.2 | 35.0 | 50.4 | 46.1 |
| Other direct investment income | -9.8 | -2.2 | -3.0 | 3.3 | 5.8 | -7.4 | -04.1 |
| Other investment income | -53.0 | -54.8 | -68.3 | -73.1 | -77.2 | -92.5 | -90.4 |
| Other official goods, services, and income | -12.9 | -10.5 | -8.9 | -11.4 | -15.6 | -14.0 | -27.9 |
| Other private goods, services, and income | -0.4 | 12.3 | 14.4 | 9.8 | 11.1 | 8.4 | 30.8 |
| Private unrequited transfers | 9.0 | 9.6 | 13.5 | 12.1 | 5.6 | 6.8 | -2.9 |
| Official unrequited transfers | -12.9 | -16.8 | -18.1 | -19.4 | -22.2 | -45.6 | -24.0 |

Note: A minus sign indicates a debit figure; n.i.e. indicates data not included elsewhere.

Data: IMF, *Balance of Payments Statistics Yearbook*, Vol. 43, Part 2 (1992)



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1990. The net acquisition of foreign financial assets declined by 47 percent to $478.4 billion, and the net incurrence of foreign liabilities declined by 49 percent to $500.4 billion in 1991.

The net acquisition of foreign assets in 1991 resulted mainly from direct investment abroad ($175.7 billion) and a marked increase in transactions in long-term securities, that is, portfolio investment assets ($308.4 billion). Even so, the uninterrupted upward trend in direct investment abroad since 1984 was broken in 1991, with the value of transactions falling by 23 percent. This reduction was evident for almost all industrial countries, but to differing degrees. The acquisition of long-term foreign securities increased by almost 90 percent to $308.4 billion in 1991, following a decrease of 28 percent in 1990. The large increase in 1991 was accounted for by a number of countries, notably the United States (56 percent, to $45 billion), Japan (85 percent, to $74.4 billion), the United Kingdom (145 percent, to $56.7 billion) and Belgium-Luxembourg (130 percent, to $34.0 billion).

Long-term securities represented the most significant component in the net incurrence of foreign liabilities by industrial countries during 1991 (a net inflow of $379.9 billion). This was accompanied by a direct investment inflow of $105.7 billion and a reduction in short-term liabilities of deposit-money banks of $133.0 billion.

### Developing Countries

The current account deficit of the developing countries increased to $81.0 billion in 1991 from $12.0 billion in 1990. This was largely attributable to a drop in the merchandise trade surplus to $11.7 billion from $57.0 billion. The merchandise trade surplus of the oil exporting countries fell as the result of a reduction in exports that was greater than the fall in imports. By contrast, the deficit of the non-oil developing countries increased, despite an increase in their exports.

In contrast to the merchandise trade surplus, the deficit in other goods, services, and income items remained persistently large, deteriorating by 46 percent in 1991 to $104.9 billion. Among the major components of this category, only the travel item showed a significant surplus, while labor income showed a small but increasing surplus. The net inflow of unrequited transfers into developing countries fell to $12.2 billion in 1991 from $31.2 billion in 1990, as private transfer receipts fell and official transfers almost doubled.

At the same time, long-term capital inflows increased sharply to $108.9 billion in 1991, from $21.6 billion in 1990, while the outflow of short-term capital increased slightly to $5.0 billion from $2.9 billion. Reliance on exceptional financing was reduced slightly to $40.4 billion in 1991, from $41.3 billion the previous year, and reserves increased by $64.2 billion in 1991 compared with $40.8 billion in 1990.

Overall, capital movements for developing countries, including changes in reserves, showed a net inflow of $79.2 billion in 1991 compared with an inflow of $18.8 billion in 1990. Capital outflows (representing net acquisition of financial assets abroad) fell to $91.5 billion in 1991, from $107.1 billion in 1990. The largest outflows were recorded for Asia ($66.1 billion) and the Western Hemisphere ($24.5 billion). Capital inflows (representing net incurrence of financial liabilities abroad) rose to $170.7 billion in 1991 from $125.9 billion in 1990. The largest inflows occurred in Asia ($69.8 billion), the Middle East ($38.6 billion), and the Western Hemisphere ($39.8 billion).

**Balance of International Transactions**

(billion U.S. dollars)

| | Current Account | | Long-Term Capital | | Short-Term Capital | | Net Errors & Omissions | | Exceptional Financing | | Liabilities Constituting Authorities' Reserves | | Total Changes | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1990 | 1991 | 1990 | 1991 | 1990 | 1991 | 1990 | 1991 | 1990 | 1991 | 1990 | 1991 |
| **Total** | -112.5 | -19.1 | 7.9 | 190.4 | 106.3 | -73.8 | 26.3 | -0.6 | 42.0 | 40.0 | 26.5 | -6.8 | -96.5 | -58.1 |
| Industrial countries | -108.2 | -18.5 | -12.0 | 90.0 | 110.7 | -79.7 | 31.5 | -3.4 | 0.7 | -0.4 | 34.7 | 1.1 | -57.3 | 10.9 |
| Developing countries | -12.0 | -81.0 | 21.6 | 108.9 | -2.9 | -5.0 | -6.7 | 1.7 | 41.3 | 40.4 | -0.4 | -0.9 | -40.8 | -64.2 |
| International organizations | 7.7 | 8.4 | -1.7 | -8.5 | -1.5 | 10.8 | 1.6 | 1.1 | ... | ... | -7.8 | -7.0 | 1.7 | -4.8 |
| MEMORANDUM ITEMS | | | | | | | | | | | | | | |
| Oil exporting countries | 10.0 | -51.8 | 1.3 | 62.2 | -7.1 | — | -1.8 | -7.7 | 2.9 | 2.5 | -0.4 | -0.1 | -4.8 | -5.2 |
| Non-oil developing countries | -22.0 | -29.2 | 20.4 | 46.7 | 4.2 | -5.0 | -4.9 | 9.4 | 38.4 | 37.9 | — | -0.8 | -36.0 | -59.0 |

Note: A minus sign indicates a debit figure.

Data: IMF, *Balance of Payments Statistics Yearbook*, Vol. 43, Part 2 (1992)



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### International Organizations

According to the data compiled by the IMF, the current account surplus of international organizations increased slightly to $8.4 billion in 1991 from $7.7 billion in 1990. The improvement was due to an increase of $1.2 billion in the surplus on other investment income, offset by a decrease of $0.7 billion in the deficit on official services.

Capital account transactions of international organizations, including changes in reserves, recorded a net outflow of $9.4 billion in 1991, similar to the outflow of $9.3 billion in 1990.

### Global Current Account Discrepancy

Whereas, conceptually, the surpluses and deficits on current account of all countries and international organizations should offset each other, leaving no global discrepancy, this does not happen in practice. Indeed, the global current account discrepancy showed a deficit of $91.1 billion in 1991, compared with a deficit of $112.5 billion in 1990. The discrepancy, which improved significantly in 1986 and 1987, worsened persistently over the next three years, reaching its highest recorded level in 1990. However, as a proportion of global current account payments, the discrepancy has shown a downward trend from -3.0 percent in 1985 to -2.1 percent in 1990 and -1.6 percent in 1991.

The global current account discrepancy is the result of incomplete coverage and inaccurate recording of transactions by countries, and the omission of countries for which data are not available. To make the balance of payments standard components more analytically useful, the *BOPSY* (Part 2) includes data that are adjusted for the global discrepancy. When these adjustments are taken into account, the global imbalance is reduced considerably. With a view to improving the coverage of transactions in the global data, the IMF's Statistics Department has also collected and incorporated data on the transactions of the major international and regional organizations.

The current account discrepancy is a composite of imbalances in the various components that partially offset each other. Among the major negative imbalances are "other investment income," followed by "shipment," "official unrequited transfers," and "other official goods, services, and income." In contrast, positive imbalances are recorded for "reinvested earnings on direct investment," "other private goods, services, and income," and "merchandise."

No attempt is made to adjust the global statistical discrepancy in the capital account. As a follow-up to the *Report on the World Current Account Discrepancy*, a Working Party on the Measurement of International Capital Flows was constituted in January 1990. A final report on its findings with recommendations for improvements in these data was published by the IMF in September 1992.

### *Yearbook* Provides Balance of Payments Data for 1985–91

The 1992 *BOPSY* (Volume 43) contains data for 1985–91, current as of September 1, 1992. The *Yearbook* is divided into two parts. Part 1 contains data and explanatory notes by country. Each country section includes two tables that present annual data in both aggregated and detailed formats. Quarterly data (when available) are presented in aggregated form. Part 2 presents data for the world, international organizations, and principal regions, as well as for individual countries. World and regional totals include estimates for countries that do not report, or whose reports are not current. However, no estimates are included for the states of the former Soviet Union. Also included in Part 2 are adjustments for selected statistical discrepancies in the current account.

The price of the 1992 *Yearbook* is US$45.00. A special rate for university faculty members and students is available. Please write to Publication Services, Box S-361, International Monetary Fund, Washington. D.C., 20431, U.S.A.



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SELECTED TOPICS

# Parallel Currency Markets in Developing Countries Analyzed by IMF Economist

Developing country authorities have found that tolerating domestic parallel markets—also known as black, informal, fragmented, or curb markets—in foreign currencies has not helped them to either defend their international reserves or maintain overvalued exchange rates, according to Pierre-Richard Agénor, Economist in the IMF Research Department's Developing Country Studies Division.

In *Parallel Currency Markets in Developing Countries: Theory, Evidence, and Policy Implications*, which is No. 188 in Princeton University's Essays in International Finance series, Agénor discusses recent theoretical and empirical analyses of these markets and considers relevant policy issues. He observes that parallel markets in any commodity develop in response to legal restrictions on its sale, ceilings on its price imposed by the country's government, or both. Many developing countries apply both types of restrictions to foreign exchange transactions, with the exchange rate typically pegged by the central bank and only a small group of intermediaries permitted to engage in currency transactions.

Since under such regimes domestic purchases of foreign exchange are restricted to uses deemed by the authorities to be essential for economic development, such as purchases of capital goods, incentives are created for the diversion of foreign exchange to illegal parallel markets, where it is sold at a price above the official exchange rate. The amount by which the parallel market rate exceeds the official rate is known as the parallel market premium.

Agénor explains that the size of the parallel market premium "will depend upon a host of factors—in particular, the penalty structure and the volume of resources devoted to apprehension and prosecution of violators." He also notes that the premium typically fluctuates considerably over time and among countries, adding that "in periods characterized by uncertainty about macroeconomic policies or unstable political and social conditions, parallel market rates tend to react swiftly to expected future changes in economic circumstances." Somewhat surprisingly, Agénor notes that in certain circumstances—for example, in an outward-oriented economy that experiences rapid economic growth and records large external surpluses, thus inducing its central bank to restrict the banking system's accumulation of foreign exchange and unintentionally creating excess supply in the country's parallel currency market—a country's parallel market exchange rate may appreciate with respect to its official exchange rate.

The author expresses the view that parallel markets "typically emerge out of restrictions on trade and capital flows. In low-income countries, the process often starts with the government trying to impose regulations on trade flows (licensing procedures, administrative allocations of foreign exchange, prohibitions). The imposition of tariffs and quotas creates incentives to smuggle and fake invoices by creating an excess demand for imported goods at illegal, pretax prices . . . . Illegal trade creates a demand for illegal currency, which, in turn, stimulates its supply and leads to the creation and establishment of a parallel currency market if the central bank is unable, or unwilling, to meet all the demand for foreign exchange at the official exchange rate."

Once a parallel currency market comes into existence, its size will depend principally on the range of transactions subjected to exchange controls and the extent of enforcement by the authorities. Agénor states that, on the one hand, in a country where demand rationing is not intense in the official foreign exchange market, the parallel currency market is likely to be of marginal importance; on the other hand, in a country with chronic balance of payments deficits and a central bank that lacks sufficient international reserves and/or borrowing capacity to satisfy the demand for foreign currency at the official exchange rate, the parallel market is likely to be well developed and organized, with an exchange rate substantially depreciated with respect to the official rate.

Parallel currency markets generally coexist with, rather than replace, the official foreign exchange market because of the penalties that parallel market traders may have to pay if they are caught. Agénor comments that "both legal and illegal markets will exist if the risk of penalties can be reduced by engaging in legal sales that mask profitable but illegal transactions." Moreover, he notes, parallel markets, though illegal, are frequently tolerated by the authorities in developing countries.

The author observes that sources of



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supply and demand in parallel markets "vary from country to country and depend heavily on the nature and effectiveness of exchange restrictions imposed by the authorities." The supply of illegal holdings of foreign currency generally comes from five principal sources: smuggling of exports, underinvoicing of exports, overinvoicing of imports, foreign tourists, and the diversion of remittances from abroad into unofficial channels. Government officials may also divert foreign exchange from the official to the parallel market in exchange for bribes or other considerations.

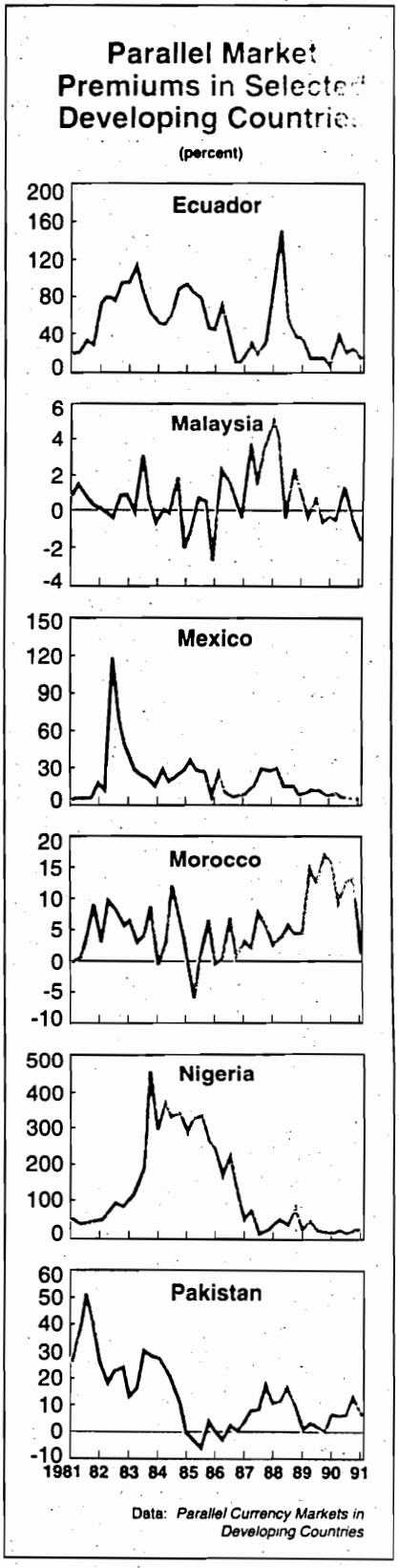
Agénor opines that "although all of these sources are likely to be used . . . there is in general a dominant source at each time and in each country." He adds that "available estimates . . . stress the importance of smuggling, underinvoicing of exports, and overinvoicing of imports as the major sources of supply of foreign currency in most developing countries."

The author notes that the demand for foreign currency in parallel markets generally reflects three principal activities: legal and illegal imports, portfolio diversification and capital flight, and residents' travel abroad. He notes that the inherent confidentiality of transactions carried out in the parallel market encourages its use for illegal activities and comments that "the portfolio motive is particularly acute in high-inflation economies and in countries where considerable uncertainty over economic policies prevails, because foreign currency holdings represent an efficient hedge against bursts of domestic inflation." He also points out that in middle-income developing countries, portfolio diversification is often a very important determinant of demand for foreign exchange in parallel markets.

The author observes that, from the viewpoint of national authorities, the operation of parallel currency markets has several adverse effects, including (1) the costs of enforcement; (2) the loss of tariff revenue because of smuggling and underinvoicing of exports, the loss of revenue from both income and domestic indirect taxes, and reduced flows of foreign exchange to the central bank (which lower the government's ability to finance imports); (3) the adverse effect of rent-seeking activities (for example, solicitation of bribes by government officials) on the country's resource allocation; and (4) the weakening of monetary control owing to the parallel market's facilitation of switching from domestic currency to foreign currency assets and the possible loss of seigniorage revenue accruing to the government.

Some developing countries' authorities argue, Agénor notes, that parallel currency markets may be socially desirable because they accommodate transactors whose demand for foreign exchange is not met by the official market or because they increase employment by increasing the domestic availability of imported inputs. He notes, however, that there is little empirical evidence to support these assertions, adding that "overall, the welfare effects of exchange controls in the presence of parallel markets are largely ambiguous."

Further, Agénor asserts, developing countries' justifications for imposing exchange controls have been seriously flawed. He observes that "rationing has created shortages of imported good and shortages have encouraged smuggling. This has made it highly lucrative for rent-seeking traders to resell in the parallel market foreign exchange illegally acquired at the official rate. The existence of a high and positive premium in the parallel market has represented in many countries a strong incentive to divert export receipts from the official to the parallel market. As a result, instead of increasing the reserves at the disposal of the



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authorities, official controls have succeeded only in diverting a substantial part of the available foreign exchange to illicit use."

The author also indicates that high premiums in parallel currency markets have considerably weakened the balances of payments of some countries and cautions that the expansion of these parallel markets may weaken the effectiveness of capital controls. He therefore concludes that "if parallel markets emerge in response to the imposition of controls, the most effective remedy is to eliminate the restrictions and let prices reflect fully the scarcity of foreign exchange," adding that in recent years several developing countries have moved, in accordance with this view, to make their exchange and trade regimes less restrictive.

The Princeton Essay also discusses the interrelations between parallel currency market premiums and exchange rate devaluation by developing countries, as well as the unification of a developing country's foreign exchange market. The same issues discussed in *Parallel Currency Markets in Developing Countries* and other issues will be discussed at greater length and at a higher level of technical sophistication in a forthcoming book entitled *Informal Financial Markets in Developing Countries: A Macroeconomic Analysis*. Written by economists Peter J. Montiel, Pierre-Richard Agénor, and Nadeem Ul Haque, the book is based primarily on work done in the IMF's Research Department and is to be published in April 1993 by Blackwell Publishers.

Copies of *Parallel Currency Markets in Developing Countries* are available for $6.50 each from the International Finance Section, Department of Economics, Fisher Hall, Princeton University, Princeton, New Jersey 08544-1021, U.S.A. Copies of *Informal Financial Markets in Developing Countries* will cost £40 each and may be ordered from Marston Book Services, P.O. Box 87, Oxford OX2 ODT, United Kingdom.

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HIID Research Review

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# Real Exchange Rate Management for Policymakers in Developing Countries

SHANTAYANAN DEVARAJAN, JEFFREY D. LEWIS, and SHERMAN ROBINSON

"EXTERNAL SHOCKS, PURCHASING POWER PARITY, AND THE EQUILIBRIUM REAL EXCHANGE RATE"
*In* WORLD BANK ECONOMIC REVIEW, *Vol. 7, No. 1, Jan. 1993.*

Faced with sharp increases in real interest rates, cutbacks in foreign lending, and deteriorating terms of trade—all of which lower the sustainable level of a country's current account balance—developing countries since the mid-1970s have been forced to reduce their trade deficits or, in some cases, to run surpluses. Often with substantial IMF and World Bank insistence, they have adopted "structural adjustment" programs aimed at facilitating the transition to lower current account deficits. A common ingredient in all these programs is a real depreciation of the exchange rate which, it is argued, will increase "competitiveness" of exports, make imports more expensive, and shift resources from sectors producing nontradables to those producing tradables.

Implicit in the recommendation of a devaluation is a view that the real exchange rate is out of equilibrium. This raises two difficult questions for policymakers: By how much? And what is the equilibrium exchange rate? Policymakers need answers to these questions to determine how large an exchange rate adjustment is required, and how large a shock the domestic price system must absorb.

***The 1-2-3 model is a very simple general equilibrium model the key implication of which is to replace the tradable-nontradable dichotomy of the Salter-Swan model with a continuum of tradability.***

Two common approaches used to determine the equilibrium real exchange rate in a country are purchasing power parity (PPP) calculations and the Salter-Swan tradables-nontradables model. The PPP approach involves choosing a benchmark year in which the current account was "in equilibrium" or "sustainable," and thereafter calculating the equilibrium nominal exchange rate in any subsequent year by adjusting this benchmark rate according to the inflation differential between the country and its trading partners. The Salter-Swan open economy model approaches the problem by defining the real exchange rate. It does this in terms of nontradable prices (for goods produced and sold in the country) and tradable prices (for goods that are or could be traded internationally) rather than in terms of domestic and foreign price levels.

Devarajan and Lewis discuss the theoretical and empirical difficulties associated with each of these two approaches. PPP calculations, for example, require one to accept the questionable assumption that the external environment and structure of the economy have remained unchanged since the benchmark period, and also rely on the use of price indices that are not conceptually identical to traded and nontraded goods. The Salter-Swan model, on the other hand, relies on a strict dichotomy between tradables and nontradables that is empirically untenable, since the number of completely nontraded commodities is quite small. Moreover, the model also fails to distinguish between exports and imports, which in man developing countries are often very different goods.

The authors then develop a model that addresses thes theoretical and empirical concerns. Toward that end the demonstrate that the PPP approach and traditional Salter-Swa formulations are in fact special cases of the 1-2-3 mode allowing a clearer understanding of the circumstances unde which the two approaches can be expected to yield simil outcomes. The resulting one-country, two-activity, three-con modity (or 1-2-3) model generalizes the Salter-Swan approach t include both exports and imports, as well as imperfect subst tutes for each.

The 1-2-3 model is a very simple general equilibrium mod (with only eight equations) in which two goods (a domestic goo and an export good) are produced, and two commodities (th domestic good and an imported good) are consumed. The ke feature is the assumption of imperfect substitutability betwee the domestic good and both imports and exports. Domesti goods and exports are imperfect substitutes in supply, implyin that it is costly to change the allocation of the economy productive capacity between the two. Similarly, domesti goods and imports are imperfect substitutes in consumptio The impact of this treatment is to replace the tradabl nontradable dichotomy of the Salter-Swan model with a *continuum* of tradability. Separate elasticity parameters allow f varying degrees of substitutability between domestic goods an either exports or imports. In other respects, the model is standard general equilibrium model: it contains no monetar or financial variables, and it determines only relative price What *drives* the model is a functional link between the re exchange rate (defined correctly as the ratio of tradable t nontradable prices) and the trade balance.

Using this model to analyze the impact of a terms-of-trad shock (in which the world price of imports and/or expor changes), the authors show how one can decompose the nece sary change in the equilibrium exchange rate into three comp nents: an *inflation differential* effect, a *terms of trade* effect,

(continued on page

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and a *balance of trade* effect. The first component is conceptually similar to the standard adjustment of the PPP approach, although the theoretically appropriate weights to measure changes in world import and export prices in the 1-2-3 model are based on the substitution elasticities, rather than on trade shares as in the PPP approach. The other two components represent exchange rate adjustments that are necessary because of *real* changes in the external environment: terms of trade movements or shifts in the sustainable balance of trade. These real effects are ignored or omitted in the usual PPP approach.

Finally, the authors illustrate their method of calculating the equilibrium real exchange rate by applying the 1-2-3 model to Cameroon and Indonesia, two oil-exporters which suffered major terms of trade shocks in 1986 when world oil prices plummeted. The exchange rates derived from the 1-2-3 model are contrasted with predictions derived from the PPP approach. The model estimates depart quite substantially from the PPP approach, which neglects terms-of-trade shocks entirely. The 1-2-3 model estimates are also compared with results derived from larger multisector computable general equilibrium (CGE) models for each economy. The similarity in results from the two models suggests that in practice, using the simple 1-2-3 model to compute equilibrium real exchange rates sacrifices little relative to building and solving a more complex model; moreover, solving the 1-2-3 model requires little more information than that required to carry out the usual PPP calculations. While the substitution elasticities are not directly observable, experience with larger models and a growing body of empirical estimates help us narrow the range for these elasticities, thereby increasing confidence in the exchange rate changes estimated by the model. ■

# Record Global Borrowing In 1992, Says OECD

Despite poor prospects for the world economy, uncertainties in Europe, and interest rate and exchange rate tensions, borrowing on international capital markets hit a record $610 billion in 1992—a 16 percent increase over the previous year, according to the Organization for Economic Cooperation and Development (OECD) in its February issue of *Financial Market Trends*, a quarterly report on developments in global financial markets. The report adds, however, that the 1992 data "vastly overstate" the contribution of the international markets to net financing because these data include significant loan refinancing and do not take account of the record volume of outstanding bonds that were redeemed in the course of the year.

Discussing borrowing by groups of countries, the report points out that

- The demand for international financing continued to be strongly concentrated in the OECD area; OECD borrowing was $535.7 billion in 1992, or 88 percent of the total. Within the OECD, a striking development was the strong expansion of borrowing by U.S. residents, which rose by $95.0 billion (27 percent more than in 1991). Borrowing by U.K. residents also rose—for the third consecutive year—to $70.9 billion. In addition, German borrowers resorted to international capital markets on a significantly larger scale, raising $28 billion in 1992—almost 50 percent more than a year earlier. Fund-raising by Japanese entities, which had been the heaviest borrowers during 1989–91, totaled $75.5 billion in 1992, or 8.4 percent less than in 1991.
- After expanding by almost 60 percent in 1991, borrowing by developing countries rose only modestly (by 2 percent) in 1992, to $47.3 billion. (However, reconstruction-related loans to Middle Eastern countries, which accounted for $11 billion of the $46.2 billion borrowed by developing countries in 1991, totaled just $3 billion in 1992.) Asian and Latin American borrowers accounted for the bulk of developing country borrowing in 1992.
- Borrowing by Central and Eastern European countries declined to $1.5 billion in 1992—about 16 percent less than a year earlier and only about one-third the yearly average during 1988–90.

## OECD Countries Dominate Borrowing on International Capital Markets

(billion U.S. dollars)

| Country Group | 1988 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|---|
| OECD area | 413.8 | 426.5 | 384.4 | 457.9 | 535.7 |
| Developing countries | 22.5 | 21.8 | 28.6 | 46.2 | 47.3 |
| Central and Eastern Europe | 4.6 | 4.7 | 4.6 | 1.8 | 1.5 |
| Others | 12.6 | 13.5 | 17.3 | 19.0 | 25.2 |
| **Total** | **453.5** | **466.5** | **434.9** | **524.9** | **609.7** |

Data: OECD, *Financial Market Trends*, February 1993



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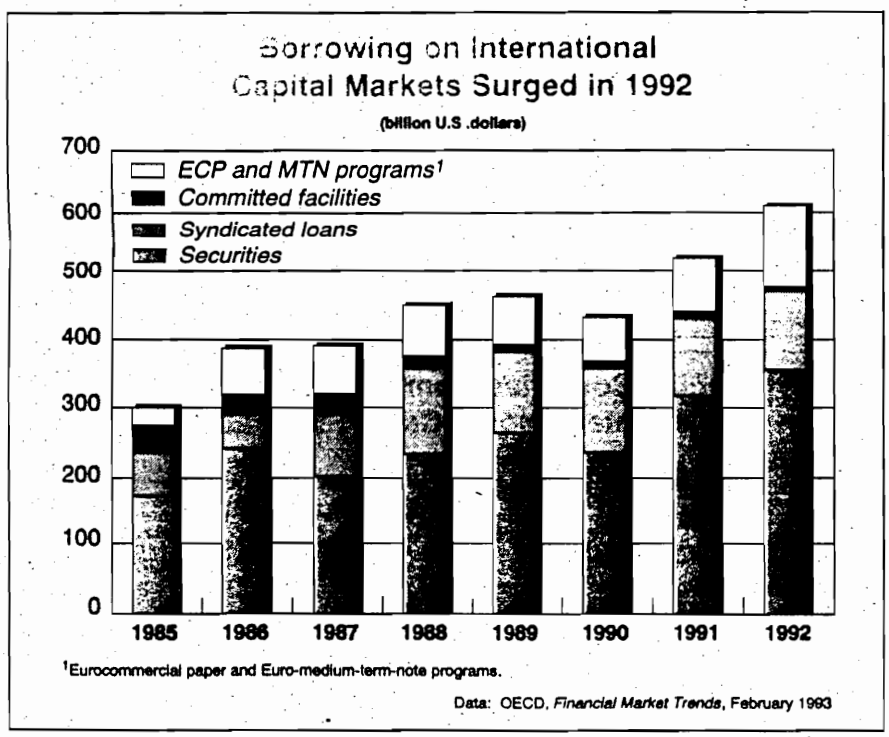
Turning to borrowing by instrument, the report notes that, after expanding by 30 percent in 1991, the volume of business in the bond markets totaled $334 billion in 1992 (or 55 percent of all borrowing)—a 12 percent increase over 1991.

New lending activity in the syndicated credit market remained weak, according to the report. The cautious attitude of banks and their emphasis on increasing rates of return continued to limit the scope for the market's growth, while resulting in a further stiffening of lending terms. Total syndicated loans amounted to $118 billion in 1992—about the same as in 1991—and this figure included an exceptionally large volume of refinancings.

A particularly striking feature in 1992, according to the report, was the expansion of Euro-medium-term note programs to $99.0 billion (16.2 percent of total borrowing), from $44.3 billion (8 percent of total borrowing) in 1991. By contrast, the value of Eurocommercial paper programs (which are borrowing instruments that have shorter maturities than medium-term notes) continued to decline in 1992, reaching $28.9 billion—about one half of the yearly totals of the late 1980s.

**Prospects**

Assessing short-term prospects for the global financial markets, the report projects that international securities markets are likely to remain buoyant. The Eurobond markets have entered 1993 on an "exceptionally strong footing," it notes, adding that all available indicators suggest "a volume of capital demand for 1993 much larger than in recent years." Borrowing requirements of OECD governments have risen considerably, and a substantial portion of these will have to be financed internationally. Non-OECD countries that have regained the creditworthiness to attract private and institutional investors are also expected to step up their borrowings on securities markets.




The report points out that, in addition to a higher volume of new demand, international bond markets will be confronted with rapidly growing refinancing needs. In 1993, the amount of scheduled payments on outstanding bonds is expected to be about $260 billion—and the total could be much higher if there are early redemptions, which is usually the case in an environment of falling interest rates. The report suggests that the competitiveness of the Eurobond markets should ensure that these markets recapture the bulk of security offerings connected with refinancing operations. Moreover, a large proportion of reflows from redemptions will be rolled over in these markets.

Two additional factors may enhance the supply of capital to the Eurobond markets, according to the report: the introduction of very large Euro-issues by sovereign borrowers, which investors find particularly attractive because of the high liquidity and scope for arbitrage that they offer; and the possibility of a sustained rally in the bond markets (given market expectations of a significant drop in European long-term interest rates), which would boost investor confidence.

Prospects for the syndicated loan market are less favorable, says the report. It notes that banks' strategic decisions will continue to be strongly influenced by considerations of credit quality and balance-sheet consolidation. Most banks will remain "very cautious" in making loans, which will limit the expansion of the syndicated market.

Finally, the report notes that the Euronote market has become much broader and deeper in recent years, with business volumes having grown rapidly. The momentum for further growth will continue to come from the market for Euro-medium-term notes, the report points out.



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DEVELOPMENT
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NEWS FOR POLICY LEADERS
December 1992

## *Focus on World Debt*

### Debt Crisis Far From Over For Sub-Saharan Africa

**New York** — For the severely indebted low-income countries of sub-Saharan Africa, debt-servicing remains unsustainably high in relation to export earnings and Gross National Product (GNP), according to a new World Bank report.

The report, 'World Debt Tables, 1992-93', released in Washington Dec. 17, says that while the pattern of external resource flows to developing countries has changed significantly in recent years, the situation of severely indebted low-income countries (SILICs), which include sub-Saharan African nations, has remained relatively unchanged.

Thus while the debt crisis that began a decade ago is largely over, the report states that "the crisis is certainly far from over" for many sub-Saharan African countries which "are indebted largely to official bilateral creditors and whose debt burdens are, in some cases, unsustainably high."

Sub-Saharan African countries affected include Ethiopia, Kenya, Mozambique, Niger, Somalia, the Sudan, Tanzania, Uganda and Zaire.

The report states that while Africa's sub-Saharan countries continued to receive external official support "at historically high levels ... the majority of them remain far from external viability."

For example, it points out that the debt-to-exports ratio for SILICs is projected at 411 percent in 1992, and the debt-to-GDP (Gross Domestic Product) ratio at 113 percent.

According to the 223-page report, the total debt of the SILICs rose by 1.6 percent in 1991 to 177.1 billion dollars. This, it says, is a relatively small proportion of the total external debt of all developing countries, estimated at 1,703 trillion dollars in 1992, an increase of over 100 billion dollars from the 1991 figure.

Much of the reason for the increase in Third World debt is because of the external debt of the former Soviet Union which is estimated by the bank at around 67.2 billion dollars at the end of 1991.

The report adds that "for some, reducing debt burdens to sustainable levels looks increasingly difficult within existing official debt reduction schemes".

To this end, the bank states that "additional debt forgiveness will be necessary for many of them if they are to reduce their currently unsustainable debt burdens."

And it notes that the "challenge" ahead "is assuring enough concessional funding for their future development needs, at a time when aid budgets are growing more slowly than is the number of old and new claimants on these limited funds".

In fact, according to the report, of the 18 billion dollars committed by the World Bank in 1991, Africa received only six percent, compared to Latin America's share (28 percent), Europe and Central Asia (23 percent), East Asia and the Pacific (22 percent), the Middle East and North Africa (12 percent) and South Asia (9 percent).

Africa was, however, the largest recipient of commitments by the International Development Association (IDA) — the 'soft-loan' arm of the World Bank — receiving a 40 percent share of commitments, followed by South Asia (30 percent), and East Asia and the Pacific (20 percent).

But the report points out that these "constraints" have resulted in a stagnation in net flows to the low income developing countries during both 1991 and 1992.

And while foreign direct investment in developing countries as diverse as Bangladesh, China, Hungary and the Philippines during 1991-92 surged to a total of roughly 38 billion dollars, new investment largely bypassed the poorest African countries.

On the other hand, North Africa and the Middle East are projected to see a substantial increase in foreign direct investment flows from 0.7 billion dollars in 1991 to 2.1 billion dollars in 1992.

According to the report, the external financing needs of the severely indebted low-income countries have been met during the 1980s through strong official support with highly concessional finance, extensive debt rescheduling and official development assistance (ODA) forgiveness.

But the World Bank warns that ODA forgiveness which had been substantial in 1990 and 1991, "will probably not surpass four billion dollars in 1992," and that grants to severely indebted low-income countries are projected to fall by more than four billion dollars in 1992.

The report also points out that because net flows on debt have remained positive for these countries throughout the 1980s, their outstanding debt has continued to grow and has led to "debt service obligations that are well in excess of sustainable levels."

It adds that the debt problems of this group of countries is exacerbated by "structural weaknesses in their economies, including poor infrastructure, low levels of skilled man-power, and undiversified exports."

In addition, it notes that "adverse terms-of-trade shocks in the mid-1980s led to a declining non-interest current-account balance (excluding official transfers) and repeated recourse to rescheduling, and to the run up of arrears." (IPS)

**Latin American Debt Crisis Has Abated But Not Over, Says World Bank**

**New York** — While the debt crisis which gripped Latin America and the Caribbean in the 1980s seems to have abated, it is still too early to consider it definitively overcome, the World Bank said in a report released Dec. 17. The region owed 439.7 billion dollars in 1991 and 432.5 billion in 1990.

The report said Latin America, like South-East Asia, had become a net recipient of capital flows from multilateral and private lending institutions and that this had changed the region's economic prospects.

The bank cited the sale of state enterprises and macroeconomic adjustment processes, especially in countries like Argentina, Brazil, Mexico and Venezuela, among factors which have led to the increased interest in the region in international financial circles.

However, in the second semester of 1992, there was a slowdown in these capital flows to Latin America and the Caribbean.

The weakening of the dollar also helped to modify the situation of the region, whose biggest debtors, such as Argentina and Brazil, signed agreements restructuring their debts to private banks this year.

Countries which have reduced the volume of their debts include Costa Rica, Mexico and Uruguay. And Chile now owes less than it did in 1982, when the crisis broke out. Moreover, Santiago slashed its debt without having recourse to the so-called 'Brady Plan'.

The plan, named after former U.S. Treasury Secretary Nicholas Brady, is a strategy to reduce the amounts owed by highly indebted countries through various financing mechanisms.

Mexico, Venezuela, Brazil and Argentina have renegotiated their foreign debts under the plan, which combines the refinancing of interest due and the issuing of external bonds.

However, the agreements reached have been different in each case, owing to the varying economic and political realities in each country.

Other Latin American countries, like Ecuador and Peru, still face serious debt obligations and are yet to reach satisfactory agreements with private banks or multilateral lending agencies.

Debt restructuring has pushed up the value of external bonds on the secondary market in the case of Argentina and Brazil. The increases have been as high as 15 percent.

However, the behaviour of the secondary market has varied from country to country, because of the drop in international interest rates and other factors.

While the worst of the crisis seems to have passed, its effects will still be felt for a long time by the economies of severely indebted middle-income countries, the report warns.

Much of the foreign capital which has flowed in to Latin American countries has gone towards relieving their debt burden, a fact which limits economic expansion. However, the rise in the prices of some products on the world market has improved the economic prospects of a few countries.

Higher oil prices, for example, helped the economies of Mexico and Venezuela, while, to a lesser extent, Uruguay benefitted from better prices for raw materials like wool, meat, rice and oil.

The report highlighted the capitalisation of stock exchanges in Mexico and Brazil, although it said that foreign investors were not yet playing a crucial role in these countries' stock markets.

It also stated that private capital played a decisive role in the upward evolution of stock exchange transactions in Chile, while Argentina was cited among the eight countries whose stock markets registered a greater volume of exchanges in 1991. (IPS)

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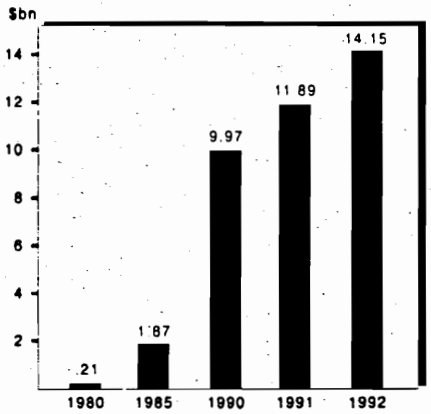
# Renewed calls for less debt, more aid

By Roy Laishley

In the face of persistent economic problems, compounded in many cases by civil conflicts, UN and other agencies are renewing calls for greater debt relief and increased aid flows for Africa. Despite some action by creditors, Africa's debt burden remains stubbornly high. Financial flows, while still positive, have been virtually at a standstill in recent years.

The region's financial distress, aggravated by stagnant export earnings as commodity prices continue to fall, is also seen in the ballooning of arrears on its debt payments. For sub-Saharan Africa, these are estimated to have jumped by 20 per cent last year, according to the World Bank's *World Debt Tables, 1992-93*. Already in 1991, only four African countries could claim to be current on payments of both interest and principal. Given this, the projected fall in the debt servicing burden — to 18.5 per cent of export earnings, from 19.8 per cent in 1991 — is less wholeheartedly good news.

**Sub-Saharan Africa's rising debt arrears**




Arrears of interest on long-term debt only
Source World Bank *World Debt Tables 1992-93*

"External debt is a millstone around the neck of Africa," UN Secretary-General Boutros Boutros-Ghali said in Geneva in December (see page 3). The continent's stock of debt rose to approximately $288 bn last year, up from some $281 bn the previous year. For sub-Saharan Africa, the Bank estimates 1992 debt at $183.4 bn, up from $178 bn the previous year. This is despite further debt cancellations by leading donors of more than $3 bn in 1991, much of it for sub-Saharan Africa.

Economic Commission for Africa (ECA) Executive Secretary Layashi Yaker has called for a "global and urgent initiative" to tackle Africa's debt problem which he says remains unsolved. The World Bank also argues that even with full implementation of debt relief on official bilateral debt, servicing levels would remain unsustainable for a number of African countries.

Debt servicing continues to cripple many countries. At $10.2 bn, actual debt servicing for sub-Saharan Africa was slightly down in 1992, from $10.4 bn in 1991 and $10.9 bn in 1990. For Africa as a whole, debt servicing was probably in the $26-27 bn range, or slightly more, similar to the 1991 level of $26.3 bn. This was equivalent to over 32 per cent of exports.

The Bank's 18.5 per cent debt service ratio for 1992 is a continuation of the steady downward trend for sub-Saharan Africa which started in 1989. The projected 5 per cent rise in export receipts upon which this is based, however, may not be borne out when the full picture emerges. The ECA, for example, is projecting a rise in export receipts last year of less than 2 per cent for Africa as a whole.

*The region's financial distress is seen in the ballooning of arrears on its debt payments.*

For sub-Saharan Africa, falling debt servicing reflects both mounting arrears and increased debt relief. In 1992, arrears on interest alone is projected at $14.1 bn, up from $11.9 bn in 1991 and $10 bn in 1990 (see graph). Arrears on principal was an estimated $17.9 bn in 1991.

### Deeper debt relief

Gains from debt relief are harder to quantify. While significant for individual countries, only a relatively small amount of Africa's total debt has so far been affected. In 1992, nine African countries secured the "enhanced Toronto" debt relief now on offer from most Western creditors. Through either cancellation or reduced interest charges this effectively halves debt payments due over a given period. This, however, is significantly less than the two-thirds' cancellation of the entire stock of eligible debt in the "Trinidad terms" as proposed by the United Kingdom in 1990, or the 80 per cent cancellation urged by the Organization of African Unity (OAU).

In its latest *Debt Tables*, the Bank shows that even with cancellation of development debt and the full implementation of Trinidad terms, debt-to-export ratios remain "unsustainable" for a number of African countries, with Guinea-Bissau, Somalia and Sudan the worst off.

The Bank's conclusion that reductions to more sustainable levels look increasingly difficult within existing official schemes mirrors views strongly voiced in the UN and elsewhere. While there are hopes that the new US administration would adopt a more positive approach to the issue of debt relief — the administration of former President George Bush had refused to implement even the "enhanced Toronto" terms — speedy action is not expected.

For many analysts, however, multilateral debt is now becoming a significant factor in the debt problem of at least sub-Saharan Africa. "It's the next big issue," according to Georgetown University Professor Carol Lancaster. Excluding Nigeria, this category of debt accounted for some 45 per cent of sub-Saharan debt servicing in 1991 (see box on facing page). Mr. Boutros-Ghali has linked Africa's debt burden directly to the shortage of financial flows into the region. The debt burden, by tagging countries as "bad debtors," acts as a major disincentive to foreign private investment, he argued in Geneva.

In its analysis of financial flows to developing countries in the *Debt Tables*, the World Bank observes that while still enjoying positive net flows, Africa has missed out on the recent surge of the last two years. The vast majority of this increase has been in the form of foreign investment. Africa is conspicuous by its absence from Bank analysis on portfolio investment flows. And direct investment flows continue to fluctuate, dipping back down in 1992 from their 1991 high of $1.7 bn, when just two countries — Angola and Nigeria — accounted for 80 per cent of total inflows.

Africa is dependent more than any other region on official flows. The Bank, UN and the Organization for Economic Cooperation and Development (OECD) all agree that such flows will remain the most sluggish, if not falling in some instances. The latest *Develop-*

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*ment Cooperation* report from the OECD's Development Assistance Committee (DAC) warns that the trend in official development assistance (ODA) is "especially worrisome," and that there is "now a real risk" that the already low ratio of ODA to OECD gross national product — 0.33 per cent — may decline. While aid rose 3.3 per cent in real terms in 1991, the annual trend over the last five years is less than 2 per cent, well below the 6 per cent target set by the UN's New Agenda for the Development of Africa in the 1990s. DAC Chairman Alexander Love has also voiced his concern that there is a significant absorption of aid for emergency needs, such as in Somalia, a trend which could increase.

**IDA replenishment**

The December agreement on the tenth replenishment of the World Bank's soft-arm affiliate, the International Development Association (IDA), at $18 bn has appeased fears that African countries could face an immediate aid crunch. Although well down on original ambitions and without the $5 bn earth supplement proposed by Bank President Lewis Preston last June, "to get $18 bn out of donors at this time was quite remarkable," one Bank official told *Africa Recovery*. With repayment of previous IDA funds included, the Bank calculates that some $22 bn will be available over the three-year life of the present fund — some 45-50 per cent of it again informally earmarked for Africa. IDA, however, will have several new members sharing the new funds. And countries which are also eligible to borrow from the Bank's non-concessional arm could face a squeeze on resources.

The IDA replenishment confirms that funding can still be found for facilities and countries that meet donor approval. Recent donor pledges for Ethiopia, Mozambique and Zimbabwe of some $3.5 bn have fully funded 1993/94 programmes.

But the IDA negotiations themselves were tough, with donors such as Australia, Canada and the UK cutting back on their share. The problems the International Fund for Agricultural Development is facing in getting renewed funding confirms the tightening of aid budgets in Arab as well as Western countries (see page 32).

The substantial jump in the US' proposed contribution to IDA is a legacy from the Bush administration that the new government of President Bill Clinton must now try to push through Congress. Bank officials and Washington-based analysts confirm that the IDA vote will face a tough battle.

UN agencies have called for more of present aid flows to be devoted to the poorer countries and more towards social and other priorities. The guidelines for IDA-10 reflect some of these concerns. They specify that the shares of social sector and poverty-targeted investments be "steadily increased" during its lifetime. The guidelines include specific poverty reduction measures in the design of adjustment programmes "whenever feasible." Environmental and sustainable development issues will also be a significant focus of IDA-10.

With Mr. Preston adding that donors "expect" countries to reduce "non-development" expenditures, such as the military, to the "maximum extent feasible," IDA-10 also confirms the direction that new conditionality on aid is likely to take. As the DAC report warns, "developing countries...will find their comparative performance to be an increasingly important factor in aid allocation decisions." It is the blend in that performance between market-oriented economic policies and more specific poverty-focused programmes that has still to be made clear. ■

## Multilateral debt: part of the problem

"Multilateral lending, based on the lending plans of the international financial institutions, is expected to grow fast," the latest DAC report observes. But, it goes on to say, "expansion in net terms will be limited, owing to expected repayments." With African countries — particularly the low-income — increasingly dependent on bodies like the IMF and World Bank for finance, their repayments are becoming an increasing part of the continent's debt problem.

In 1980, the multilaterals accounted for 14 per cent of Africa's debt. Today it is closer to 25 per cent. Multilateral debts cannot be rescheduled and, as preferred creditors, the Bank and Fund tend to get paid back first. This has meant that multilaterals loom large in Africa's debt servicing bill — despite the concessional nature of some facilities, such as IDA. In 1991, the multilaterals' share of Africa's debt servicing was 25 per cent, but for sub-Saharan Africa, more highly dependent on official flows, it was 36 per cent.

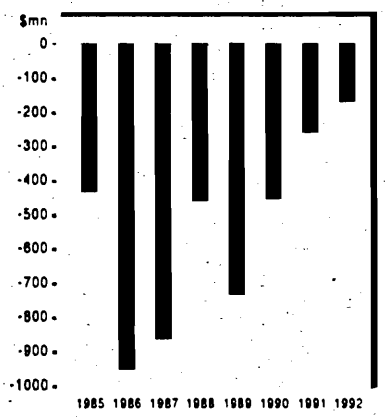
Sixteen African countries owe 50 per cent or more of their foreign debt to multilaterals, and another eight, 40 per cent or more. A number of these countries, such as Botswana and Lesotho, face little or no debt repayment problems. For others, such as Chad and Togo, multilateral debt service, while more than half of total payments, is still relatively light.

But for a number of African countries, multilateral debt servicing is now both a large and burdensome part of their debt obligations. In 1991, payments to multilaterals were equivalent to over 36 per cent of export earnings for Uganda and Zambia. They were over 10 per cent of export earnings for another eight countries, including Côte d'Ivoire (14 per cent), Ghana (17 per cent), Kenya (13 per cent) and Madagascar (17.6 per cent). For some, such as Burundi, Malawi, Niger and Rwanda, multilateral payments are scheduled to take a rising share of debt obligations this year, even excluding the IMF, which is included in the above figures.

For sub-Saharan Africa, new concessional facilities in the IMF and the sharp reduction in the countries borrowing from the relatively expensive main arms of the World Bank and African Development Bank, should ease future reflows. Net transfers with the IMF are still negative, but improving on the $900 mn a year outflow registered in 1986/87. Net transfers from sub-Saharan Africa to the IMF in 1992 were an estimated $170 mn, down from $261 mn in 1991 and $455 mn in 1990. For Africa as a whole, transfers, while negative, have fluctuated sharply, depending on Fund activity in the larger economies of North Africa.

For the Bank, net transfers are positive for sub-Saharan Africa, though sharply down on net disbursements — $783 mn against $1.64 bn respectively in the Bank's last fiscal year. With the so-called 'fifth dimension' arrangement, the Bank is helping to meet the current interest payment obligations on main Bank debt of IDA members. In 1992, funding of some $150 mn helped to meet 90 per cent of the interest due from eligible countries, according to the Bank's *World Debt Tables*. Funding for the scheme comes from repayments of previous IDA credits, which themselves could become a heavy burden for some borrowers.

**IMF net transfers: sub-Saharan Africa**




Source World Bank *World Debt Tables 1992-93*

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# Russian Sachs Appeal

*by Jeffrey Sachs*

*The G7 Has One Last Chance.*

THE COLLAPSE OF REFORMS IN RUSSIA IS accelerating dramatically in both the economic and political spheres. Because of a drift in reforms since April, and a takeover of monetary policy by the industrial lobby since July, the economy is on the verge of hyperinflation. Prices are rising between 5 and 10 percent per week. The money supply has risen an estimated 150 percent since July 1. The currency has collapsed from 110 rubles per dollar in June to 390 rubles per dollar in October.

The collapse was not inevitable. The economic reforms started to work in the first six months of 1992, in the same general way as in Eastern Europe. Inflation was coming under control; shortages were being eliminated; markets were starting to function; the currency was stabilizing; the service sector was starting. But as in Eastern Europe, the initial effects also put the squeeze on heavy industry, including the politically powerful military-industrial complex. The military-industrial complex in Russia began to struggle against the reforms. The reformers largely capitulated, in part because they had little international support beyond supportive rhetoric.

In political terms, the reform team has been deeply compromised by several forces: a return of anti-reformers to the helm of the Russian Central Bank; the admission of several representatives of the military-industrial complex to the cabinet; the emergence of a "national security council" protective of the military-industrial complex around President Yeltsin; and the coalescence of nationalists, communist hardliners, and the military-industrial complex in the Parliament and the People's Congress. Reformers were further compromised during December, when the hardline Congress of People's Deputies met. Prime Minister Gaidar's premature departure will cause further erosion of the reform program.

The two telltale signs of policy reform will be monetary policy and privatization. On the first, the current risks

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## G7 Leadership Vacuum

- Russia is on the verge of hyperinflation and a shift in power back to representatives of the military-industrial complex. Despite the gravity of the situation, Russia received almost no effective financial assistance from the West in 1992. Clearly, the Russian reform effort cannot succeed without significant amounts of Western assistance.

- The G7 has ceased to lead. Without United States leadership, the aid effort will certainly fail.

- The United States and the new administration should quickly develop a new strategy, to be financed jointly by the G7 and other governments. The aid has to become both more effective and — most crucial — *politically visible* in Russia.

- The G7 should appoint a senior and highly respected official, responsible to the G7, to coordinate and manage the aid effort. He or she should be based in Moscow, and should set up a resident office that will coordinate the aid provided by the international agencies (IMF, World Bank, etc.) as well as the Western governments, and work in close cooperation with the Russian government to push the reform process as rapidly as possible.

- There is little time left. The Russian government should be informed immediately that the West is rethinking the aid effort, with the goal of making it more effective. Russia should also be informed that the West will not support a return to a policy based on the military-industrial complex.

are of imminent hyperinflation. Hardliners would like to reestablish price controls, artificial exchange rates, state orders, etc., to address the problems through administrative means. Reformers call for a cutback in the recklessly large (and ineffectual) subsidies to the military-industrial complex. On privatization, hardliners are trying to stop the voucher program, which offers widespread ownership and a diffusion of power in the society. They favor a system in which managers (almost all from the old nomenklatura) would have the prerogative to take over ownership of the enterprises, or would once again be part of a system of top-down bureaucratic control in new "holding companies."

The Western role in Russia since the start of the Gaidar cabinet has been totally insufficient. Western governments made a fateful choice at the start to duck any direct responsibility vis-a-vis Russian reforms by vesting key authority in the IMF. This was an enormous mistake for several reasons. First, the IMF was completely understaffed for the task. Hundreds of technical experts are needed on the ground in Moscow to help with reforms in banking, budgeting, management, trade, and finance. As an institution of around 1,000 staffers, however, the IMF was simply unequipped to provide the needed assistance from in-house resources. In any event, and as incredible as it may seem, the IMF did not have a single monetary specialist on the ground in Moscow in 1992. It relied totally, and ineffectually, on fly-in missions to try to cover the workload.

Second, it is necessarily a political task of the first order to mobilize tens of billions of dollars in Western support for Russia, and to link the support in systematic ways to fundamental changes in the Russian economy. The IMF was unequipped to carry out these functions. It did not succeed in mobilizing funds; in designing an aid program in cooperation with the Russians; and in carrying out conditionality. In fact, not one dollar of usable conditional assistance flowed to Russia in 1992! The only conditional aid was $1 billion of IMF money, but even that paltry sum was given under the amazing condition that Russia not use the money.

The $24 billion aid package announced on April 1 has simply vanished. Russia received approximately $7 billion of commodity credits in 1992, but none of the



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loans were linked to the reform program. Loans have basically stopped since July. The IMF money has been essentially non-existent; the first World Bank loan has not even been finalized. The EBRD remains a small player on the scene, partly because its mission has not yet been made clear.

The Western effort on debt rescheduling has been equally inexplicable. The main Western efforts at the start of the Yeltsin-Gaidar government were directed at getting Russia to accept responsibility for the entire debt of the former Soviet Union. This has led, predictably, to a legal mess in subsequent negotiations. Moreover, the West continued to press Russia for interest servicing of the debt even when Russia was completely out of foreign reserves. The pressures contributed to Russia's macroeconomic instability. Most importantly, after one year of radical reforms, Russia has still not received any formal debt rescheduling, and the balance of payments pressures arising from Russia's debt overhang continue to weigh heavily on the economy.

*As incredible as it may seem, the IMF did not have a single monetary specialist on the ground in Moscow in 1992. It relied totally, and ineffectually, on fly-in missions to try to cover the workload.*

While the IMF has been overwhelmed with its assigned task, Western governments have simply stood by and done virtually nothing. The U.S. role has been minimal. There has been little strategic thinking in the U.S. government, and there has been no single senior U.S. government official whose main responsibility was design and coordination of the U.S. response to Russian economic and political reforms. The role of the other G7 countries has been similarly problematic. The German financial role has been large in recent years, mainly in the provision of export credits, but the extent of German efforts should not be overestimated. Many or most of the credits went to support the continued export of sub-standard Eastern German products to Russia, more as a form of internal export subsidy than as real assistance to Russia's reforms. Moreover, the supply of new credits declined during 1992. Germany has sent few advisors and has been rather hardnosed on the question of debt rescheduling. At this point, support in Germany for further financial assistance to Russia is slight. The EC has provided a modest amount of aid, but its role has hardly been decisive. Other individual European countries have also contributed moderately to Russian assistance, but again without a decisive role.

The Japanese have so far played a harmful role by pursuing a vocal policy opposing large-scale aid until the return of the Kurile Islands. This policy finally backfired in September, when President Yeltsin canceled his trip to Japan at the last minute. But the costs have been high. Mutual antagonisms have grown; Russian hardliners have seized on the Kurile issue with great effect, to fight against the reformers (who would relinquish Russian territory hard won in the Patriotic War); the West is once again reacting with hostility toward Russia's interests; etc. U.S. policymakers were silent as Japan pursued this mutually destructive approach; we share a complicity in the downward spiral of Russian-Japanese relations, through our inaction.

## A NEW WESTERN RESPONSE

There should be an urgent rethinking of the Western response to Russia during the presidential transition period, and in the early days of the new Administration. The nature of the response must be carefully modulated to the events in Russia over the next two months. If the reformers are able to survive the coming onslaught, then the West should aim to reinforce the reforms with considerable urgency. If the reformers are routed out, then the West must respond in a clear way, holding back on most aid until the reforms get back on track. If the situation remains muddled, then a nuanced carrot-and-stick approach would have to be used.

Most urgently, the West needs new institutional means to deliver its message, and its support in the case that the reforms go forward. The G7 should establish a political-economic umbrella, within which the IMF, World Bank, and EBRD could act. In effect, the G7 would establish a coordinated Administrator of Western Assistance (as in the case of the ECA as the administrator of the Marshall Plan), with a substantial presence in Moscow. Unlike the IMF, the new administator would have an *on-the-ground* team of businessmen, bankers, and economists, helping the Russian government implement practical reforms in key areas.

In organizational terms, there should be a senior coordinator (and personal staff) reporting to the G7 countries, an economic advisory committee with representation from each of the G7 countries, and several departments linked to the delivery of assistance:



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macroeconomic analysis; military conversion; social safety net; small-business development; energy; and agriculture. In each case, the department would have direct liaison with the Russian government to ensure smooth delivery of resources and effective operation of the aid effort. The international organizations would continue their tasks, but in strict liaison with the G7 coordinating authority. The IMF would maintain lead responsibility for macroeconomic advice and conditionality; the World Bank would have lead responsibility for privatization and industrial restructuring; and the EBRD would have lead responsibility for encouraging private sector development. Mission leaders from these organizations would report regularly to the G7 authority.

Within the U.S. government, there should be a new senior position to coordinate U.S. policies in support of economic and political reforms in Eastern Europe and the former Soviet Union. This person must clearly be the "President's person."

*The aid package should be spelled out in political terms, so that everybody in Russia understands the high cost of losing the international support.*

### Financial Assistance

Financial assistance should be redesigned to give the maximum political and economic backing to the reforms. The assistance should come in forms that are easily understandable to the Russian people and to Russia's political leadership, so that the assistance is viewed as vital and much too important to abandon. The money should also come largely in ways that help finance Russia's budget deficit, as a substitute for direct inflationary financing.

The specific types of aid will have to be determined in the course of negotiations with the Russian government and the G7 partners. Note that the IMF has spoken in terms of $22 billion in multilateral assistance in 1993, suggesting an order of magnitude of overall funding. The most urgent task is to allocate the international support in an appropriate way. The following package makes sense in terms of the political and economic support that it would offer to the reforms:

**Emergency Social Fund:** To subsidize unemployment compensation, emergency medical support, and supplements for pensioners. The Fund would be supported by direct grants from Western countries. All Russians would understand that if the aid is cut off, the choice would mean risking the key social safety net for the country. The money would obviously help to cover direct budgetary expenditures in Russia in a non-inflationary way.

**Industrial Restructuring Fund:** To help pay for military conversion and other industrial restructuring operations. This money would come in the form of loans from export credit agencies and from international financial institutions. Part of the fund would be for military conversion, and part for energy and agricultural investments.

**Small-Business Loan Program:** Modelled on the Polish-American Enterprise fund, which would make loans to small- and medium-sized enterprises. This fund would be managed by the EBRD.

**Balance of Payments Support:** From the IMF, to help cover the foreign exchange requirements for basic imports.

**Ruble Stabilization Fund:** From the IMF.

**Debt Rescheduling:** For three years, in which each year's rescheduling would depend on being in compliance with overall reform targets during that year.

The key strategy in such a program is simple, but was basically neglected last year. The aid package should be spelled out in *political* terms, so that everybody in Russia understands the high cost of losing the international support. The general public needs to know that Western support funds the emergency social protection; industrialists should understand clearly that Western support funds their access to restructuring money; small businesses should see that Western support actually provides credit to them; and everybody should understand that international support is key to making the money stable in value via a stabilization fund.

The funding would be strictly multilateral in character, involving funds from government budgets, export credit agencies, the IMF, World Bank, EBRD, and the EC. The U.S. budgetary contributions would have to rise, as would contributions from Eximbank. Perhaps most important, the U.S. should insist that Japan step up its contributions, in view of Japan's financial resources, its minimal contributions to date, and its enormous stake in the success of Russia's democratic and economic reforms. ◆

# *Latin America Within the World Economy*

Q Let me begin with some general questions about the international economy and then we will move to Chile. You have been Chair of the Development Committee of the World Bank and the IMF for two years, an accolade for the Chilean economy as well as for yourself. I thought it would be interesting for you to reflect a bit on your two years there and on the accomplishments that the Committee achieved during that period. In addition, are there some reforms with regard to the functioning of the Development Committee that you think would be worthwhile? As the committee was created during the oil shocks of the mid-1970s to fill the need for increased developmental systems, do you think its time has passed?

A. The Development Committee provides a useful forum for the ministers of finance to meet twice a year and voice their views on international economic problems. The Development Committee has some obvious limitations because it must address simultaneously the IMF and the World Bank, as opposed to the Interim Committee, which is an IMF committee only and which has a tighter relationship with its parent institution. The IMF and World Bank are less inclined to listen to the Development Committee, so that it makes it less of an influential policy body. Having said that though, in the last two years the Committee was useful for advancing views in a very consistent way on what we finance ministers consider to be main issues.

For instance, trade. In every single session of the Committee during my tenure as chairman, trade was a central issue. Of course, all we were able to do was advocate for macro-level trade liberalization and to press for completion of the Uruguay Round. We always invited Arthur Dunkel, chief of the GATT to speak—both at the Committee meeting and then at the minister's luncheon—and we gave him as much opportunity as we could to press the ministers of finance for decisions. Ministers of finance generally are very favorable to free trade, but ministers of trade tend to be more careful because they see all the details, product by product, sector by sector, and they see more problems than we see as ministers of finance. We see the broad picture. So what we were trying to do was to influence trade ministers through the ministers of finance.

That was one issue. The second was to press the financial institutions to increase their transfer of resources. This is the main mandate of the Committee and two very different aspects have been brought to its attention. One was the IDA replenishment discussion, and the other was the increase in the capital of IFC, which was finally approved. We

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actively promoted that because we really believed that these international financial institutions should play a more active role in stimulating private sector investment, mainly through active privatization.

These institutions have to find a role for newer types of lending, and become more flexible in order to accommodate the transfer of many enterprises from the public to the private sector. They must allocate more capital for IFC to work with the countries.

Regarding the environment, we discussed specifically the financial need for a coordinated effort on the environment—both internationally and to support each nation's domestic efforts. My own impression right now is that after Rio the mood in the industrial countries is to postpone any ambitious project in this area as there is retrenchment towards domestic policies.

Q. It sounds like you were successful in modernizing the agenda of the Development Committee, going well beyond the traditional aid issues, to tackle trade, private investment, and the environment. Did you notice much of a shift in the attitudes between the industrial and development countries in the last several years in the context of the work of the Development Committee or, more broadly, during the Bank/Fund meetings?
A. I have not participated in the G-24 meetings, but I have heard their statements in the Development Committee. It seems to me they have adopted a more cooperative attitude with the industrial countries—less confrontational, less antagonistic, and with more emphasis on trade, which is they key issue of the 1990s.

## *The future of the Bretton Woods Institutions*

Q. What do you see as the role of the World Bank and the IMF for Latin America in the post-adjustment period? The roles that they have played up until now—either transferring resources or giving advice on stabilization or adjustment—become less important for countries that have passed through those stages.
A. It seems to me that however much we might have complained about the conditionality of the Bank and the IMF in the past, we have to accept the fact that today, as Michael Camdessus (Managing Director of the IMF) said in his speech, the region is performing so much better than in the past several decades. At least in part, this is a result of the process of structural adjustment: smaller fiscal deficits, more openness to trade, more emphasis on private sector development, less inefficient government involvement, and so on. So for the Bank and Fund this is a success story.

From our point of view, the institutions have provided an external rationale that made sense. Now, when the countries "graduate" from this, when they finish their adjustment, what external factor will prevent them from backsliding; what will maintain the direction toward greater liberalization and integration into world markets? What external discipline will you have?

I think the answer is essentially international competitiveness. That is why it is easier to think in terms of trading blocs, which give you support to face this very tough international competition. I think the Bretton Woods institutions have to evaluate what their role may be in supporting better integration of these economies into world markets. It will not be enough to repeat in the 1990s that countries should simply conform to GATT rules. The Bretton Woods agencies should have a policy, for instance, to influence they way trading blocs are formed.

Q That's an issue that I've noticed neither the World Bank nor the IMF has been willing to touch so far.
A. Because the trade bloc ideology conflicts with theirs.

Q. Yes, they are devoted globalists. The World Bank just put out a study that criticized the Enterprise for the Americas Initiative.
A. Correct. Instead, the financial institutions could stimulate private sector investment, and joint ventures among firms of different countries that enhance the integration program. At the same time, they could attach some conditions to ensure that blocs are formed in a way that is consistent with the GATT, and which is not unfair for third parties. But the institutions have not been willing to do that. I mentioned this early on several times in the Development Committee but it wasn't picked up.

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Q. I sense that the Inter-American Development Bank is more sensitive to this issue now, which is logical because they are regionally based.
A. Yes, much more so.

Q The World Bank has begun to look at the impact on Latin America of differing growth trends in the industrialized world, and the IMF does that in its *World Economic Outlook*. Do you think the Bank and the Fund could become effective instruments in affecting G-7 macroeconomic policies, to induce them to take into account, at least at the margin, the impact of their macroeconomic policies on Latin America and on the developing world?
A. That's another area where I think recent events are pointing toward the need for better policy coordination. This reality has been recognized by almost everybody during the annual meetings, and it's quite clear that G-7 policy coordination has been weakened in recent years. But policy coordination with Latin America is non-existent, except for the experience that the Inter-American Dialogue helped promote, which was the meeting of finance ministers with Treasury Secretary Brady this June in Washington. That was an extremely positive and very significant first step.

In fact, the U.S. proposal at the IDB meeting last Saturday—for the capital increase of the Bank, more emphasis on social policies, the closer integration of the Inter-American Investment Corporation (IIC) in the workings of the Bank as such, so that the Bank gets more directly involved in private sector lending—all these proposals surfaced and developed, at least partially, during that June meeting. So the precedent for fruitful policy coordination within the Western Hemisphere now exists.

## *International finance*

Q. There has been a tremendous reversal of capital flows since the early 1980s toward Latin America. These inflows—much of which are short-term—are creating some problems for management of monetary policy, and resulting in the appreciation of exchange rates. Capital seems to be flowing rather indiscriminately into virtually all countries. Aside from what the monetary authorities of individual Latin American countries might do to try to moderate capital movements, is there anything that the international community should be doing to try to produce more stable financial flows into Latin America?
A. That's a difficult question. I think there is a need for policy orientation in terms of what domestic policies countries should pursue in order to regulate and control the inflow. We already know from the previous crisis that a sudden inflow of capital can be extremely destructive: it forces an appreciation of the currency that can be of such magnitude that it will seriously hurt the domestic productive structure.

The other issue is that Latin American countries are beginning to access international markets again, and the temptation is great to borrow indiscriminately. I think there is a need for international organizations to offer technical assistance in financial engineering so that countries will not be amateurish players in a truly sophisticated world capital market. So we have an important job for the World Bank—a point I tried to make in the last meeting of the Development Committee. They were very receptive to this, and it will be one of the main issues in the next two meetings of the Committee.

## *Trade policy and regional blocs*

Q. Where would you like to see economic integration headed in the Western Hemisphere?
A. A proposal for economic integration should have political significance. To seek to consolidate and stabilize democracy throughout an entire region of the world, and to create the political conditions for faster growth, is a very powerful idea. So a hemispheric project makes sense from the point of view of the U.S. and from our point of view.

As I see it, the feasibility of this process and the number of countries involved will be determined by the capacity of the political leadership to persuade their populations and their congresses to accept the inevitable costs attached to any free trade agreement.

## *Fiscal reform and the social agenda*

Q. Turning to the social agenda, during their sessions at our Washington Exchange, Minister Aspe, Hausmann and Boloña all talked about the importance of addressing the issue of poverty, if for no other reason than to create support for economic reform. Based upon your own experience in Chile

with tax reform, are there particular lessons that you think can be generalized to at least a number of other Latin American countries?

A. Well, I am convinced that such fiscal reforms are a key component of sound economic policies in the region, and a key component of political legitimacy for economic reform more generally. My advice would always be to put this as a first step in the economic program.

Secondly, I think that collecting more tax revenues, while important, does not resolve the problem of relative inefficiency of the state apparatus, and its ability to handle a sudden increase in resources to devote to social programs. There is an absorption problem and a lag between the moment when you "rob" the revenues and when the people actually perceive the impact of the new social programs. To implement programs, particularly at the local level, can take a very long time. So there is an important need to modernize government structures and improve the quality of civil servants in the different ministries.

The most vulnerable aspect is the local government. Local governments in Latin America have historically been the last link in the patronage chain for political parties. Locally, you find the fourth-level politicians who finally have a chance to get a slot in the state apparatus and to act as power brokers, where they can impede the implementation of efficient social policies in their tendency toward patronage, clientelism, and populism. They are not managers, and what we need are local government managers. I think it will be a very severe test for democracy, if it is to really take root in Latin America, whether we are able to make local governments work efficiently.

Q Corruption was a common theme in the discussions of Peru, Mexico and Venezuela at the Washington Exchange meetings. Corruption is a threat to democracy, and a threat to the continuity of economic reform. Minister Hausmann suggested that if you reduce the role of government you reduce the opportunities for corruption. Chile has always enjoyed a relatively honest governmental system, irrespective of the particular economic policies at the time. What would you suggest other Latin American governments and societies do to reduce both the realities as well as the perception of governmental corruption?

A. That's a tough one. I can say obvious things: transparency of information, the role of the media, the accountability of the congress and the political elite. All these things help, but it is extremely difficult to get rid of a culture of corruption. I do agree with the notion that if you reduce the number of big enterprises in the hands of the state you certainly decrease the possibility for corruption.

## *Technopols*

Q. Last topic. You are a "technopol," correct? Do you accept this definition?

A. I accept it.

Q. How would you define the term?

A. I would define it in two ways. First is the realization that to do a good technical job in managing the economy you have to be a politician. If you do not have the capacity to articulate your vision, to persuade antagonists, to bring people around on some unpopular measure, then you are going to be a total failure.

Q As an economist?

A. Right, exactly. Economists must not only know their economic models, but also understand politics, interests, conflicts, passions—the essence of collective life. For a brief period of time you could make most changes by decree; but to let them persist, you have to build coalitions and bring people around. You have to be a politician.

This type of activity is perceived by others in a somewhat disparaging way. When they look at these ministers of finance or economics shaping events, people say "Look, this guy is not a technocrat, this guy is a politician! Look at what he's saying in the media." That creates two reactions. The business community, which distrusts politicians, says "He is now a politician"; other people will say "Look, maybe this guy could do a competent job." But what counts at the end of the day are good results. The better those are, the more "technopols" are legitimized, not only as economists, but also as political figures.

Q. But always with a sound technical base.

A. Yes, the technical base is there to stay because that's what makes for consistent policy.

Q. And it is precisely the combination of the economics and the politics that enables the technopols to become leaders within the cabinet and to emerge, as I believe they have in a number of countries, as virtual prime ministers.

A. The job is such that you must exert authority over your colleagues. This might sound presumptuous, but you are tested constantly by everybody around you—whether they can get more things out of you than you are willing to give. So you are continually being tested in your determination to pursue a certain policy trajectory. This forces one to develop leadership skills, and I think that's good.

Finally, the nature of the job is such that you always have to be looking at the whole, and it turns you very quickly into an "hombre estado"—somebody who tends not to think along partisan lines or in terms of partial interests, but always looks at the interrelationships for consistency.

Q. If you look at the reform policies being pursued in Peru, Mexico, Venezuela, and Chile, they are all at different stages, but they are all moving along rather similar trajectories. How do you account for this convergence in macroeconomic policy in Latin America?

A. External factors, such as the international financial agencies, have played a role in persuading countries to open up to trade. Moreover, I think Latin America for a long time felt it was out of the main flow of events in the world. Latin American countries are much more willing to do the difficult things they must to become full "members of the club."

Just a brief comment on the cases you mentioned. I do not think that one should ever find an excuse—because you have to accomplish economic objectives—to think political democracy is expendable. There is nothing that justifies getting rid of democracy. Furthermore, as the Argentine and Chilean examples have shown, democracy can be effective and efficient in producing change.

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THE WALL STREET JOURNAL FRIDAY, JANUARY 29, 1993

# Successful Latin Economies Show the Gain Before the Pain

## The Americas

By David Malpass

President Clinton, Lloyd Bentsen, Robert Reich et al. take note: Latin politicians who have raised gasoline and consumption taxes and cut government subsidies merely to reduce their budget deficits have failed both politically and economically. However, when Latin leaders unleash the growth potential of all levels of the economy through liberalized fiscal policies built on a solid currency, they get public support and achieve lasting change.

Like the incoming administration, Latin America is seeking a sweeping change in its political economy. In a very short period of time, Latin America adopted democracy as its preferred form of government, and market-based economics as its preferred economic system. In countries such as Mexico, Argentina, El Salvador and Chile, governments promoted policies that led to an almost immediate improvement in the growth potential of the average citizen. However, in Venezuela, Ecuador, Brazil, Nicaragua and others, the consensus movement toward a market-oriented economy was slowed by leaders who focused on deficit reduction without first declaring a program designed to improve the people's economic situation.

Most of Latin America's unsuccessful attempts at economic change rely on austerity – the "no pain, no gain" recipe. In this recipe, "courageous" politicians use up their political capital getting their people to accept economic slowdown, tax increases and public sector layoffs. It's hard enough to sell that message in developed countries like the U.S., but in poor Latin countries – where mere survival is a challenge for most – it can be a political death sentence. Leaders who promote these policies are left with political instability, a deep recession and higher, not lower, deficits. Nevertheless, many economists laud this policy of impoverishment, and urge Latin politicians to "stay the course" as their popularity erodes and per capita incomes sink further.

The examples build a clear case that deficit reduction must be kept in the context of improved living standards. While deficits do impede growth and should be reduced, sound deficit reduction programs must be built on creating an environment for private sector growth. Deficit reduction cannot be pursued as an end in itself.

When President Carlos Salinas set about revolutionizing the Mexican economy, he first promised, and achieved, economic stability and the prospect of rapid growth. Taxes on production, capital formation, international trade and internal commerce were radically reduced. Almost immediately, the economy began to expand and tax revenues increased rapidly. This gave government the revenue it needed to pursue far-reaching efforts at modernizing Mexico's infrastructure and reaching out to the most impoverished (most notably through the multibillion-dollar Solidarity program).

The expanding economy and increased social spending gave President Salinas the popularity he needed to enter into a trade agreement with the U.S., embark on agricultural reform and sell off state enterprises. Only after the fruits of this growth strategy were harvested was significant revenue allocated to retire Mexico's internal and external debts. If Mexico's original policy objective had been merely deficit reduction, rather than improved living standards, these radical changes might never have occurred.

Similarly, Argentina's budget deficit has fallen sharply not because the government imposed deficit reduction and austerity on its people but because it imposed a sound currency and very rapid growth. Yet conventional wisdom increasingly attributes its success to deficit reduction. A report in the Financial Times earlier this month claimed that "virtual elimination of the budget deficit has already cut inflation to less than 20% a year." But Argentina's budget-balancing revenue surge began in April 1991, just after it embarked on its growth policy based on a sound, freely exchangeable currency combined with dramatic fiscal incentives for growth (income tax rates were lowered to 20% on incomes up to $60,000 with no tax on capital gains).

Argentina's treasury income rose from under $400 million monthly between January and March 1991 to $618 million in April and nearly $1 billion per month in 1992. Beginning in June 1991, the budget was practically in balance. In the meantime, Argentina's rapid growth began almost precisely in April 1991, the result of a stabilization program reliant on growth, not on economic contraction.

> *Sound deficit reduction programs must be built on creating an environment for private sector growth.*

In contrast, Brazil has spent nearly three years blindly pursuing deficit reduction while its economy continues to sink. Brazil's January 1992 standby arrangement with the IMF agreed on another vigorous attack on the deficit as the primary thrust of economic reform. The Economic Commission on Latin America noted in its September 1992 report that "Brazil's federal government cut back sharply on expenditure in response to a decrease in its revenues, and managed to generate a surplus as a result."

Of course, during this attack on the deficit, the government was printing so much money that inflation stayed above 20% a month. Yet the Jan. 6 editorial in the Financial Times claimed modestly that "although he may not realise it, fiscal reform should be [Brazil's new President Itamar] Franco's priority. Only through such reform will the budget deficit be closed, inflation subdued, interest rates lowered and confidence restored." No mention of the importance of monetary policy in fueling inflation or of reducing subsidized credit to farmers, states and state enterprises.

In Venezuela, Peru and Ecuador, government-led austerity programs – the blind pursuit of deficit reduction with little regard to growth – has brought falling political fortunes, economic hardships on the people, and a faltering desire to continue with economic change. Peru's real GDP may have fallen as much as 3% in 1992 with inflation still above 40% in spite of a "successful" deficit reduction effort.

Ecuador's new president entered office last August with 90% public approval. He immediately set bout fixating on his government's too-high deficit by increasing gasoline taxes and devaluing the currency. His popularity plummeted, much-needed economic reform plans were shelved, and growth remained stagnant.

Before the new U.S. administration turns the helm point blank at deficit reduction, it should tell the average American exactly what the benefit will be. Above all, countries end up with smaller deficits when their economies expand, not when they contract, so deficit reduction measures should promote growth.

*Mr. Malpass was deputy assistant secretary of state for Latin America during the Bush Administration.*

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TESTIMONY

OF

THE HONORABLE WARREN CHRISTOPHER

BEFORE

THE SENATE FOREIGN RELATIONS COMMITTEE

TUESDAY, APRIL 20, 1993

Mr. Chairman:

It is a pleasure to appear again before you and this Committee. Three months have passed since our first official meeting at my confirmation hearing. Much has transpired in that time. We have conducted an activist, internationalist, democracy-oriented foreign policy.

In my confirmation hearing, I set out in some detail the three pillars that would guide this Administration's approach to foreign affairs: First, enhancing America's economic growth. Second, updating our military forces to meet new challenges. And third, promoting democracy, human rights, and free markets. I believe that the policies we are now putting into place will position us well to make significant progress in each of these areas.

In our meeting this morning, I look forward to exploring the full range of challenges we confront. I will limit my formal remarks to two key issues. First, I want to update you on our single most important foreign policy priority: the effort to help reform succeed in Russia. Second, I will review the Administration's foreign affairs budget requests and management strategy.



ASSISTING REFORM IN RUSSIA: FROM VANCOUVER TO TOKYO

Mr. Chairman, the last few weeks have witnessed important developments in Russia's relations with the United States and the West. The Vancouver Summit between Presidents Clinton and Yeltsin marked a milestone. It was the first truly post-Cold War summit, where talk about economic reform and democracy played as central a role as negotiations over nuclear weapons did in the past.

The centerpiece of the summit was the commitment on the part of the two presidents to build a true strategic partnership between our countries. And the first priority of that partnership is supporting the historic and heroic struggle of the Russian people to make the transition from communism to democracy and free markets.

The presidents agreed on a new package of bilateral programs designed to address Russia's immediate human needs and contribute to the building of a market economy. The American core package was developed in close cooperation with Russian reformers. It will target areas that we have both identified as high priority. This includes a resumption of U.S. food exports to Russia; support for privatization and new businesses; help in dismantling nuclear weapons; a housing program for demobilized soldiers to speed Russia's withdrawal from the Baltic countries and parts of the former Soviet Empire; funding for programs to enhance nuclear safety; help in

resurrecting Russia's dilapidated energy sector; and an increase in people-to-people exchanges.

These programs were designed to ensure that our investments in Russian reform meet certain basic goals. First, they must deliver quick and tangible benefits to average Russians who have been reform's unintentional victims. Second, our help must support Russia's long-term transformation to the market, by equipping Russians with the tools they need to make their economic revolution self-sustaining. Third, our programs must be part of a long-term strategy of engagement that supports reformers wherever they are found across Russia's eleven time zones. In this connection, three quarters of the initiatives announced at Vancouver will be targetted at regions outside of Moscow and St. Petersburg. Finally, and most importantly, our investments in Russian reform must serve the direct interests of the American people -- by reducing the former Soviet nuclear arsenal, and opening up promising new markets for American farmers, workers, and businesses.

At Vancouver, Presidents Clinton and Yeltsin also agreed that, ultimately, the long-term success of Russian reform would depend more on Russia's full integration into the world economy than on outside assistance. Toward that end, they expressed their determination to promote access to each other's markets and to remove impediments to bilateral trade and investment. Here, President Clinton assured President Yeltsin that he would work closely with the Congress to review our remaining



legislative barriers to trade with Russia. Where appropriate, and after careful consideration, we should act to repeal Cold War legislation that was designed to isolate a totalitarian Soviet Union, but which now only serves to punish a free Russia.

Mr. Chairman, while a new U.S.-Russian partnership will be critical for promoting reform, it cannot succeed unless it is part of a much larger partnership between Russia and the international community. Building that broader cooperative effort was precisely the purpose behind last week's extraordinary meeting in Tokyo between foreign and finance ministers of the G-7 countries and Russia.

At that meeting, Russia's Deputy Prime Minister Fyodorov outlined a bold new plan to control Russia's money supply, reduce its budget deficits, and achieve macroeconomic stabilization. In response, we and our G-7 partners -- working through the international financial institutions -- announced a major new multilateral initiative to support reform. In addition to the Paris Club's recent rescheduling of $15 billion of Russia's foreign debt, the $28 billion Tokyo package will include helping Russia to stabilize its currency, to finance critical imports, to restructure key sectors of its economy, and to reduce the threat of its deadly nuclear legacy.

The strategy pursued in Tokyo reflected two key lessons learned from efforts to aid Russian reform over the past year.

First, Russia's effort to impose fiscal and monetary discipline cannot remain mere words on paper. Practical steps must be initiated to combat the threat of hyperinflation. This means limiting the printing of rubles and the granting of easy credit to inefficient state-run enterprises. President Yeltsin's determination to make the Central Bank more responsive to the policies of his government gives us reason for cautious optimism. But now we need to see some results.

The second lesson guiding the Tokyo discussions concerned the disbursement of multilateral support. Everyone was agreed that the West cannot afford to repeat last year's experience. In retrospect, it was not sensible to promise help for economic stabilization, and then withhold most of it on the grounds that the Russian economy is not yet stabilized. To break this frustrating circle, a two-stage strategy was agreed on. Stage one calls for simultaneous steps on the part of Russia and the international community. As Russia launches its initial macroeconomic reforms, the international community will respond up front with a significant injection of resources. Stage two will then link additional assistance to Russia's continued progress on stabilization.

Mr. Chairman, the vast majority of this new support for Russian reform will come from the international financial institutions. But it is also going to require contributions from G-7 members, as well as other countries in Asia, the Middle East, and Europe that are capable of participating.



Here, America must be willing to pay its fair share. That's the right thing to do because it directly serves our national interests. But our leadership is also essential to catalyze the large-scale international effort that Russian reform requires. We cannot do it alone, but without us, it will not get done at all.

Let me briefly outline our thinking as concerns the U.S. share of these efforts. As President Clinton stated in Vancouver, our strategy consists of three steps. The first is the $1.6 billion package of bilateral programs announced at the U.S.-Russian Summit. As you know, the monies for this package have already been appropriated by the Congress.

The second step is the new multilateral support program announced in Tokyo. One of the most important and innovative parts of that program could be the creation of a G-7 privatization fund. This fund is designed to help Russia cope with the economic and political consequences of privatizing the huge -- and hugely wasteful -- state-owned enterprises that are bleeding its budget dry and fueling inflation. Our share of this effort would amount to some $500 million, and would take the form of a "challenge grant". That is, it would be contingent on our G-7 partners contributing another $1.5 billion. We would then look to the international financial institutions to commit an additional $2 billion in co-financing, bringing the fund's total resources to $4 billion in grants and loans.

The third step in the President's plan to support Russian reform is to work intensively with the Congress to develop further bilateral assistance efforts. A starting point will be the assistance request in our FY-94 budget to continue current programs to dismantle nuclear weapons, deliver humanitarian help, and promote democracy and privatization.

In recent talks with the Russians, our G-7 partners, and the Congress, we have reached the conclusion, Mr. Chairman, that even more must be done. As I announced last week in Tokyo, the President has decided to seek an expanded package of U.S. bilateral programs, to build upon the ones announced at Vancouver, and in addition to the requests contained in our FY-94 budget. This package would focus on those areas where Russia's reformers have told us they urgently need more help, and where members of Congress have suggested our efforts should be aimed. This includes energy and the environment, privatization, housing for demobilized soldiers, medicines, trade and investment, and exchange programs.

This expanded package of bilateral steps, together with our $500 million contribution to the prospective G-7 privatization fund, would require an additional appropriation of approximately $1.8 billion. We are now consulting with this Committee and others in Congress to determine how best to structure such a request.



Mr. Chairman, I realize this is a difficult proposal at a time when so many Americans face hardships here at home. But President Clinton and I are convinced that this investment in Russia's democratic future is an essential investment in America's future. By making this investment, we can help turn our most dangerous enemy into an enduring partner. That, I believe, is a critical -- indeed, a noble -- mission.

The President and I will continue to make the case to the American people that a focused program to assist Russian democracy is in our deepest self-interest. We are counting on the members of this Committee to join us in this effort.

## THE INTERNATIONAL AFFAIRS BUDGET

Mr. Chairman, let me now turn briefly to a discussion of our FY-94 international affairs budget. It is a budget that accurately reflects the times we live in. In its funding requests, it recognizes the tight fiscal constraints confronting our government today. And in its priorities and objectives, it marks a first but important step toward addressing the new challenges of the post-Cold War era.

Let me highlight several of those priorities for you. The first is promoting democracy and human rights. I have already described the especially high stake America has in helping freedom triumph in Russia, Ukraine, and the other new states of

the former Soviet Union. But our efforts must be worldwide. Eastern Europe's democratic revolutions must be consolidated. And the rising tide of democratic aspirations stretching from East Asia to Central America must be carefully nurtured. The lesson of this tragic century is clear: the best check against international aggression is the emergence of governments that encourage tolerance, pluralism, and respect for the dignity of the individual.

Our budget also places a new emphasis on promoting multinational peacekeeping and peacemaking. The end of the Cold War has unleashed long-suppressed conflicts in Eastern Europe, the former Soviet Union, and elsewhere. But it has also opened up new possibilities for international cooperation. Our task is to harness that cooperation to contain, and far more importantly, to prevent conflict. The tragedies of the Balkans and Somalia bear grim witness to the price of international delay. International peacekeeping -- especially by the UN -- can and must play a critical role. Capabilities must be enhanced to permit prompt, effective, preventive action.

And the United States must be prepared to do its part. At a time when we are calling on the United Nations to do more, we simply cannot support it less. That is why funding for multilateral affairs has received a significant increase in our budget. The President and I are convinced that millions spent now on preventive diplomacy and peacekeeping can save hundreds



of millions of dollars in defense and international relief later.

Another priority will be our new global agenda. By moving actively to counter environmental degradation, we can improve the quality of life in poor and rich countries alike. And by combatting terrorism and narcotics trafficking, we make America and the world a safer place.

These priorities, as well as others highlighted in our budget, represent an important effort to re-orient our scarce resources to the realities of the post-Cold War era. The budget reflects a commitment to using the taxpayers' dollars wisely and efficiently, in full support of the President's economic and deficit-reduction programs. Here, I think it is always worth providing some perspective. In its entirety, spending under the 150 Account has historically represented just over 1 percent of total federal expenditures. Used responsibly, this indeed is a modest investment in pursuit of our nation's most vital international objectives.

REFORMING OUR INSTITUTIONS

As important as how much we spend on foreign policy, however, is how we spend it. I'm convinced that the Department of State cannot hope to respond effectively to post-Cold War challenges unless we improve the way we deal with complex

problems that cut across traditional bureaucratic boundaries. A stifling bureaucracy, an obsolete division of labor, or cumbersome decision-making are luxuries we cannot afford.

As a first step in remaking the State Department, I announced a broad-based reorganization plan in February. The plan shifts portfolios and creates new positions to mirror post-Cold War missions. It will reduce excessive layering within the Department and streamline the policy process. Our objective is simple: quicker policy-making, more open policy-making, and, most importantly, better policy-making.

Reform of the State Department will be an ongoing process. I have asked Deputy Secretary Wharton to direct it. In addition to overseeing our reorganization plan, Dr. Wharton will be working with our management team to modernize the Department for the twenty-first century. We need to ensure clearer financial accountability for our operations. We must invest in better training for our personnel. And we must work unceasingly to ensure that the face the Department shows to the world is an American face in all our diversity.

We also need to refocus our foreign assistance priorities and programs. AID should be overhauled. Its purposes must be concentrated to more directly serve our national interests. Its focus must be sharpened. And its programs must be less bureaucratic and more efficient. I have asked Deputy Secretary



Wharton to examine the role of AID in the post-Cold War era and report his recommendations to me by the end of this month.

The reform agenda for our foreign policy institutions is an ambitious one. In addition to State and AID, it also must include rethinking and renewing the roles of ACDA, USIA, and the Board for International Broadcasting. We look forward to working closely with this Committee and the full Congress in all of these efforts.

CONCLUSION

Mr. Chairman, together we and the American people face a daunting challenge. To succeed in this new era will require a real partnership -- between Democrats and Republicans, between the Executive Branch and the Congress, and, above all, between the American people and their government. Today, I want to reaffirm with you my commitment to that partnership.

Thank you.

**Prepared Testimony of Larry Diamond**
**To the House Foreign Affairs Committee**
**March 23, 1993**

# WHAT THE UNITED STATES SHOULD DO TO PROMOTE DEMOCRACY

*Chairman Hamilton, Distinguished Members:*

## Foreign Aid and Democratic Assistance

1. Total U.S. spending for democracy assistance should be increased significantly over the coming years. A reasonable goal would be to double current expenditures for aiding development of the political and societal infrastructures of democracy from roughly $200 million to $400 million in the foreign aid and democracy assistance budgets. These additional funds can come from redirecting a small share of existing expenditures in development assistance, economic support, and military assistance.

2. USIA should increase the proportion of its total expenditures that is devoted to advancing the ideas and institutions of democracy. Democracy promotion should also continue to receive growing emphasis in such existing USIA programs as scholarly exchanges, foreign visitors' programs, lecture tours, and publications support. More emphasis should be put on promoting exchanges among democratic political and civic leaders in various developing and post-communist countries, and somewhat less on expensive tours of the United States.

3. AID and USIA should seek to encourage and support development of regional centers of democratic training, assistance, defense, and institution-building, like those which exist within the Western Hemisphere (e.g. the Inter-American Court and Commission on Human Rights, the Center for Electoral Assistance (CAPEL), and the OAS Unit for Democracy). Comparable structures could be particularly valuable within the framework of existing regional organizations such as ASEAN and the OAU.

4. Funding for non-governmental organizations that promote democracy abroad should be sharply increased, and, as much as possible, institutionalized in direct Congressional budget allocations like NED's allocation in the USIA budget and The Asia Foundation's in the State Department Budget. Current AID program funding of these organizations should be substantially consolidated in the increased Congressional allocations. Congress should approve the Administration's request for an increase in the NED budget from $30 million to $50 million in FY94, and comparable increases should be planned for each of the next several years. The Asia Foundation's Congressional allocation should be increased from $16.693 in FY93 to roughly $30 million in FY94, and program grants from AID should in turn be phased out or greatly reduced. Congress should search for or encourage creation of a comparable non-governmental donor that can perform in Africa many of the cutting edge democracy promotion activities that The Asia Foundation has been conducting in Asia. One possible candidate for such a Congressional allocation would be the African-American Institute.

5. AID should continue with its "Democracy Initiative" but should focus primarily on assisting development of the governmental institutions of democracy and the social and economic foundations of democracy: independent universities and policy think tanks, grassroots development organizations, strong private business sectors, and government policies and institutions that promote market-oriented economic growth with social justice. AID should thus be a strong participant but not the leading actor in U.S. democracy promotion efforts. Internally, AID should appoint a highly placed official, either a strong coordinator or an assistant administrator, to coordinate all of its activities for democracy promotion and liaise with other public and private agencies.

6. Government-to-government foreign aid should be conditioned on respect for basic civil liberties, organizational pluralism in civic life, and a reasonably free press, or demonstrable progress toward these goals. These three conditions do not mandate any particular set of political institutions and are not specific to Western cultural norms. Rather, they encompass pan-human aspirations for protection of the dignity of each individual, freedom from discrimination, torture, and fear, and the ability to organize around group interests, express those interests, and obtain independent information. These conditions are necessary both for human dignity and for accountable governance. Institutional measures to ensure accountability - such as an independent auditor general and anti-corruption board - should also be a condition for receiving U.S. foreign assistance. Governments that refuse to institute effective procedures for accountability should face termination of official assistance.

7. The U.S. should work with its G-7 allies and multilateral institutions to suspend debt repayment for those low-income countries (particularly in Africa) that meet international standards with respect to democracy, accountability, and economic reform. While this moratorium is in place, each country's debt should be permanently written down at a rate of perhaps 10 percent a year for each year the above conditions are met.

8. Where broad popular pressures for genuine democratization coalesce to demand a democratic transition, the U.S. and its allies should support these efforts. In such transition situations, we should suspend foreign assistance to those governments - as in Kenya and Cameroon - that fail to implement free and fair elections and other democratizing reforms.

9. Congress should amend the foreign assistance act to permit the provision of democratic and economic assistance to non-governmental actors even where conditions call for the termination of government-to-government aid.

10. Countries that demonstrate strong commitments to democratic reform and institution-building should receive higher priority for U.S. foreign assistance.



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Small countries like Nepal and Zambia should not be neglected; every new democracy can be an important source of innovation and diffusion.

11. The U.S. should coordinate with its allies in the OECD more closely to forge, as much as possible, a common set of conditions for international assistance to governments and a common set of strategies for dealing with individual governments in the developing world.

12. A fund should be created to support social science and policy research on the political, social, economic, cultural, and institutional factors that facilitate or obstruct the development of democracy. This research support fund, at an initial level of perhaps $2 to 3 million, could be administered as a grant-making program within NED. It would help significantly to enhance our understanding of developments in the recently established democracies, and of the kinds of institutions and policies that are most conducive to democracy under different types of conditions (such as ethnic divisions, economic reform, or low levels of economic development).

Global Institutions

1. The United Nations must be strengthened institutionally. The United States should rally its democratic allies to demand comprehensive reforms that improve efficiency, reduce waste, fraud, and abuse, and institutionalize more rigorous procedures for accountability and effective management.

2. The democracy assistance functions of the United Nations, including prominently its capacities for election monitoring, electoral administration, and conflict mediation, should be enhanced. More financial and human resources should be invested in these functions and close coordination should be established with comparable regional, national, and nongovernmental organizations.

3. U.N. peacekeeping and peace enforcement capacities should be significantly enhanced. U.N. peace forces should be given clear authority by the Security Council to enforce the peace, and to engage in offensive operations if necessary to do so. This will require much greater commitments of troops and weapons and much more effective command and control, including: clear authority for the U.N commander to command and discipline troops and units of every nationality; more effective discipline, coordination, and accountability for U.N. administrative personnel as well; a common operational language, so that all officers of all nations can communicate with one another; a common doctrine and operating system throughout the entire U.N. force; common training for both administrative and military operations; an effective and coherent intelligence component; adequate transportation, communications, and medical support. The



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U.N. security council should have available to it for global peace enforcement a substantial array of predesignated forces within a number of countries, ready to be deployed within 48 hours, trained in common procedures, and utilizing standardized equipment.

4. The U.S. should join with its OECD allies to encourage the international financial institutions, particularly the World Bank and the IMF, to take into more explicit consideration the political challenges and requirements of effective economic development and macroeconomic management. Effective governance and particularly accountability should be made stronger criteria for concessional lending from these institutions. At the same time, both institutions, and particularly the IMF, should approach with somewhat greater flexibility the economic conditions for assistance, appreciating that timing can be everything in politics and that reform policies that impose massive economic dislocation without having the resources to cushion the resulting suffering may threaten the viability of reformist governments.

Strategic Priorities

1. U.S. economic and technical assistance to Russia should be accelerated as rapidly as possible. Particular priority should be given to implementing the $24 billion assistance package announced last year to help stabilize the ruble and facilitate economic reform. Procedures for accountability should be required, but other strict terms of conventional IMF conditionality should be relaxed to allow the aid to precede rather than follow further radical reforms. The U.S. and its Western allies should also agree to reschedule Russia's $84 billion foreign debt on the condition that it adhere to the course of economic and political reform, and should offer a sizeable fund or "safety net" to support pensioners, unemployed workers, and displaced soldiers; maintain the real value of police and military incomes; and otherwise cushion the pain of radical economic reform.

2. U.S. and Western technical assistance to Russia should be substantially increased, but volunteers and experts should be trained in Russian culture and language, and should be expected to treat their Russian counterparts respectfully as partners. Democratic assistance programs should also be increased, and the Democracy Corps should be implemented as rapidly as possible.

3. Additional funds should be established to provide seed loans to emerging Russian entrepreneurs and to encourage foreign investment in Russia.

4. Economic and political assistance should be accelerated to other post-Soviet states, particularly Ukraine, Kazakhstan, Belarus, and the Baltic states.

5. The U.S. and its democratic allies should press China to improve its human rights record, respect the political reform process in Hong Kong, terminate its support for the repressive military dictatorship in Burma, and negotiate a settlement of the decades-long Tibetan conflict. While we should be realistic in recognizing the limits to which we can use our trade with China as a lever for democratic progress, China must be held accountable by the global democratic community to certain basic, internationally recognized human rights standards. MFN status for China should be conditioned on monitorable human rights conditions, including the release of political prisoners, access to prisons by the International Committee of the Red Cross, and reversal of the population transfer from Tibet. Greater funding from U.S. nongovernmental programs should be devoted in the coming years to supporting Chinese NGOs and autonomous or semi-autonomous think tanks and professional associations; strengthening the capacity of China's media to provide a forum for public opinion and policy debate; assisting private business associations; and otherwise advancing China's transitions to a market economy and a more pluralistic society. If these transitions are successful, China will experience irresistible pressure in the coming years for democratic political change.

6. Similar work with NGOs, private business groups, and economic reform programs should be undertaken in Vietnam, but the U.S. should not restore diplomatic relations until Vietnam meets certain basic conditions with respect to human rights, including the release of political prisoners.

7. The U.S. should mobilize comprehensive diplomatic and economic pressures to force the military junta in Burma, the SLORC, to hand over power to the legitimately elected national assembly and the coalition government that represents it in exile. If the SLORC has not complied with U.N. resolutions to release political prisoners, cease human rights violations, and restore democracy to Burma, the U.S. should mobilize an international coalition to remove the SLORC from Burma's seat in the U.N. General Assembly when it reconvenes in September. Failing such compliance, we should also organize an immediate global embargo of weapons transfers and all military and security assistance to the SLORC, and comprehensive economic sanctions on the regime, including a complete ban on aid, trade, and investments. These embargos should be codified in U.N. resolutions and the democratic powers should endeavor to obtain the compliance of relevant nations, especially China and Thailand.

8. In exchange for Thailand's cooperation in halting trade with the Burmese regime and the Khmer Rouge, the U.S. should should offer Thailand tangible improvements in our bilateral relationship, including trade concessions and increased diplomatic and security cooperation.

9. The U.S. should strengthen its economic and political ties with Turkey, encourage investment in its economy, and encourage the European Community to admit Turkey as a full member. At the same time, the U.S. and E.C. should press Turkey to improve its human rights record, particularly with respect to the treatment of minority groups.

10. NAFTA should be ratified and then extended to other countries in Latin America and the Caribbean, but ratification should not be completed until Mexico provides strong guarantees for workers' rights, including the right to organize and operate fully independent trade unions.

*Conclusion*

Advancing the cause of democracy in the world will be a formidable challenge in the coming years. In the midst of spreading conflict and instability, it will not be easy to maintain the democracies that have recently come into being, and it will be harder still to increase their number. The keys to progress will be patience, steadfastness, institutional innovation, and increasing cooperation on the part of the established democracies around the world. The United States must lead, but our democratic allies - Europe, Japan, Canada, Australia, and others - must also commit their resources and prestige to the protection and expansion of democracy and human rights. And increasingly, we will need to work through the United Nations and regional bodies to promote democracy and collective security. Promoting democracy cannot be our only foreign policy goal, but neither can it be effective as a partial and piecemeal strategy. The Cold War is over, but we remain the only country that can catalyze the world to move in new directions. Now more than ever, we must continue to think and act globally.



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## Senate

### A STRATEGY FOR FOREIGN AID REFORM

Mr. LEAHY. Mr. President, 3 years ago, by the end of my first year as chairman of the Foreign Operations Subcommittee, it became clear to me that foreign aid is in need of fundamental reform. We need to change the way we make decisions about programs and funding and the goals and priorities we pursue.

In a speech on this floor in 1990 I urged the Bush administration to look ahead to the 21st century. I asked that the President send to the Congress a foreign aid budget that would respond to the momentous changes that were sweeping the world since the fall of the Berlin Wall. I called for new directions in foreign aid. I stressed the need to modernize the Agency for International Development and to confront the enormous global problems that have replaced communism as the greatest threat to our security.

Needless to say, the Bush administration did not heed my voice. However, I have continued to push that same message year after year. In the Foreign Operations Subcommittee, in the face of administration opposition we managed to begin shifting funds to new priorities. I am pleased that finally a consensus has emerged—accepted by the Clinton administration according to Deputy Secretary of State-designate Wharton—that real reform of foreign aid can no longer be delayed.

Today, I will make the first of several statements during the next 100 days explaining why I believe foreign aid reform is so urgently needed. I will address what I see as the major obstacles to reform, and what I believe we must do. I will offer my views on a strategy for pursuing reform, and I will propose specific changes I believe are necessary.

In this first statement, I would like to concentrate on the context for reform. Before we can begin to change, we must understand how we got where we are, why reform is necessary, and why change must begin now.

The U.S. foreign aid program began after World War II with a farsighted decision to help the Western European countries to rebuild. Certainly one of the motivations for the Marshall Plan was generosity, but the fundamental reason was alarm over the rising tide of communism in Europe. The belief that poverty and hopelessness bred communism, and that economic prosperity and political freedom were the best antidotes, was formed in those early days. The linkage between economic development and political liberty, the driving force for our foreign aid policies for the next four decades, was forged right at the start.

The Marshall plan, which involved huge infusions of American aid, was a great success. It is often cited as the model for other major assistance efforts, such as the Alliance for Progress in the 1960's.

But what many people failed to understand is that the Marshall plan was so successful because it was carried out in countries that had already developed the traditions, institutions, and human resources necessary to produce sustained economic growth and politically open societies. What the devastated nations of Europe lacked was the means to rebuild. The Marshall plan, very simply, provided those means, and quickly produced an explosion of economic growth.

After the Marshall plan, the focus of United States aid shifted primarily to Asia, first to protect Korea, and then Taiwan, Vietnam, and other countries against Communist expansion. While it nearly always had an economic development component, again our assistance was driven fundamentally by a national security goal of containing the spread of communism.

As United States foreign assistance efforts expanded into new areas, principally Latin America and the emerging new nations of Africa, the same basic national security considerations continued to apply. We maintained a linkage between economic development and the modernization of political institutions, with the idea that creating economic growth was an essential first stage on the way towards functioning democracies.

Through the Vietnam war, United States foreign assistance was primarily oriented toward bolstering governments which were—or claimed to be—anti-Communist. That such governments were often themselves authoritarian or even dictatorships was considered a lamentable but unavoidable cost in a larger strategy of containing communism. One these nations achieved economic growth, we thought, political pluralism and accountability to the people would surely follow.

Two features of this period in our foreign aid program's history are worth recalling. They do much to explain many of the failures and difficulties our foreign assistance efforts have encountered.

First, most of the Third World countries we sought to help did not possess the infrastructure and traditions necessary for economic growth and open political systems to flourish. Our aid programs lacked the fertile institutional ground upon which to work the economic and political miracles which occurred in Europe in the late 1940's and early 1950's.

Second, the threats to these countries were perceived to be principally military, as communism was seen to be expanding through guerrilla insurgences. While assistance was often aimed at economic development, the underlying rationale was that stronger economies meant greater ability to resist Communist attacks.

Because we are a generous people, for the most part we really did intend and expect that our assistance, while given primarily for security reasons, would also benefit the recipients by stimulating economic development. Or, to put it another way, we saw no inconsistency, and in fact a direct connection, between deterring communism and economic betterment. Looking at our own historical experience, as well as the Marshall plan in Europe, we thought economic growth naturally led to democracy and political stability. Traditional cultures would, we believed, give way to rapid political and economic modernization in the context of industrialization, urbanization, and economic growth.

As many more nations joined the international community, our aid programs expanded vastly in scope, though, in comparison with the Marshall plan, not in the level of resources. We spread our limited assistance ever more thinly, trying to support non-Communist regimes in inherently unstable countries with very weak political and economic institutions. We continued to give priority to our goals of political stability and anticommunism in the face of a revolution in mass communications and related political and economic awakening of billions of impoverished peoples in the developing world.

And measured in terms of what we sought to do, our foreign aid programs were successful. Communism was deterred and finally defeated without global war. In defense of freedom and to contain communism, the American people have been generous. Since the Marshall plan, we have spent many hundreds of billions of dollars to support economic, development, and military programs in more than a hundred countries.

Yet throughout those years, and particularly since Vietnam where massive infusions of aid were unable to achieve our other goals of economic development and the spread of democracy, disillusionment about foreign aid has steadily grown.

With the waning of the national security justification for foreign aid, and I am sure the distinguished Presiding Officer hears, as I do, people increasingly asking how those hundreds of billions of dollars helped poor people abroad? Where, they ask, is the sustained economic development? Where are the Democratic institutions? Where are the open, pluralistic societies where basic human rights are respected? Why is degrading poverty still so pervasive?

There are many reasons why the complex process of political and economic development in the Third World is moving so slowly. But it is now clear that some of our basic assumptions about the stages of economic and political development in many new nations were wrong.

We expected foreign aid to work in poor, Third World countries the way it had worked in Western Europe. We are still discovering just how wrong our assumptions were in apply Marshall plan

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thinking to the developing world. Only in the last few years have we come to recognize how enormously difficult it is to create—where none exist—the basic institutions necessary to sustain economic growth and political pluralism.

So what lessons have we learned?

First, by placing such a high priority on political stability and anti-Communist credentials, we failed to insist on the establishment of Democratic forms and institutions. Too much aid went to support corrupt and repressive governments and not enough to fostering the basic machinery of Democratic societies. These are the very things that make democracy so strong in the face of political, economic, or military challenge.

Second, by paying too little attention to how Third World governments themselves functioned, we wasted hundreds of millions of dollars of American taxpayers' money. We did not demand that our development aid be used wisely, nor did we penalize recipient governments that did not produce better lives for their own people. Political stability came far ahead of demands for improved government efficiency and accountability.

As just one example, in Africa the four largest recipients of United States aid during the 1970's and 1980's were Somalia, Sudan, Zaire, and Liberia. Every one of those nations has lain under the boot of dictators who pillaged the treasuries and murdered their own people. As U.S. aid dollars flowed in, political oppositions were crushed, corruption flourished, military and political elites bled the economies white. Today those countries are devastated by civil war, anarchy, and famine.

Third, while our aid to Europe was received with appreciation and a realistic sharing of our national security interests, in the Third World it has often been met with suspicion about our motives and criticism of our country. Third World peoples are not fools. They knew what our priorities were. There was—and still is—much resentment that with our mouths we preached Democracy and political pluralism while with our dollars and weapons we supported dictators and authoritarian regimes. Too often our deeds did not match our words.

What we have is now a twofold disillusionment. At home, the American people are fed up with an outdated foreign aid program that no longer serves what most would agree are indisputable American national interests. Even our national generosity seems to have been perverted, since we see so little improvement in the lives of the poor we sought—or claimed we sought—to help. In fact, in many ways, particularly in the area of health, real advances were made. But across the board, progress was very uneven.

Abroad, there is anger that so much money and so much time has been wasted with so little result in the development of functioning economies, political pluralism, and social justice. Decades of assistance have made little difference to most people in Africa, or to many millions of the poor in Latin America and parts of Asia. Recipient governments have mishandled hundreds of billions of dollars of foreign aid which should have improved the lives of their peoples.

The consequences of this disillusionment on the political consensus here at home in support of foreign aid have been profound. As the national security rationale for foreign aid has grown ever more strained and unconvincing, Congress has been groping to find a new approach that would reestablish a relationship between foreign assistance and tangible American national interests.

To be blunt, we in Congress must be given an explanation we can believe why continued foreign aid is in the national interest. And we must be able to persuade the American people that this national interest is real and will be advanced by foreign aid.

Since the height of the Marshall plan when in a single year we gave $13 billion to Western Europe, the foreign aid budget has decreased. The recent high point was $20 billion in 1985. Since then, the trend in foreign aid is downward. Today, the total stands at $14 billion and accounts for less than 1 percent of the total Federal budget.

In fiscal years 1992 and 1993, Congress slashed the foreign aid appropriation deeply. In these 2 years, actual appropriations fell by about $1.5 billion, and far more steeply from President Bush's requests.

Confronted by a growing gap between expectations and reality, appalled by lack of leadership, angered by accumulating evidence of substantial mismanagement and waste, and shaken by profound foreign policy disagreements, Congress increasingly has tried to push the foreign aid program into more positive directions. Cooperation with the executive branch has become a casualty of the loss of trust engendered by the Vietnam war and accentuated by continuing scandals, such as Iran/Contra, and widening disputes over policy, such as the war in El Salvador.

Reform efforts have abounded in recent years, but with inadequate political, bureaucratic, or intellectual preparation, all have failed. An ever growing list of theories has sprung up about what foreign aid should be used for and how to make it more effective. All this reflects the disintegration of the postwar consensus about what interests foreign aid is supposed to now serve. We now confront an absence of agreement about why the United States should have a foreign aid program at all, and if we are to continue to provide foreign aid, what specific national interests it is to serve.

Mr. President, as chairman of the Foreign Operations Subcommittee responsible for drafting and moving the annual foreign aid appropriation through the Senate, I do not believe it will be possible to enact another business-as-usual foreign aid bill. The last foreign aid bill was carried through the Congress only by the Israeli loan guarantee program. It was impossible to pass a fiscal 1992 foreign aid appropriation at all; the entire program was funded through a year long continuing resolution.

That stark reality explains why a top to bottom reexamination of our entire foreign aid program is essential. It cannot be delayed. I know the Clinton administration wants to focus on domestic issues, a focus I agree with and support. But I also know there must be major changes in foreign aid funding priorities and in the rationale for the foreign aid program if we are to enact new foreign operations appropriations bills without their being gutted on the Senate floor.

I am pleased by Deputy Secretary-Designate Wharton's statement in his confirmation hearings that he will be in charge of developing a plan to reform foreign aid within 90 days. If the Clinton administration had decided to postpone the foreign aid reform issue, Congress would have to take reform up itself. We can afford no further delay in the complex task of redefining foreign aid goals and restructuring AID ourselves.

Even with full scale executive branch leadership, redefining the fundamental purposes of foreign assistance in the post-cold-war world will be difficult. There are many competing points of view. Many interests will be affected by change. Some argue that our assistance should focus mainly on promoting American commercial interests overseas in the way that some of our competitors, such as the Japanese, do. Others say foreign aid should be targeted at solving global problems which threaten our national well-being and the future of the planet, such as overpopulation and environmental degradation, the international drug trade, and AIDS.

Still others insist that ending poverty should be the goal of all foreign aid, and that sustainable economic development, political stability, reduced population growth, and preservation of the environment will follow naturally. And there are those who believe the only valid reason for providing large scale foreign aid is to advance concrete U.S. national security interests in specific areas of the world.

Complicating the task, Congress, and most of the executive branch, has lost confidence in the Agency for International Development. It is a rudderless agency in search of a mission. Torn in every direction by competing forces within the executive branch, under unrelenting pressure from special interest groups, and besieged by Congress, AID has become a bureaucratic stepchild.

Once AID shaped U.S. foreign assistance policy and its key programs. Today AID has been reduced to little more than an implementer of decisions expect that our assistance, while given primarily for security reasons, would also benefit the recipients by stimulating economic development. Or, to put it another way, we saw no inconsistency, and in fact a direct connection, between deterring communism and economic betterment. Looking at our own historical experience, as well as the Marshall plan in Europe, we thought economic growth naturally led to democracy and political stability. Traditional cultures would, we believed, give way to rapid political and economic modernization in the context of industrialization, urbanization, and economic growth.

As many more nations joined the international community, our aid programs expanded vastly in scope, though, in comparison with the Marshall plan, not in the level of resources. We spread our limited assistance ever more thinly, trying to support non-Communist regimes in inherently unstable countries with very weak political and economic institutions. We continued to give priority to our goals of political stability and anticommunism in the face of a revolution in mass communications and related political and economic awakening of billions of impoverished peoples in the developing world.

And measured in terms of what we sought to do, our foreign aid programs were successful. Communism was deterred and finally defeated without global war. In defense of freedom and to contain communism, the American people have been generous. Since the Marshall plan, we have spent many hundreds of billions of dollars to support economic, development, and military programs in more than a hundred countries.

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With the waning of the national security justification for foreign aid, and I am sure the distinguished Presiding Officer hears, as I do, people increasingly asking how those hundreds of billions of dollars helped poor people abroad? Where, they ask, is the sustained economic development? Where are the Democratic institutions? Where are the open, pluralistic societies where basic human rights are respected? Why is degrading poverty still so pervasive?

There are many reasons why the complex process of political and economic development in the Third World is moving so slowly. But it is now clear that some of our basic assumptions about the stages of economic and political development in many new nations were wrong.

We expected foreign aid to work in poor, Third World countries the way it had worked in Western Europe. We are still discovering just how wrong our assumptions were in apply Marshall plan made by others. The State Department micromanages AID's Eastern Europe and New Independent States programs. With proposed the new Under Secretary of State position for global issues, State is evidently going to take full control of environment, health and population policy and programs. After years of resisting pressures from Congress to take leadership roles in all these areas, AID missed the boat on what are sure to be the driving forces of foreign aid in the future.

In my mind, so low has AID fallen that it is an open question whether the Agency should continue to exist, at least in its present form. The new Administrator will have a huge and difficult challenge to redefine and reshape that Agency in ways that will justify its future existence. I intend to address this question in detail in a future statement.

Any serious reform of AID must begin with the question: With the cold war over, do we even need a bilateral foreign aid program any longer?

I am struck by President John F. Kennedy's response to that question in 1961:

The answer is that there is no escaping our obligations: our moral obligations as a wise leader and good neighbor in the interdependent community of free nations—our economic obligations as the wealthiest people in the world of largely poor people, as a nation no longer dependent upon the loans from abroad that once helped us develop our own economy—and our political obligations as the single largest counter to the adversaries of freedom.

To fail to meet those obligations now would be disastrous; and, in the long run, more expensive. For widespread poverty and chaos lead to a collapse of existing political and social structures which would inevitably invite the advance of totalitarianism into every weak and unstable area. Thus our own security would be endangered and our prosperity imperiled. A program of assistance to the underdeveloped nations must continue because the Nation's interest and the cause of political freedom require it.

But the definition of how foreign aid was to serve the national interest in 1961 is no longer valid. Congress and the administration must find a broadly acceptable redefinition of the purposes of foreign assistance that will meet President Kennedy's basic tests of foreign assistance: A renewed foreign aid program must meet the national interest and further the cause of freedom and justice in the world.

What are our foremost national interests today, what goals should we set to further those interests, and how can we use foreign aid to achieve those goals?

I will address those critical questions in other statements on the future of foreign aid during the next 100 days. Today, I want to close by emphasizing that unless there are screams from the special interests and the multitude of lobbyists who have sprung up to protect virtual entitlements in the present foreign aid program, we will have failed to define a new direction for foreign aid. Unless we can make serious changes in funding allocations and in the goals of our programs, we will only be going through the motions. It will continue to be business-as-usual—for a little while longer. And then the patience of the American people with this noble experiment will be gone.

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ODC NEWS

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PRESS RELEASE
**February 10, 1993**

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# EXPERTS URGE ADMINISTRATION TO ADOPT NEW STRATEGY AND STRUCTURE FOR DEVELOPMENT COOPERATION

Washington, D.C. "We applaud the Administration's intention, as announced by Deputy Secretary of State Clifton Wharton last Friday, to review the mandate and organization of the U.S. Agency for International Development," said John W. Sewell, member of The Independent Group on the Future of U.S. Development Cooperation and President of the Overseas Development Council. In a memo originally presented to President-elect Clinton and the transition team after the election, the Independent Group urges the Administration to adopt a new foreign aid program to promote sustainable development. The new program, would focus on three main objectives: investing in people, protecting the earth, and strengthening democratic institutions.

The report was prepared by a group of development experts, and endorsed by a larger group including three former USAID Administrators, former World Bank president Robert McNamara, Reverend Theodore M. Hesburgh, several individuals who served on transition teams or are now in government, and others. The group cautions, "we are deeply concerned that current development cooperation policies have run out of time and need to be replaced with programs more responsive to American interests and global problems in the 1990s. If this is not done, we risk losing support in Congress and among the general public for American

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leadership in the global cooperative effort to address the great challenges of alleviating poverty, sustaining the environment, and supporting transitions to democratic market-based societies."

The "White Paper on U.S. Development Cooperation in a New Democratic Era" advocates that sustainable development, defined as growth that leads to poverty alleviation and environmental preservation for successive generations within the context of participation and social justice, should be the core of a reformed and restructured development assistance program. The program should utilize the strengths of both multilateral and bilateral assistance to meet the development needs of the 1990s.

To implement the new sustainable development agenda, the White Paper recommends that U.S.A.I.D. be replaced with a new Sustainable Development Cooperation Agency (SDCA) that would operate in a much more flexible manner than U.S.A.I.D., and would be freed from short-term foreign policy concerns. Project funding would be implemented on a competitive basis, open to all bidders in this country and abroad. The new agency would include a separate division for Eastern Europe and the new states of the former Soviet Union. The Paper also recommends the creation of a Development Coordination Group in the Office of the President to ensure cross-agency coherence of policy and coordination particularly involving the multilateral development agencies.

Whether closely linked to the Department of State as AID is now, or independent, the Group urges President-elect Clinton to elevate development to a principal goal of U.S. foreign policy and aid, divorcing the program from short-term political and strategic concerns that dominated the program in the Cold War era.

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Preparation of the "White Paper on U.S. Development Cooperation in a New Democratic Era" was facilitated by the Overseas Development Council, which acted as the Group's informal secretariat, and The Rockefeller Foundation, which provided financial support. The White Paper does not necessarily reflect the views of the Board, Council, or staff of the ODC or The Rockefeller Foundation and is solely the responsibility of the individuals involved.

The Christian Science Monitor April 1, 1993

# Rethink, and Cut, Aid to Developing Nations

*Communism is no longer a threat, and much of the aid money is spent among American interest groups anyway*

By Pat M. Holt

AMONG the other adjustments brought on by the end of the cold war, there ought to be a reassessment of United States policy toward the third world. This could bring with it budgetary savings as well as political benefits for our foreign policy.

For 50 years the US saw its primary interest in the third world as keeping communism out. That is no longer relevant; we ought to look at our other interests.

These include sizeable US investments and substantial and profitable trade. Transit rights are important for American aircraft and ships. The third world is the source of minerals and other raw materials the US needs. The third world remains politically important if for no other reason than its governments vote in the United Nations. We also have interests in third-world economic growth (it is good for business) and in supporting democracy and respect for human rights.

These are important interests, but they are humdrum compared with the drama of fighting communism. They are best served by the same policies that promote them in non-third-world countries – enlightened trade and economic policies, wise diplomacy, and political policies based on nonintervention and respect.

One casualty of a third-world reassessment ought to be foreign aid. Like members of Congress arguing against closing a military base, foreign aid partisans will find new reasons to keep it alive. But its time has passed. It is falsely presented to the American people as a program to help the poor in other countries. In fact, it is designed to help a variety of American interest groups, not the least of which is the bureaucracy that administers it. The UN report on human rights abuses in El Salvador lays out evidence of the ineffectiveness of the aid program in promoting democracy and human rights while dispensing $6 billion.

THE lesson in this for American foreign policy is that our capacity to influence other countries is limited more than we would like to admit. As has been amply demonstrated for almost half a century, foreign aid does not enhance this capacity. Neither Congress nor the State Department have been able to resist using foreign aid as an all-purpose foreign policy tool to pursue unrelated objectives for which it is an inappropriate instrument.

So many different groups, not least the ethnic special interests, have an interest in foreign aid that it is unrealistic to talk of ending the program. One wonders if it would be more difficult than closing military bases. But there is strong opinion in Washington that it cannot be done. The Israelis, who get more than anybody else, would complain mightily. What the Egyptians get is related to what the Israelis get. The Greeks would complain: and what the Turks get is related to what the Greeks get. We cannot, it is argued, cut off the Pakistanis, because then we would not have any aid left to cut off as a way to punish them for building a nuclear weapon. And so it goes. Maybe we can't end it, but surely we can cut it back.

There is another American interest looming on the horizon of the third world – humanitarian relief. It is hard to argue against this, given the heart-wrenching pictures of hunger and other human suffering. But the problem might also be recognized as a bottomless pit. The need for relief is most apparent in Africa. In part, it results from the natural disaster of drought. In part, it results from civil strife. But overwhelmingly, it results from rapid population growth.

Unless short-term relief is accompanied by long-term measures to improve production (which may mean to increase political stability) and to control population growth, there will never be an end to the short-term crisis. This is a tall order for foreigners, because it involves some of the most sensitive points of a people's culture and personal lives.

Even before US population policy was blown completely off course by Reagan-Bush administration ideologues, it was a matter of great delicacy. Large segments of the third world were (some still are) predisposed to believe the US interest stems from a fear that too many Mexicans, or Africans, or whoever will threaten US hegemony. American initiatives, especially if they are seen as prodding, are likely to be counterproductive. The best results come from responding to local interest in population programs. If there is no local interest – in population growth, economic reform, or democracy – there is not much we can do.

■ *Pat M. Holt, former chief of staff of the Senate Foreign Relations Committee, writes on foreign affairs from Washington.*

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# FY 1994 International Affairs Budget

United States Department of State
*Bureau of Public Affairs*
April 8, 1993

PRELIMINARY

## Budget Highlights by Major Area

### Building Democracy

Building democracy is a fundamental long-term goal of US foreign policy. By promoting and protecting human rights and basic freedoms, the United States not only honors the values on which it is founded, but also helps ensure the prosperity and security of its citizens. Democracies are more representative of their citizens and are less aggressive abroad. They make better partners in diplomacy, trade, arms control, and cooperation on global issues such as the environment, narcotics, and terrorism. Americans have a clear moral *and* material stake in the expansion of democratic values. And that stake is no more vital than in Russia and the other new independent states (NIS) of the former Soviet Union. The long-term security of the United States is integrally linked to the progress made in Russia and the other new independent states toward democracy and the establishment of a market economy. A successful transition also is important to world economic growth and the US economic future.

#### New Independent States of The Former Soviet Union

Supporting reforms in the new independent states is vital to US interests, because those reforms offer unique and historic opportunities:

- Enhancing US security, through weapons reductions agreements and peaceful relations with new democratic states;
- Resolving global problems by engaging the new states as partners, rather than as adversaries in foreign policy;
- Increasing US economic growth by investing more at home while spending less on defense; and
- Strengthening US prosperity as the new states move to become attractive markets and prosperous trading partners.

The FY 1994 budget requests $704 million for grant assistance for democratic and economic reform in the new independent states of the former Soviet Union. This is an increase of $311 million over last year's level. The Administration intends to focus assistance on expediting delivery of emergency humanitarian relief and technical assistance in support of democratic and market economic reforms. Specifically, the President requests $704 million to provide technical assistance to create and strengthen democratic institutions; to encourage private sector development; to strengthen key human services and to provide medical and food supplies; to promote sectoral reform in the areas of agriculture, energy, environment, and housing; and to support research and training.

Resources from other budget functions also will provide support for Russia. For example, the Department of Defense (DOD) will be requesting $400 million for dismantlement of weapons. The FY 1994 request builds on the President's commitment at the Vancouver Summit to deliver concrete, visible assistance in order to reinforce democratic reforms in Russia and the other new independent states at all levels of their economies and societies. The Administration is reviewing additional options for expanding these efforts and will work with Congress to identify additional support as part of a broad internationally coordinated effort.

#### Central and Eastern Europe

The successful transformation of the democracies in Central and Eastern Europe will provide the best proof to reformers elsewhere that democracy, along with economic prosperity, can be built on the ashes of failed communist systems. Prosperous, democratic countries in Central and Eastern Europe provide more than hope and example for the NIS: They also contribute to Western security by providing stability against the spread of further nationalist fighting or of retrenchment further east.

The FY 1994 budget requests $409 million for assistance to Central and Eastern Europe. The program provides assistance to more than a dozen new democracies, from Estonia to Albania, with a population exceeding 135 million.

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*"Bringing Russia—one of history's most powerful nations—into the family of peaceful nations will serve our highest security, economic, and moral interests. For America and the world, the stakes are just monumental. If we succeed, we will have established the foundation for our lasting security into the next century."*

*—Secretary Christopher*
*Chicago Council on Foreign Relations*
*March 23, 1993*

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The program is designed to consolidate and strengthen the new democracies of Central and Eastern Europe with three mutually reinforcing objectives:

- Developing and strengthening democratic institutions, including national parliaments, local governments, independent media, and other key institutions;
- Developing a market economy and strong private sector through removing constraints to entrepreneurship, advancing privatization and enterprise restructuring, providing capital and assistance to new entrepreneurs, and supporting the development of the financial sector; and
- Improving the basic quality of life in key areas through assistance to build cost-efficient health care and housing systems, labor retraining and unemployment services, and regulations and policies to promote responsible environmental management.

A related objective which applies to all major priorities above is the use of US assistance resources whenever possible as leverage to bring in US private sector capital, goods, services, and expertise. The involvement of the Western private sector is key to the successful transformation of these countries, and the US assistance program can help the US private sector take advantage of commercial opportunities in the region.

### Information and Exchange

The free international exchange of information and ideas is a critical, cost-effective, and integral part of the Administration's foreign policy strategy. Two agencies lead US public diplomacy efforts—the United States Information Agency (USIA) and the Board for International Broadcasting (BIB).

USIA increases international understanding of American society and foreign policy through personal contacts, academic and leadership exchanges, distribution of books and periodicals, English-language teaching, operation of cultural centers abroad, and global satellite television and radio broadcasting. USIA has found ready audiences for its programs in democracy-building, rule of law, freedom of the press, and free market institutions. Proposed funding for USIA is about $1.2 billion in FY 1994. The budget includes increases for two key initiatives:

- $30 million is requested for the creation of a new "Radio Free Asia" operation under the USIA umbrella in FY 1994 to provide surrogate broadcasting to China and other communist countries in Asia; and
- $20 million is requested to increase the budget of the National Endowment for Democracy (NED) to $50 million. NED will provide "venture capital" to help nascent democratic movements in non-democratic societies overcome social, cultural, political, and historical obstacles and will support independent, politically active organizations working to broaden democratic participation in newly democratic countries.

Through grants to Radio Free Europe/Radio Liberty, BIB provides surrogate broadcasts to the people of Central and Eastern Europe, the former Soviet Union, and Afghanistan. Surrogate broadcasting operates as a domestic radio service in the target countries, providing local news and analysis of regional developments where independent media are weak or do not exist at all.

In light of both the dramatic changes in the world and the need to increase government efficiency, the Administration plans to consolidate all US-funded, non-military international broadcasting by the end of FY 1995. Consolidation will eliminate administrative overlap and save an estimated $243 million between 1994 and 1997. Specific measures to effect consolidation are the subject of an Administration review.

### Other Democracy Programs

USAID also will undertake democracy-building programs in Asia, Latin America and the Caribbean, and Africa using Economic Support Funds and Development Assistance. More than $100 million in Development Assistance will be devoted to democratization and governance projects, a $15-million increase over FY 1993. These longer term investments are designed to improve the institutional underpinnings of democracy, from reform of judicial systems to decentralized government structures.

## Promoting and Maintaining Peace

For 40 years, containing the Soviet threat defined US national security. With the demise of the Soviet Union and the Warsaw Pact, America entered into a new more complicated and unstable security environment. Now, more than ever, the United States must be engaged in promoting peace. The lesson of this century and its two great wars is clear: The cost of American neglect is high, not just for the world, but also for Americans.

The US approach must take into account the complex post-Cold War security environment. Americans must work to adapt US military forces to new challenges. The United States must give sustained attention to advancing peace processes in vital regions like the Middle East. But above all, the United States must work *collectively* with other nations to solve conflicts and crises, promote peace, and combat proliferation of dangerous weapons and technologies. The FY 1994 budget reflects these new realities.

The end of the Cold War has unleashed long-suppressed ethnic, religious, and regional conflict in the former Soviet bloc and elsewhere. But it also has opened up new possibilities for international cooperation. Our task is to harness that cooperation to contain and, far more importantly, to *prevent* conflict.

The FY 1994 budget shifts more than $200 million of resources from traditional security programs to peace-keeping and non-proliferation.

### Peace-keeping And Related Programs

The President's FY 1994 federal budget will request more than $1 billion in State and Defense Department accounts to support international peace-keeping. Significant increases are requested to support assessed UN peace-keeping operations and other regional peace-keeping efforts that are funded on a voluntary basis. Some security assistance funding supports the goals of peace-keeping. The President's budget also funds peace-keeping in a new, separate, DOD account of $300 million.

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About $700 million is requested in the International Affairs function of the budget for assessed and voluntary contributions for peace-keeping activities. This includes:

- $445 million for the Contributions for International Peace-keeping Activities (CIPA) account to pay the US share of UN assessed peace-keeping costs in FY 1994, including large UN operations in Somalia and the former Yugoslavia. About $22 million will be used to pay arrears to the United Nations.
- $175 million in "no-year contingency funds" requested in the FY 1994 CIPA account for unanticipated peace-keeping activities (assessed and voluntary) and related activities of the United Nations and other multinational organizations.
- $77 million for the peace-keeping operations account to make voluntary contributions to multinational peace-keeping efforts, such as the Conference on Security and Cooperation in Europe (CSCE) in the former Soviet Union and the UN/Organization of American States (OAS) observer mission in Haiti. This is $50 million above FY 1993 enacted levels. Voluntary contributions can be a cost-effective alternative to paying 30.4% of UN peace-keeping costs, because the Administration can determine the extent of its financial involvement on a case-by-case basis.

In addition, security assistance programs will provide bilateral support to peace-related efforts in Africa, Southeast Asia, El Salvador, and Cyprus.

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*"Never before in the history of the United Nations have so many nations and peoples expected so much from the UN system, particularly its peacekeeping operations. . . ."*

*—Madeleine K. Albright*
*US Ambassador to the UN*
*March 12, 1993*

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## Non-Proliferation and Arms Control

One of the main security problems of the post-Cold War era is the risk of proliferation of deadly weapons—nuclear, chemical, biological, and enhanced conventional weapons—as well as their delivery systems. This Administration gives high priority to preventing proliferation. Our task is to fulfill President Clinton's promise to the American people in his campaign ". . .to clamp down on countries and companies that sell proscribed technologies, punish violators, and work urgently with all countries for tough, enforceable, non-proliferation agreements."

To help achieve this, the FY 1994 federal budget request includes almost $600 million to support non-proliferation programs; $441 million of this amount will be requested by DOD, and $3 million will be a part of the Department of Energy's budget request. Within the International Affairs function of the budget, the State Department and the Arms Control and Disarmament Agency (ACDA) will request $197 million for these purposes, including the US contribution to the International Atomic Energy Agency and a new Non-Proliferation and Disarmament Fund. ACDA requests an incremental $16 million for expenses related to implementation of the Chemical Weapons Convention Preparatory Commission in The Hague, which commenced in February 1993. These costs include both the US shared contribution and the administrative support costs for the US delegation.

Together, these programs are designed to:

- Support weapons reductions agreements with Ukraine, Belarus, and Kazakhstan during the 7-year implementation period of the Strategic Arms Reduction Treaties (START), or sooner if possible, and to reduce and restructure the Russian strategic nuclear force into a smaller and less destabilizing force;
- Support and enhance US bilateral and multilateral efforts to establish effective controls on destabilizing weapons systems and materials;
- Dismantle existing systems and create effective export controls on related technologies and materials; and
- Increase the effectiveness of existing non-proliferation and arms control agreements, particularly in the states of the former Soviet Union and in Central and Eastern Europe.

The funds will support four primary program areas:

**Education and training programs** to fund education of foreign government officials about non-proliferation issues and instruction in the creation and implementation of effective export control mechanisms in areas of high proliferation concern;

**Destruction/conversion programs** aimed at eliminating activities of "proliferation concern" as well as implementation of global conventions and treaties, such as the Chemical Weapons Convention and START;

**Enforcement and interdiction programs** to help curb illicit trade in materials related to weapons of mass destruction; and

**Safeguards and verification programs** to assist international agencies in application of Non-Proliferation Treaty safeguards and in the verification of international non-proliferation regimes.

## Middle East Peace

The search for peace in the Middle East has challenged every US Administration since 1948. This is one of the Clinton Administration's highest foreign policy priorities. The more than $5 billion requested for Middle East peace supports the long-standing foreign policy goal of seeking a just, lasting, and comprehensive peace between Israel and its Arab neighbors, including the Palestinians. Secretary of State Christopher, in his confirmation hearings, reaffirmed this commitment and promised to "build upon the considerable accomplishments" of previous Administrations in the quest for Middle East peace.

To this end, this budget reflects the Administration's unshakable commitment to Israel's security and to preserving its qualitative edge over any likely

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combination of aggressors and to support Egypt's vital role in regional stability, security, and the promotion or peace. For the past several years, roughly $3 billion in security assistance has been provided to Israel and $2.1 billion to Egypt annually. Because of declining overall levels, these programs have grown from 70% of total US security assistance in the late 1980s to almost 85% in FY 1993 and 87% in the FY 1994 budget. A new request for $5 million to support the multilateral working groups of the peace process will help fund activities agreed upon in the groups and augment progress in the bilateral talks.

Middle East peace assistance will support economic growth and stability while helping these countries meet their legitimate defense needs. Over time, economic reforms being undertaken will strengthen their economies so that they can meet their own economic and security needs.

### Defense Cooperation And Regional Security

About $260 million is requested to support key countries which have close cooperative defense relations with the United States and provide access by US forces to important military facilities which are essential to US power projection capabilities. Significant economic assistance will be requested for Turkey, an important ally which plays a constructive role in several areas of strategic importance, such as the Middle East, the Balkans, the Caucasus, and Central Asia. Most of the Foreign Military Financing is for loan programs for Greece, Turkey, and Portugal which finance the purchase of defense equipment and services from US sources, bolstering the security of the recipient countries.

The FY 1994 International Affairs function requests about $50 million in Foreign Military Financing and Economic Support Funds to promote regional stability and to assist key friends and allies in meeting their critical defense and economic needs. In recognition of generally reduced levels of tension throughout the world and the need to invest greater resources in promoting sustainable economic growth, the amounts requested for military assistance represent a substantial reduction from the levels requested in prior years. A savings of $266 million also is realized by a proposal to terminate the Special Defense Acquisition Fund beginning in FY 1994.

## Promoting Economic Growth and Sustainable Development

Growing global economic interdependence has brought down forever the wall between foreign and domestic economic policy. US policy goals and mechanisms are being redesigned to keep the US secure and competitive in a global economy.

Prompt congressional passage of the President's economic renewal program is but the first, most critical step toward improving America's competitive position in the international economy. His program challenges American firms and workers to win in world markets, while it seeks to support these efforts by reducing barriers—those of trade, of poverty, and the waste of underdevelopment—and by engaging in cooperative activities with other nations to support international growth and stability.

This budget signals the President's commitment to a *comprehensive* approach to the global economy that promotes:

- Macroeconomic policy coordination among industrial nations;
- Hemispheric trade and investment through implementation of the North American Free Trade Agreement and the Enterprise for the Americas Initiative (EAI);
- Successful conclusion of a new multilateral trade agreement under the General Agreement on Tariffs and Trade (GATT) accord;
- Vigorous promotion of US trade opportunities, including funding efforts by existing programs to identify markets for and finance US exports (e.g. Export-Import Bank (Eximbank), the Overseas Private Investment Corporation (OPIC), the Trade Development Agency (TDA), and the Commodity Credit Corporation—a program in the domestic budget;
- Targeted provision of funds to support economic development; and
- Support for international institutions, both those which help strengthen the international financial system and also generate development and trade benefits (the International Monetary Fund and multilateral development banks) and those with a specific focus on economic development issues (e.g., the UN Development Program).

### Bilateral Economic Development Programs

The FY 1994 budget requests about $1.7 billion for human capital development, building markets and income opportunities, and expanding science and technology efforts in developing countries. This includes funding from a number of accounts, including development assistance, Economic Support Funds, PL-480 Title III food aid, OPIC, the Peace Corps, and debt restructuring under the EAI (see Appendix A).

**Human Capital Development.** To contribute to a dynamic and growing world economy, countries must have a strong human capital base. Countries lacking this resource have fallen further behind in efforts to achieve strong economic growth and to increase the standard of living for their citizens. Without basic health and nutrition, competence in both literacy and numeracy, as well as a set of productive skills, it is nearly impossible for people to create and/or to take advantage of opportunities to better their own lives. Technical skills and professional competencies in management, research and science also are of growing importance in today's dynamic global economy. Thus, US programs will include efforts to enhance these human resources by "investing in people."

**Building Markets and Income Opportunities.** Some of the fastest-growing markets for US goods are the emerging economies of developing countries. Programs in the FY 1994 budget will encourage policies that provide incentives for investment (public and private) and production, while protecting the natural and social environment. Programs will help transfer the know-how and materials f

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technological improvements and increase the flow of and *broad* access to financial capital. The Administration recognizes the need to use resources more effectively to eliminate the bottlenecks to individual initiative and to allow "spontaneous" and "demand-driven" change to take place from the grassroots to the national level.

**Expanding Science and Technology.** If developing countries are to contribute to global prosperity in the 21st century, greater access to and better management of science and technology will be essential. US programs aim to uncover ways to identify and adapt new and existing knowledge to increase economic productivity in specific sectors such as agriculture (where there have been many breakthrough successes), health care, environmental conservation and protection, manufacturing, telecommunications and other key utilities, and transportation throughout the world. The advancement of technology and science, along with development of human and other economic capital, is a critical element in creating the resources to improve people's standard of living.

**Building Institutions.** Funding also will support the development and strengthening of those key economic, political, and social institutions—both micro and macro—which are vital contributors to achieving sustainable economic development. Institutions that promote market-driven growth are particularly critical. Examples include credit unions, chambers of commerce, research institutes, and other non-governmental community organizations.

## Multilateral Development Programs

In an era of tight government budget constraints and heavy demands on world capital markets, multilateral institutions are key to the continuing ability of the international financial system to support and encourage economic reform and development in a fast-changing world. Each taxpayer dollar invested in the multilateral development banks (MDBs) generates more than $20 in the same year. The US economy also benefits from the long-term growth and stability that MDB lending and advice foster. More immediately, US companies receive a larger share of MDB procurement contracts than any other donor country.

The need for international resources and cooperation and the US stake in the success of these efforts, also have increased as a result of the economic transformations being undertaken in the countries of Central and Eastern Europe and the former Soviet Union.

**Multilateral Development Banks.** The FY 1994 budget requests $1.9 billion for contributions to the MDBs. About $1.2 billion of the request is for the US contribution to the recently negotiated 10th replenishment of the International Development Association. Resources will be targeted on poverty alleviation and the enhancement of good governance and sustainable development in the world's poorest countries.

**UN Development Program (UNDP).** The FY 1994 request also includes about $127 million for the UNDP. It provides technical assistance with an emphasis on building recipient country capacities to manage their own development, policy planning, human resource development, and environmental protection. Public and private follow-up investment exceed UNDP contributions.

## Trade Promotion

Trade promotion aims to create new markets for US goods and services, thus generating new jobs. In addition, it enables the United States to forge market ties to facilitate developing new product lines and processes, thus speeding US technological and commercial advancement. Many federal programs contribute to enhancement of US trade, but targeted efforts are being made in large part through the programs described below.

**US Export-Import Bank.** Eximbank finances US exports to developing country and emerging markets through direct loans, loan guarantees, and insurance programs. Eximbank programs assist US exporters by absorbing reasonable credit risks that are beyond the current reach of the private sector and by matching officially supported foreign credit competition. The Administration's FY 1994 request of $752 million will support an increase of more than $1 billion in export financing to support a significant expansion of US exports, stimulating economic growth and job creation.

Through Eximbank and other federal agencies, developed countries have agreed to reduce subsidies for "tied aid" credits (export credits offered in combination with direct foreign aid grants). By reducing trade-distorting tied aid, this agreement helps US exporters compete in expanding global markets.

**Trade and Development Agency.** TDA funds feasibility studies and other project planning services on major infrastructure and industrial projects in developing and middle-income countries. By positioning a US firm at the initial planning stages of a project, TDA increases the likelihood that US equipment and services will be used in the implementation of the project. Through this process, TDA leverages its funds for the benefit of both the recipient country and the US private sector. The Administration's request of $60 million will enable TDA to provide greater assistance to developing and middle-income countries, while at the same time increasing US exports and jobs.

**Overseas Private Investment Corporation.** OPIC supports, finances, and insures sound business projects that positively affect US employment, US global competitiveness, and the host countries' economy and development. OPIC participation promotes privatization and market-oriented economic reforms in Central and Eastern Europe; it is expected to play a similar role as US investors seek participation in the emerging market economies of the former Soviet Union.

For FY 1994, the Administration requests $17.9 million for OPIC, $8.1 million for credit, related administrative expenses, and $9.8 million of subsidy budget authority to support loans and guarantees. These funds will support $20.7 million of direct loans and $375 million of loan guarantees.

# Addressing Global Problems

The FY 1994 budget also reflects the Administration's strong commitment to demonstrating US leadership on

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pressing global concerns. Protecting the environment, reducing rapid population growth, suppressing narcotics trafficking, and combatting terrorism are essential to US domestic and international future. Addressing these problems today will be of fundamental importance to the well-being of all Americans as the United States prepares for the 21st century.

Budget increases are proposed for population and environment programs.

### Population Programs

The Administration proposes a $100-million funding increase for population programs over FY 1993 enacted levels. Enhanced funding will help position the United States to broaden the scope of its efforts to address population growth and to exert strong leadership for the 1994 International Conference on Population and Development. This includes a State Department request for a $50 million contribution to the UN Population Fund (UNFPA) and a $50 million increase, over the FY 1993 level of $420 million, for population programs funded from USAID's Development Assistance and Development Fund for Africa programs.

### Global Environment

The Administration request includes enhanced funding to address global environmental concerns such as global warming, ozone depletion, ocean pollution, and biodiversity conservation. Key multilateral initiatives include a proposed $31 million contribution for the Global Environmental Facility, which provides grants to developing countries for projects that benefit the global environment. Funding also is requested for international funding mechanisms designed to combat ozone depletion and strengthen environmental capabilities in developing nations. A $25 million contribution is requested for the UN Environment Program.

Bilateral initiatives include a $10 million request for the Department of State's environmental and scientific grants program and increased funding for USAID's environmental assistance efforts. USAID environmental funding will increase to $304 million, from the FY 1993 level of $279 million, to support ongoing international forestry, pollution, and soil and water conservation initiatives, as well as new efforts to preserve biodiversity and stem desertification abroad.

### Combatting AIDS, Narcotics, Terrorism, and Crime

International affairs resources also will be devoted to other priority global issues, such as fighting the spread of AIDS and combatting international crime, terrorism, and narcotics production and trafficking.

### Strengthening Institutions

In addition to the resources being devoted to these global problems, the Administration is committed to making US institutions more effective in dealing with global problems. The Administration has proposed creating an Under Secretary for Global Affairs in the Department of State to give greater voice to these priority issues.

## Providing Humanitarian Assistance

America's conscience always has been a fundamental part of America's character. During FY 1993, US Government foreign humanitarian assistance programs will provide relief to refugees and victims of poverty, natural disasters, and crises, such as war, famine, and drought in Africa, Asia, Europe, and Latin America and the Caribbean. Large amounts of humanitarian assistance will be directed to the Horn of Africa and Southeastern Europe in response to events in Somalia and the former Yugoslavia. Alleviating human suffering remains a high priority in the FY 1994 budget, and the Administration is committed to continuing the high funding levels that Congress has provided for these activities in FY 1993. At the same time, achievements in other programs designed to promote peace, economic growth, and the spread of democracy abroad (addressed above) should work to reduce the need for humanitarian assistance in the future.

### Refugee Programs

The Administration's FY 1994 budget request includes nearly $641 million for Migration and Refugee Assistance (MRA) and $49 million to replenish the US Emergency Refugee and Migration Assistance Fund. MRA includes $353 million to support international efforts to provide protection, care and maintenance, local resettlement, and repatriation assistance to refugees and conflict victims abroad. It also includes $221 million to support the admission of about 120,000 refugees for resettlement in this country; $55 million is requested to support the resettlement of refugees in Israel.

### Disaster Assistance

The Administration requests $149 million for USAID's Disaster Assistance Program. This level continues the FY 1993 combined funding level for the worldwide program and the separate appropriation for disaster assistance to Sub-Saharan Africa. The FY 1994 request consolidates disaster assistance into one account to allow for its use where the need is greatest worldwide.

### Food Aid

Title II of the PL-480 Food Aid program administered by USAID supports emergency and humanitarian food aid programs sponsored by private voluntary organizations, the UN's World Food Program, and foreign governments in emergency situations. The Title II request, by the US Department of Agriculture, will total $832 million, a $22 million increase over the FY 1993 enacted level reflecting the continuing need for significant levels of emergency feeding in Africa and elsewhere.

### Development Assistance

USAID's Development Assistance program funds humanitarian assistance in the form of child survival interventions (aimed at reducing child mortality through immunizations, oral rehydration treatment for diarrheal diseases, and improvements in child nutrition) through related health efforts to deal with the spread of tropical diseases such as malaria, to increase the capacity of health care systems, and to

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improve women's health and nutrition. Funding for this program will be maintained at roughly last year's level.

## Advancing Diplomacy

The effective use of diplomacy and international organization is critical to success in achieving all US goals. This budget is based on the need for timely prevention, rather than costly cure, in US foreign policy. The tragedies of Somalia and the Balkans bear grim witness to the price of international delay—a human price paid daily by their inhabitants in pain, privation, and death. But Americans, too, pay a price if US diplomacy is reactive, rather than active. By spending millions on peace-keeping today, we may save hundreds of millions in humanitarian relief tomorrow. By combatting proliferation now, we can avoid rising defense expenditures later. And by aggressively moving to arrest environmental degradation, we can dispense with heavy clean-up costs during the years to come.

In short, assertive, *preventive* American diplomacy, especially in the multilateral realm, constitutes an *investment* in America's future.

### State Department

The State Department provides the diplomatic and operational support to advance US foreign policy leadership. Its people and missions are crucial components of US efforts to promote peace, prosperity, and democracy in a changing world. The Department understands that it must change with changing times abroad and at home. It is moving forward aggressively with a broad-based reform of its organization and operations. Streamlining, more efficient decision-making, and a division of labor that reflects post-Cold War realities and our new global agenda are key elements of this reform. Within the context of a constrained operating budget, the Department will reprogram resources when necessary to reflect new priorities and reallocate resources from lower priorities to accomplish these tasks. Above all, however, the Department's ability to operate effectively abroad must be preserved.

In this context, the FY 1994 request of $2.2 billion for the Department's salaries and expenses account reflects increased attention on emerging diplomatic and economic opportunities in the post-Cold War period. The Department's operating budget is frozen at FY 1993 funding levels and is consistent with the President's directive to cut the federal work force by 4% over the next 3 years and reduce operating expenses by 14% by FY 1997. In addition, the FY 1994 request reflects the closing of a number of posts where it is no longer economically feasible or practical for the United States to maintain an on-site diplomatic presence. Finally, the FY 1994 request includes modest systems investments to promote less personnel intensive operations.

The FY 1994 budget requests $420 million for the third year of projects and activities programmed for the Department's initial 5-year plan for the overseas facilities program ("Foreign Buildings"). The funds will be used for the acquisition, construction, maintenance, and repair of diplomatic facilities abroad in support of State Department and other agencies' overseas operations.

### International Organizations

In the wake of the Cold War, the United Nations and other multilateral bodies are taking on the most intractable problems of the new era, such as ethnic conflicts, aggression, genocide, famine, epidemics, refugees, population growth, proliferating weapons of mass destruction, global warming, grinding poverty, and the survival of democracy in the face of tyranny. With strong US support, the UN can take the lead in responding to these international crises.

The President's budget includes $959 million for the US share of assessed contributions to international and regional organizations. The request meets our treaty obligations for annual payments to the regular budget of the United Nations and such international bodies as the International Atomic Energy Agency, International Civil Aviation Organization, and GATT. Other treaty obligations include annual assessments for regional bodies like the Organization of American States, Asia-Pacific Economic Cooperation, and North Atlantic Treaty Organization.

The request also recognizes the President's commitment to restoring the financial stability of the United Nations and other multilateral organizations and includes a plan to pay off US arrears over the next 2 years. The budget includes $98 million for a FY 1994 arrearage payment and appropriation language seeking $163 million in advance budget authority for completing arrears payments in FY 1995. Payment of arrears will be directed toward activities that are mutually agreed upon by the United States and respective multilateral institutions.

The budget also includes a $65-million increase over FY 1993 enacted budget levels for voluntary contributions to international organizations that serve US interests through their support of development, humanitarian, scientific, and environmental activities. Increases for specific programs have been discussed above.

### US Agency for International Development Operating Expenses

USAID operating expenses finance salaries and support costs of personnel responsible for administering Development Assistance, the Development Fund for Africa, the Economic Support Fund, Special Assistance Initiatives, and the new Humanitarian Assistance Program in the former Soviet Union. Because of the initiation of programs in Central and Eastern Europe and the former Soviet Union, USAID has experienced a dramatic increase in the number of countries with operational aid programs. The FY 1994 request for operating expenses is at the same level as the FY 1993 enacted level of $512 million. The Administration is working to restructure USAID to enable it to achieve maximum development results using the resources available.

### Presentation of Request by Appropriation Account

This presentation of the FY 1994 budget is intended to begin the process of redefining US international affairs programs and institutions. The Administration views this as a dynamic and cooperative process with Congress and public and private groups.

With a few exceptions, the actual appropriation requests will be within last year's appropriation account structure. Tables 2 and 3 show the Function 150 request by subfunction and by appropriation bill. ■

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American Enterprise Institute for Public Policy Research

On the Issues

# Boutros-Ghali, Gunslinger of the World

By Jeane J. Kirkpatrick

UN Secretary General Boutros Boutros-Ghali continues his drive to make himself the world's commander in chief.

Last month, he proposed the creation of a new force for Somalia (UNOSOM II) and a new mandate that "deployment will be at the discretion of the secretary general, his special representative, and the force commander acting under the authority of the Security Council."

Now, he has suggested that U.S. and NATO forces be put at the service of the United Nations and under the secretary general to drive Serbian troops out of areas of Bosnia.

The Clinton Administration, which has experienced some difficulty in extracting U.S. troops from Somalia, wisely rejected the suggestion that American forces become involved in a land war in Bosnia.

These unprecedented efforts by a secretary general to create broad military powers should be firmly rebuffed because that office has neither the authority nor the competence to fight wars.

But Boutros-Ghali is apparently very serious in the claim that he should command any military forces that act with the authorization of the Security Council. In his first report to the Security Council (Jan. 31, 1992) he recommended "peace enforcement"—volunteer units from member states trained by their national forces to be "available on call...under the command of the secretary general."

For Somalia, Boutros-Ghali made clear his view that forces should be under the secretary general, even as he accepted then-President Bush's offer of U.S. forces to deliver food. And he continued a determined effort to define the mission of U.S. forces. That mission, he insisted, was not only to deliver food to the starving, but also to disarm Somali warlords. This was a larger task than that which Bush thought American forces were committed to.

In his report to the Security Council two weeks ago, the secretary general was still obliquely insisting that U.S. forces had not completed their job—as he defined it. While some weapons had been confiscated, he said, "The operations so far have only scratched the surface of the problem."

If the Security Council follows the secretary general's latest recommendation it will establish a new force with a new mandate and a new mission to create order, a viable government, and an effective police force in Somalia. This mission would take the UN more deeply than it has ever been into the internal affairs of a nation.

In making these unprecedented claims to expand the role both of the United Nations and of its secretary general, Boutros-Ghali pursues a vision not in the UN Charter and never agreed to by member states.

The UN Charter bars the United Nations from interfering in the internal affairs of nations and specifically vests in the Security Council decisions about international peace and security. Should the Security Council find force necessary, the charter provides, "The action required to carry out the decisions of



the Security Council for the maintenance of international peace and security shall be taken by all the members of the United Nations or by some of them, as the Security Council may determine."

Military requirements and plans shall be made by the Security Council with the assistance of the military staff committee, "which shall consist of the chiefs of staff of the permanent members of the Security Council" and "shall be responsible under the Security Council for the strategic direction of any armed forces."

The UN Charter is not ambiguous about when military force may be used, nor why, nor under whose command.

Member states acting through the Security Council should define the mission, provide the forces, and determine the strategy. The secretary general has no role in these matters. Nor should he.

Modern armies are complex, sophisticated, and dangerous. Their management is not a matter for ad hoc arrangements. Military commanders are not interchangeable parts. Tactics must be adapted to forces and weapons.

Governments rely for management of their military forces on defense departments. Secretary generals have very different qualifications and jobs. They do not have armies, define military missions, and map military strategies.

The UN Charter is not the Maastricht Treaty or the U.S. Constitution. The United Nations is an organization of sovereign states that join together for limited purposes. The collective security provided in the charter entails no loss of sovereignty or control. But the secretary general advocates transferring command of armed forces to someone outside a national chain of command and responsibility.

An American president has no authority to assign forces to some other command for some undefined mission. On this, it matters not at all whether the secretary general is advised by Americans or Mongolians.

[from the *Los Angeles Times*, March 11, 1993]

Jeane J. Kirkpatrick is senior fellow at the American Enterprise Institute. Her latest book is *The Withering Away of the Totalitarian State...and Other Surprises* (AEI Press, 1990).

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# Peacekeeping Task Demands Strong Hand

By Frank Crigler

YOU would think that after American-led forces risked their necks and got the Somalia relief operation moving again, the United Nations could move in and finish the job. Yet weeks drag by, tensions rise, tempers flare, more marines get hurt, and departure dates get pushed back again and again.

Why the delay? Now that the hard part has been done, why are UN officials dragging their feet?

The answer lies not in Mogadishu, but at UN headquarters in New York, where officials are carefully hammering out terms and conditions for transferring responsibility from the United States to UN military commanders and political authorities. The outcome of the New York negotiations could radically change the character of UN peacekeeping operations, not only in Somalia but in a dozen other nation-state crises from Angola and Bosnia to Zaire.

Precedents set in Somalia could be far-reaching. In shaping ground rules for the handoff there, negotiators are redefining the concept of national sovereignty in post-cold-war terms, redrawing its limits to reflect the world community's growing concern for the innocent victims of civil disorder and its frustration over glaring weaknesses in UN peacekeeping. Up to now, effective UN action in trouble spots like Somalia has been handcuffed by Charter provisions that prevent the organization from applying armed force to curb conflicts that are essentially internal in character. This has made UN attempts at peacekeeping appear half-hearted and weak-willed.

However, if Secretary-General Boutros Boutros-Ghali has his way, Somalia could turn out to be different, and UN peacekeeping activity could become a lot more muscular and intrusive.

The present tug-of-war between Washington and the secretary-general's staff over when and how to transfer responsibilities in Somalia looks like another example of can-do Americans frustrated by international bureaucrats. But the Security Council has already saddled the secretary-general's meager peacekeeping staff with more than a dozen similar crises around the world, and Mr. Boutros-Ghali is keenly aware that present UN peacekeeping machinery and finances are unequal to the task. With no taste for another costly embarrassment, he is using the Mogadishu hand-over to test just how serious the US and its coalition allies are about preventing social collapse in places like Somalia.

To Washington's credit, the Clinton administration seems to be buying into the bolder option, one that would give the secretary-general and UN commanders unprecedented authority to impose order and enforce Security Council resolutions in Somalia, notwithstanding doubts about whether such authority squares with principles of nonintervention enshrined in the UN Charter.

AMERICAN officials here share Boutros-Ghali's blunt awareness that without tougher enforcement authority, UN commanders will be unable to keep the peace after US combat troops leave.

It was this kind of authority that was embarrassingly lacking when UN security forces from Pakistan first arrived in Mogadishu last September and found themselves unable even to ensure their own safety, never mind that of Red Cross and other relief workers. As a conventional peacekeeping mission, UNOSOM was a failure from the start, partly because there was no peace to be kept and no chance the warring factions would voluntarily lay down their arms, but also because the Pakistanis lacked the mandate they needed to impose order.

Mercifully, the UN operation was overshadowed by Operation Restore Hope, politically as well as militarily, as soon as the Marines waded ashore Dec. 9.

UNOSOM II is now shaping up to be a very different operation. If all goes according to plan, it will look and act more like Operation Restore Hope itself than a conventional UN peacekeeping mission. On the ground, there should be almost no sudden change. An overall UN military commander, a Turkish general whom Boutros-Ghali chose with Washington's concurrence, will take charge gradually over the next three to six months. His deputy will be an American officer.

Turnover of military command and control at the regional level will occur in stages, as a semblance of normalcy is achieved in each region according to bench marks now being negotiated.

As US combat forces withdraw, their positions will mostly be taken by troops from other countries already in place as participants in the US-led Unified Task Force. A major contingent of noncombat US forces, probably some 5,000 troops, will remain in Somalia to provide logistical support and crucial financial underwriting to the UN command.

But the key difference will lie in the tough new mandate UNOSOM II is expected to receive from the Security Council. Both Washington and the UN recognize that Somalia is far from "pacified" after barely three months' occupation by American-led forces. Renewed clan fighting and suffering of the innocent are very real possibilities as the American troops leave.

With US support, Boutros-Ghali will therefore insist on a Security Council resolution that, for the first time, instructs UN commanders not merely to keep the peace but to impose order as necessary. Such a mandate would give UNOSOM II the same UN Charter authority Operation Restore Hope had, allowing it to intervene preemptively whenever it appeared that violence or vandalism might occur.

Instead of watching passively or issuing hand-wringing reports while Somalia slides back into chaos, UN forces would be expected to confiscate weapons, patrol the countryside, and organize civilian police forces to keep order.

UNOSOM II could thus give Somalis the kind of political breathing space they will need as they sort out their differences and rebuild their country. If the experiment works, the same sort of beneficial but iron-fisted UN intervention could be the right antidote to chaotic conditions and human suffering in other faltering nation-states.

■ *Frank Crigler, a consultant on international conflict, was US ambassador to Somalia from 1987 to 1990. He visited Somalia privately in December 1992 as a consultant to ABC Nightline News.*

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# Give the United Nations Its Dues

By Paul Volcker

Every day, sobering news from Yugoslavia, Somalia and Cambodia assaults our consciousness. There are incessant demands on the United Nations to "do something." In still other places, some with strange names in unfamiliar regions—Tajikistan, Myanmar, Nagorno-Karabakh—ancient antagonisms and new conflicts smolder, threatening peaceful development. We hear less these days from older trouble spots like El Salvador, Namibia and the Golan Heights. In substantial part, that is because U.N. peacekeeping forces have been on the spot, "doing something."

In most such instances we have come to look to the U.N. for an appropriate response. That response has been largely effective, in a way that no purely national, or even regional, response could be. Far from the exaggerated image of an impotent "talking shop" prevalent when the Cold War frustrated decision-making, the U.N. now finds itself in an increasingly operational role. Plainly, after nearly 50 years, the organization has come much closer to the potential its founders envisioned at the end of World War II.

But the U.N.'s ability to respond to new challenges, especially in peacekeeping, is being undercut by the precarious and exceedingly narrow financial base it inherited from an earlier era.

This is the finding of the Ford Foundation's International Advisory Group, which I had the honor of co-chairing with Shijuro Ogata, former president of the Japan Development Bank. The 11 members, all widely experienced in international affairs and finance and broadly representative of different parts of the world, agreed on measures that can and should be taken to strengthen the U.N.'s financial base. The premise of these proposals is that the Security Council and the secretary-general must have assurance that funds will be available when they are required. At present, that is simply not the case.

The recurrent, regular expenses of the U.N.—for the General Assembly, the Secretariat, the International Court and the like—have been covered only by depleting reserves and by unorthodox borrowing from other accounts. These expedients have now been exhausted. A more difficult and dangerous situation exists with respect to the U.N.'s peacekeeping forces, the demands for which are unpredictable and, when they do appear, urgent.

The start-up phase of a peacekeeping mission is usually the most costly, and delays only cripple chances for success. The arrival of forces on the ground is also the time of greatest danger for the men and women involved, when the need for trained personnel and new supplies is most urgent.

As things stand, each mission has to be started from scratch. The secretary-general has only limited funds at his disposal for airlifts and essential equipment. For the rest, he must wait until the U.N.'s lengthy budgetary deliberations are complete, national governments are assessed for funds, and those assessments are paid. There is no continuing training program, base of logistical support, or adequate stock of equipment to draw upon. Often national forces must fill the gaps, impairing efficiency and risking confusion about the U.N.'s role.

The advisory group's proposals do not require striking new departures from the U.N. charter, or any loss of financial discipline. They do require that member states respect their treaty obligation to support budgetary decisions of the General Assembly. Those decisions, it should be emphasized, are now reached by consensus. Thus the interests of the larger countries, which are inevitably called upon for the great bulk of resources, are fully reflected.

The advisory group calls upon governments to pay their assessments on time, to make up for past shortfalls, and to replenish and enlarge the U.N.'s reserves.

It is in these areas that the U.S., while not alone, has been the single largest laggard. Although substantial progress has been made in clearing U.S. arrears, more needs to be done. Quite apart from the size of the $240 million U.S. shortfall, U.S. action is critical: It can set an example of fiscal responsibility for other countries.

Another set of recommendations addresses the need for more rapid and effective deployment of peacekeeping forces when new operations are approved. The group recommends setting up an adequate reserve fund from which the secretary-general can draw to initiate missions when they are authorized by the Security Council, and it recommends annual appropriations for training and logistical support.

The advisory group was acutely aware that adequate U.N. financing is dependent on confidence that funds will be well spent. We have been encouraged by clear evidence that the current secretary-general fully understands the need to improve the U.N.'s management. The group also emphasized the key role that member states themselves have in supporting this effort.

In the end, we cannot escape the fact that the operations of the U.N. do cost money. But those requirements need to be kept in perspective. All the current peacekeeping expenditures of the U.N., spread over 13 operations, totaled $1.4 billion in 1992, about a 10th of 1% of the total defense budgets of member states, and less than the annual cost of the police force in the U.N.'s home city of New York. The entire regular budget of the U.N. was $1.2 billion, less than the average cost of one Stealth bomber.

Successful diplomacy is an enormous bargain in financial as well as human terms. And when diplomacy needs to be reinforced by a military presence, there is no alternative as economical as the U.N.'s blue helmets, for their cost is shared by every government in the world. No country has more at stake in successful peacekeeping than the U.S.—whether the cost is measured in dollars or the risk to the men and women in its armed forces.

It is such simple propositions that justify and require that the nations of the world turn their attention to repairing the finances of their U.N.

*Mr. Volcker was chairman of the Federal Reserve from 1979 to 1987.*

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*ohen S. Rosenfeld*

# ıssing Hot Potatoes to the U.N.

sed to be that the dirty work of American n policy was assigned to the CIA—the f business, like anti-Soviet covert opera- that was thought to be essential but that vernment didn't wish to take on up front. he passing of the Cold War, there is less : to be done, but other hard cases linger, ich Yugoslavia is currently the most cuous. Now, however, they are more to be brought out into the light of day and ed to the United Nations.

important American purpose is being l by this odd institutional progression: ead the burden and avoid sole responsi- President Clinton's show of hedged m is following this pattern. There is , too, an intention to make a virtue out very process of international diploma- ome enthusiasts—not Clinton—may e more interested in the example of tation in Bosnia than in the outcome the s is producing there.

the outcome is central. Designers of N. 10-province Bosnia plan see in it the the only hope, to stop the war and the and to keep the war from spreading. regard this as a goal that needs no y. With no little pride in their handi- they challenge critics to say what itive policy might have been created out of the poor materials the nations of the world brought to them. The world body was not handed the case until disintegration was far advanced, for instance. And no force was made available to help Muslims even the odds against preponderant Serb and Croat arms.

*There are costs of using the world body as a dumping ground for its members' political mistakes.*

But surely it is not sheer sentimentality to think that the United Nations was meant for better than carrying the can for the evasions of sovereign states.

Much is said, and in some rapture, to the effect that finally the United Nations is doing these days what its high-minded founders had in mind in establishing a body to keep the international peace. You can say the United Nations had the truly difficult double task not only of saving Muslims in Bosnia but—this is often lost sight of—of providing an acceptable political place for Serb minorities there and in Croatia.

Still, in Bosnia the U.N.'s name and prestige adorn a rank political deal. It leaves much Serb aggression unreversed and unpunished and much Muslim agony unrequited. It appears to confound the prospect of effective policing by the means most likely to be available. It may even seed the next Balkan war as Muslims gather over time for justice and revenge.

The U.N.'s connection to Bosnia's Muslims is painful. The Muslims are the party most in need of the U.N.'s rescue. Yet seeing that the United Nations has been unable to keep them from being butchered and uprooted, they display little loyalty in return. On the contrary, they feel betrayed. To the U.N.'s horror, desperate and cynical Muslim units have fired mortars from a hospital, provoking a typically merciless Serb response that Muslims then denounced as Serb degeneracy. Muslims have sought to enlist the U.N. to police Serb units but not their own. This angers U.N. officials, whose focus on their own neutral mediator's role visibly shrinks their empathy for what Muslims see as a mortal struggle for their very survival.

It is not some abstract disembodied "U.N." that has brought the organization to this tortured pass. Nor is it its secretary general, who has ambitions for the institution but not independent authority. It is the collective decisions of the U.N. membership, especially the top dogs. This makes it idle to think that the United Nations, to avoid tarnish, could have stayed out of Yugoslavia. The members for their own reasons engaged it—and engaged it in the pinched way we see today.

I happen to think Germany is more responsible for the form engagement took than any other outside state. The Germans, attentive to Yugoslavia's Catholic voices, lit the fuse by granting recognition to some constituent republics, notably Croatia, before fair provision had been made to protect the rights of the resident Serb minorities. Thence flowed the subsequent horrors, including the Serbs' own continuing disproportionate and monstrous acts.

The United Nations is doing a mean job—the job its masters bid it to do. This is the way it used to be with the CIA. Only when the regular agencies had failed—in dealing with Fidel Castro, for example—was it called in. It will take time to tote up the costs of using the U.N. as a dumping ground for its members' political mistakes. What number of small and not-so-small nations are going to redouble their determination not to have to depend on the United Nations for their ultimate security?

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*Jim Hoagland*

# Getting Out Gracefully

When elephants clash, the grass gets trampled: Africans used that adage in the time of the Cold War to describe their role as objects of modern history. Now, with the elephants on the sidelines, the grass tramples itself.

Civil war rages again in Angola, this time without the Americans, Cubans, Soviets and South Africans, who engaged in a decade of ideological warfare and then abruptly left without resolving anything.

In Somalia, Africa's other significant Cold War battleground, American troops have had to intervene to keep Somali clans from starving and annihilating each other with leftover superpower-provided weapons.

It is tempting to mark down the anarchy and the conflict that plague these two former client countries as the delayed costs the locals pay for getting swept up in superpower zero-sum competition—to keep on blaming the elephants and absolve the grass.

But the tragedies of Somalia and Angola are the result of mutual manipulation, with local leaders pursuing their own ends through the arms, economic help and police-state equipment and training they solicited in the name of ideology and global competitive advantage.

The crucial difference was that the foreigners could and did leave when the game got too complex or costly. When the United States refused to back up Somalia's invasion of the Ogaden territory in 1979, after initially encouraging it, Somali dictator Mohammed Siad Barre was mortally embarrassed before his own people. He had to resort to warfare against them and the nation's institutions to stay in power for another decade. Anarchy took over when Barre was driven from power two years ago.

That history is worth pondering as the first American expeditionary force to fight in sub-Sahara Africa reaches the beginning of the end of its mission.

How America extricates itself from Somalia will determine whether Operation Restore Hope becomes an odd footnote in Africa's long history of foreign interventions or a chapter heading for things to come for the international community.

As they grope their way toward the exit in Somalia, American diplomats and soldiers see a positive initial balance sheet for Operation Restore Hope, the humanitarian armed intervention launched by the Bush administration in December. Lives have been saved, warlords have been reigned in.

But the long-term outlook is uncertain: America has disclaimed any intention of fixing Somalia or accepting responsibility for rebuilding it as a nation. That is the job of the United Nations, which authorized the American humanitarian intervention and promised to take over once U.S. firepower cleared the way.

The moment of exit is the politically defining moment of this unusual military operation. Fixing the date and method of departure of American troops is not a detail to be determined after strategic goals are met. Departure *is* the strategic goal of the Pentagon, which wants to end Operation Restore Hope in another month, or perhaps two. America went into Somalia with the overriding goal of getting out quickly.

The United States is in effect negotiating its withdrawal from Somalia with the United Nations, which had indicated that it wanted the division-sized force dispatched by Bush to stay on in Somalia at least for another four to six months. (The American force is far more effective than anything the United Nations could field. Moreover, Washington foots most of the bill for the current operation.)

But that extended commitment is unacceptable to U.S. officials who have begun to criticize U.N. Secretary General Boutros Boutros-Ghali for "foot dragging." Within the Pentagon's uniformed services, the Egyptian diplomat has become a symbol of international duplicity.

After meeting with Boutros-Ghali on Monday, Secretary of State Warren Christopher described the U.N. secretary general as moving toward acceptance of a speedy U.S. departure and accelerated deployment of the U.N. successor force.

This is promising. A nasty quarrel with the United Nations over Somalia is the last thing the Clinton administration needs. That would poison the atmosphere for crucial decisions to come on sending more U.N. forces into Bosnia and elsewhere.

Instead, the United States should grasp the opportunity to shape the U.N. successor force in Somalia through the discussions with Boutros-Ghali, which constitute informal negotiations about the terms of the American exit.

The future U.N. force should not be hamstrung with the passive rules of engagement that have caused many other U.N. peace-keeping missions to fail. A more active U.N. approach to the use of troops operating under its flag is needed for the local conflicts that bedevil the post-Cold War world.

Achieving and contributing to that kind of successor force—and not simply setting a withdrawal date—should be the U.S. objective in Somalia now. It is a chance to show how much things have changed since the Cold War, when Washington was capable of treating Africa as a collection of marginal places and peoples unless they fit into a superpower strategy.

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# How the West Can Aid Former Soviet Union

By William D. Jackson

AS the Commonwealth of Independent States begins its second year of exis-ce, its future is unclear. The spects for stability across the ire territory of the former So-t Union are poor. The expanse t was the USSR has become a t zone of political uncertainty which civil wars flare, eco-nic crises deepen, and orderly ilian and military authority is eatened by anarchy.

The West behaves, however, as he old Soviet empire has at st found new governmental thing in the form of 15 republi-governments and a common-alth in which two-thirds of se governments participate. eryone acknowledges that se governments face enor-us problems and that many of m lack the will to implement essary reforms. But there's re or, rather, less to it than t.

What's lacking to a very seri-degree is government itself. e the emperor in the old fairy , much of the former empire is not naked – far less clothed in ernment than is admitted.

Officially, the Soviet Union has n reorganized into 15 sover-n states whose claims to independence have been widely recognized by the international community. On the surface this seems to be a relatively neat tidying up following the collapse of the world's last and largest empire.

The realities are otherwise. The empire has yet to stop collapsing, and it is either wishful thinking or self-deception to ignore the anarchic conditions that now exist and threaten to worsen.

Consider the following: The war between Azerbaijan and Armenia over Nagorno-Karabakh is entering its sixth year, the belligerents equipped by weapons stolen from or sold by a demoralized Russian Army beyond the control of Moscow.

Civil wars or militarized secession struggles are underway in Georgia, Moldova, Tajikistan, and in the Caucasus region in Russia.

Independence movements have developed in many of the autonomous republics within Russia, from Tatarstan to Yakutia. Some, such as the one in Tatarstan have begun to attract international support. In the Narva region in Estonia, in the Crimea in the Ukraine, and in northern Kazakhstan, secessionist movements stir among ethnic Russian residents.

In Russia many politicians and at least a part of the military and security establishment do not accept the borders of the new Russian state. They regard Boris Yeltsin's government and the independent republics as the illegitimate products of a coup by President Yeltsin and republic nationalists against the USSR.

Exacerbating the situation, the Russian military shows signs of internal anarchy. Corruption and the freelance sale of weapons have become extensive. The quantity of military weapons "lost" these days is substantial and does not augur well for the future, especially in the Caucasus region. In the first 10 months of 1992 in the Transcaucasus Military District, nearly 4,000 artillery pieces, 1300 military vehicles, and at least 600 train-car loads of munitions were reported missing or stolen. These weapons have found their way to factions on all sides of the conflicts in the region.

IN Moldova, local Russian military units continue to transfer weapons to ethnic Russian secessionists in the Trans-Dniester region and to pursue a local foreign policy distinctly at odds with Yeltsin's efforts to negotiate with the Moldovan government.

The state of government in Russia itself is poor. In an impassioned address to the Congress of People's Deputies in December, Valery Zorkin, the chairman of the Constitutional Court, warned that "legal nihilism" had reached critical proportions. The powers of the branches of government are vague. Political stalemate and chaos in Moscow threaten the adoption of badly needed reform legislation as well as a new constitution. The legal system is a shambles – a situation that suits the increasingly powerful mafias and old-style bosses.

Moscow's authority in the rest of Russia is very weak. It is struggling to control rebellions in the Russian Caucasus and has been reduced to negotiating with a growing list of regional leaders as equals. Administrative machinery to fill the vacuum left by the collapse of the Communist Party has yet to appear. Ironically, in republics such as Kazakhstan, where a limited democratization is occurring even though the old party machinery remains intact, government appears more effective than in Russia.

Finally, the commonwealth remains a "project" of limited importance. It has provided a framework for the transitional location of command over the strategic forces of the former Soviet Union located in Russia, Ukraine, Belarus, and Kazakhstan.

The commonwealth is a symbol of a commitment of some republics – the Baltic states and Georgia have never joined, and Moldova and Azerbaijan have since rejected full membership – to maintain special political and economic ties.

What should and can Western governments do to improve the situation, if establishing effective government is a task that can be accomplished only by the people of the former Soviet Union?

First, discourage unwarranted, premature international recognition of claims to independent status by "micro-nations" in the former Soviet Union.

Second, offer more substantial technical and financial aid relevant to increasing the effectiveness of government in the republics. This should include not only technical aid in improving public administration, but regional development grants that republic governments could use to promote development and as incentives to restore regional peace and reintegrate alienated regions into the republic.

Finally, Western governments should use their collective influence in the capitals of the original members of the commonwealth to support transforming the commonwealth into a more meaningful and effective instrument for economic coordination. Without such an instrument, the economic crises in the republics will continue to deepen.

■ *Willam D. Jackson is a professor of political science at Miami University, Oxford, Ohio.*

# Use of Force to Settle Global Disputes Has Its Limits

IN his inaugural address, President Clinton stated: "When our vital interests are challenged or the will and conscience of the international community are defied, we will act – with peaceful diplomacy wherever possible, with force when necessary." In his reference to the use of force, Mr. Clinton undoubtedly wished to appear no less resolute than his predecessor.

The experience of the last few months of the Bush era, however, whether in Iraq, Somalia, or Bosnia, casts considerable doubt on the readiness of publics in the United States and Western Europe to use force at levels likely to achieve substantial results. Peaceful diplomacy may become the only option.

Air raids against Iraq were designed to force Saddam Hussein to permit the unrestricted inspection of weapons facilities and to cease deterrent actions against patrols in the no-fly zones. Reports from the United Nations and Baghdad indicate that at least the first objective may have been achieved. Other reports suggest that the raids may have temporarily enhanced Saddam's position in Iraq and reduced support for US actions among European and Middle Eastern allies.

In Somalia, the US forces have, for the moment, stabilized the situation. But doubts still exist about the capacity of the UN to mobilize forces to replace the Americans or to restructure the Somali government. The outgoing US administration appeared to be moving toward the use of aerial bombing to enforce a no-fly zone in Bosnia, but refrained, primarily because of the opposition of its principal European allies, the British and the French.

DAVID D. NEWSOM

In each of these cases, strong pressures for the limited use of force by those understandably sympathetic with the victims have been accompanied by proponents' assurances that the action would achieve proclaimed objectives: Somali gunmen would fade away in the face of the Marines; Saddam would be cowed if not overthrown; only a few bombs on Serb positions would be needed to bring the Serbian leaders to their senses.

The threat of force can be an effective tactic in negotiations, but if not carried out or, if carried out ineffectively, the tactic backfires. And increasingly, US threats to use force in international crises are becoming hollow.

The hard fact is that Western publics are not prepared to support effective levels of force under present international circumstances. In the Gulf war, as in other wars, major objectives could not be achieved without extensive use of ground forces, and ground forces mean a greater risk of casualties. A deep reluctance exists in the US and its principal Western allies to undertake any action that will risk large casualties unless the individual nations appear to be under direct threat. Proponents of military action, nevertheless, insist that desired results can be accomplished with minimum casualties through the use of air power. In so doing, they seriously overestimate the accuracy and effectiveness of air power, underestimate the political impact – on populations and on allies, and give misleading encouragement of support to victims.

Proponents of aerial action against the Bosnian Serbs, for example, insist that artillery positions can be destroyed from the air, but they do not acknowledge the difficulty air forces have experienced in attempting to take out mobile anti-aircraft positions in Iraq. Gen. Colin Powell has rightly claimed that substantial forces may be needed to bring an end to threats and conflict in unsettled regions. He also stresses that if partial measures are to be taken, the question must be squarely faced: What will be done if those measures fail? Proponents of limited actions have seldom ventured an answer.

If the estimate is correct that the people of the US and other Western countries are not prepared to use sufficient force to achieve substantial objectives in areas of conflict, the world community has few alternatives to diplomatic efforts to resolve crises.

Former US Secretary of State Cyrus Vance and former British Foreign Secretary Lord Owen have been severely criticized for continuing to negotiate with the leaders of Serbia and the Bosnian Serbs. But, in the face of broad reluctance to use major force and unrealistic prophecies regarding the utility of partial military measures, do the organizations they represent have any choice but to continue the grueling, frustrating efforts to use the pressures of economic sanctions and global isolation to end the bloodshed?

■ *David D. Newsom, former undersecretary of state, is Cumming Memorial Professor of International Affairs, University of Virginia.*

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FOREIGN AID

# Lawmakers Think Globally After Threat to Yeltsin

*Members say plan for Russian assistance must provide quick, concrete results*

The turbulent power struggle in Russia has jolted U.S. lawmakers, until now preoccupied with the domestic economy.

The dispute between Russia's President Boris N. Yeltsin and its conservative parliament has demonstrated the fragility of the nuclear-armed nation's fledgling democracy and the potential threat to U.S. national and economic security.

But it has also underscored the uncertainty over how much difference the United States can make in influencing the outcome.

REUTERS

**One of about 200 Communists who gathered outside the parliament building in Moscow to protest Yeltsin's special rule.**

For now, most members of Congress appear willing to defer to the administration as it tries to pull together a package of financial and technical assistance. President Clinton has said he will present the package to Yeltsin when the two meet in Vancouver, Canada, on April 3-4.

But many members — especially those who have been closely tracking developments in the former Soviet Union for the past year and a half — say Clinton must make sure his aid plan will produce quick, concrete results for both the Russian and the American people.

Lee H. Hamilton, D-Ind., chairman of the House Foreign Affairs Committee, said many of the 100 House members who met privately with Secretary of State Warren M. Christopher on March 24 requested that he and the president "make clear what U.S. intentions are in Russia, what are the stakes and why we need additional aid. They're getting a lot of questions from constituents."

*By Pamela Fessler*

Events in Moscow compelled the administration and Congress, which had been equally determined to concentrate on the domestic economy rather than international affairs, to shift their focus.

On March 20, Yeltsin made the startling announcement that he planned to assume emergency presidential powers. Members of the Congress of People's Deputies, many of them Communist holdovers, threatened to oust him from office.

By March 26, the crisis appeared to have been defused but not resolved. The emergency decree Yeltsin issued did not include his threatened assertion of "special powers" that effectively would have stripped the Congress of authority. And, despite hours of speeches denouncing Yeltsin, the Congress did not move to oust him, apparently lacking the votes to do so.

As events unfolded, Clinton delivered on a promise to consult closely with Congress, although the administration did not offer details of the aid package it was preparing for the Vancouver summit.

The president invited groups of House and Senate leaders to the White House on March 25-26 to solicit their suggestions, and Christopher conducted closed-door meetings, inviting all House and Senate members. Taking the tack urged by congressional leaders, Clinton and other administration officials repeatedly stressed that providing aid to bolster Russian democratic and economic reforms was as much in the United States' interest as in Russia's.

"It will save the American people billions of dollars in money we don't have to spend maintaining a nuclear arsenal," Clinton told reporters March 24. "It will make the American people billions of dollars in future trade opportunities. And it will make the world a safer place."

### Beyond the Dollars

Administration officials have said Clinton will seek about $700 million in direct economic and technical aid, a 75 percent increase over this year's amount, and some increase is also expected in the $800 million now set aside to help dismantle nuclear weapons in the former Soviet states. *(Weekly Report, p. 609)*

But the questions about aid go far beyond dollar amounts. Administration officials working on the package are trying to craft proposals that will

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# What They're Saying About Russia

## From Moscow...

REUTERS

**Yeltsin in TV appearance.**

"Today I signed a decree on special rule until the overcoming of the crisis of power. In accordance with the decree, on 25 April 1993 there will be a vote of confidence in the president and vice president of the Russian federation.

"Until the new elections the Congress and Supreme Soviet will not be dispersed, and their work will not be suspended. The powers of the people's deputies of the Russian federation are maintained, but in accordance with my command, no decisions of organs and officials which aim to change or suspend commands and instructions of the president or resolutions of the government have any legal force....

"I especially want to stress that my order guarantees the observation of human rights in its full measure...."

*—President Boris N. Yeltsin, March 20 address*

"A direct threat of the return to the worst times of neo-totalitarianism is looming over the country.... The situation dictates an unequivocal solution, the repeal of all unconstitutional decisions and return to the path of search for concord."

*—Ruslan I. Khasbulatov, Speaker of Parliament, as reported by The New York Times*

## From the Administration...

REUTERS

**Clinton at news conference.**

"The United States supports the historic movement toward democracy and free markets in Russia. Russian President Boris Yeltsin is the leader of that process, and as Russia's only democratically elected national leader, he has our support, as do his reform government and all reformers throughout the Russian federation."

*—Statement by President Clinton, March 20*

"This in my judgment is the greatest strategic challenge of our times. Bringing Russia . . . into the family of peaceful nations, will serve our highest security, economic and moral interests. . . . But if Russia falls into anarchy or lurches back to despotism, the price that we pay could be frightening. Nothing less is involved than the possibility of renewed nuclear threat, higher defense budgets, spreading instability, the loss of new markets and a devastating setback for the worldwide democratic movement."

*—Secretary of State Warren M. Christopher, Chicago, March 22*

"Boris Yeltsin is the elected president of Russia, and he has shown a great deal of courage in sticking up for democracy and civil liberties and market reforms, and I'm going to support that

*—Clinton, news conference, March 23*

## From Capitol Hill...

"As a practical matter, right today, we do not have a plan, the West as such, to deliver [assistance to Russia]. We cobbled together right here in the United States a form of foreign aid, which is fast breaking down.... The biggest challenge to President Clinton is to have some consensus right here in the United States what we are willing to do, and then be able to bring that to the rest of the West and Japan and say, 'Now here's what you're going to have to do to add to it.' "

*—Sen. Patrick J. Leahy, D-Vt., March 20, CNN*

**Hamilton**

**Dole**

"We have to state the national interests of the United States in terms of encouraging the move toward democracy and market reform. Now Yeltsin happens to be the leader of that reform, and so we support him. But there are many other reformers; there are many other democrats in Russia, and we must be prepared to support them and let them know that the national interests of the United States is the direction toward democracy and reform."

*—Rep. Lee H. Hamilton, D-Ind., March 21, CNN*

"The worst case is that the army takes sides or splits apart, that security forces split apart. And while all of this is going on — a contest between the parliament and Yeltsin and impeachment and so forth — the regions start splitting apart, and we end up having a disassembly of the Russian empire. That could happen. If that happens, what's going on in Yugoslavia now might look calm."

*—Senate Armed Services Committee Chairman Sam Nunn, D-Ga., March 21, NBC*

"One thing that the president might consider, instead of having the summit in Canada, he might have it in Moscow. If he wants to try and give Boris Yeltsin a boost, I think that would be a dramatic indication of where the West is....

"We better go back and take a look at what Clinton wants to do on the defense budget. He wants to cut it far too much. This is just an example of what could happen. We better go slow on defense cuts."

*—Senate Minority Leader Bob Dole, R-Kan., March 21, CNN*

"It's clear that Boris Yeltsin had to move as he did.... If he had not moved, it's clear that his economic reforms could not have continued; in fact the parliament clearly is opposed to private property as a general proposition, and privatization was clearly required to get the economy moving."

*—Sen. Richard G. Lugar, R-Ind., March 22, CNN*



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send a clear message to Russians that the West wants to see their free-market and democratic reforms succeed, while not appearing to intrude in their nation's tumultuous internal affairs.

Perhaps even more important, aid advocates say, the United States and other leading nations must convince the Russian people — who appear increasingly cynical toward the West after $24 billion in promised aid last year failed to materialize — that new assistance pledges are real.

In an appearance before the House Foreign Operations Appropriations Subcommittee on March 25, Christopher described previous aid efforts as "halting and inadequate." He said the new package would include "practical, tangible, down-to-earth, nonideological programs for prompt assistance to the Russian people."

Clinton and Christopher indicated that much of the aid would be technical assistance for fledgling private enterprises and for Russia's energy sector, which has the largest potential to draw hard currency.

Also under consideration is housing aid for the Russian military, people-to-people exchange programs and a range of aid to ease immediate hardships, such as high unemployment and high inflation, as the Russian people endure the difficult transition to a market economy.

Clinton is also working closely with Western allies to put together a wide-ranging multilateral aid package to stabilize the Russian economy. High on the list is a proposal to relieve some of the burden of Russia's $80 billion foreign debt, much of which the former Soviet regime incurred. Also under consideration is loosening stringent lending conditions that have blocked multilateral institutions from doing more over the past year to stabilize Russia's economy.

The Japanese government announced March 26 that the foreign ministers and finance ministers of the Group of Seven (G-7) industrial nations would meet in Tokyo on April 14-15 to work on a multilateral aid package. It also said Yeltsin would be invited to a G-7 summit in Tokyo in July.

Members of Congress say that while they recognize the necessity to support Yeltsin and his reform movement, Clinton must help U.S. voters understand the urgency of such aid when he is asking Congress to raise taxes and cut domestic spending.

Rep. Sonny Callahan, R, told Christopher during the Foreign Operations Subcommittee hearing that he needed something to tell his Alabama constituents "who have financial needs of their own" and wonder why Russia needs more aid. "I've not been able to come up with a suitable explanation for them," Callahan said.

REUTERS

**A democratic supporter waves a photograph of Yeltsin during a rally outside the city government offices in his support.**

### An Unfinished Story

It is no wonder that many Americans doubt the need to send more of their tax dollars to Moscow. The latest test of wills was the first indication for many Americans that the end of the Cold War might not be a fait accompli.

The instability within Russia, which still has more than 25,000 nuclear warheads, was especially sobering because of continued ethnic and regional conflicts throughout the former Soviet Union.

The political impasse in Moscow came a week after the Russian Congress had voted to strip Yeltsin of many of his presidential powers and to cancel a planned April 11 referendum on the government's structure.

But it was also the culmination of a yearlong struggle between forces in Russia pushing forward free-market economic reforms and conservatives who said Yeltsin's "shock therapy" was destroying a country demoralized by shortages, runaway inflation and unemployment.

When Yeltsin finally published his promised decree March 24, it made no mention of turning to "special powers" but only of his call for a referendum on April 25 on a new constitution and a vote of confidence in his rule.

The next day, Ruslan I. Khasbulatov, speaker of the Russian parliament and leader of the effort to unseat Yeltsin, told reporters that he did not favor impeachment, although he had previously said it was justified because of a ruling by Russia's Constitutional Court that Yeltsin's actions were unconstitutional.

By week's end, it appeared that the 1,033-member Congress did not have the two-thirds vote necessary to unseat Yeltsin. Valery D. Zorkin, chairman of the Constitutional Court, proposed a compromise that included new elections for both the presidency and a new bicameral parliament. *(Key players, p. 766)*

Throughout the week of crisis, the Clinton administration expressed support for Yeltsin as the first popularly elected Russian president in 1,000 years and as the leader of its reform efforts. But Clinton also emphasized that only the Russian people could resolve the political struggle.

Administration officials clearly wanted to do as much as possible to bolster Yeltsin in the dispute without feeding anti-American sentiment. Yeltsin's rivals have accused him of selling out to the West.

"Too much official kibitzing from the United States government won't help," Strobe Talbott, Clinton's nominee as ambassador-at-large to oversee U.S. policy toward the former Soviet Union, told the Senate Foreign Relations Committee at his confirmation hearing March 23. The panel favorably reported his nomination March 25.

Suggestions by some in Congress that the summit be moved from Vancouver to Moscow so that Yeltsin would not have to leave his country were considered but ultimately dropped.

As usual during times of interna-

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tional crisis, members of Congress rallied behind the U.S. position, saying Clinton had expressed the proper balance between backing Yeltsin and the reform movement. Some foreign policy experts, most notably former President Gerald R. Ford and former Secretary of State Henry A. Kissinger, warned that the administration could alienate other factions in the Russian government by aligning too closely with Yeltsin.

Rep. Howard L. Berman, D-Calif., said most members recognized that Yeltsin needed to be supported as the leader of the reform movement. But, he added, "There's also a recognition that this is not about individuals, but ideas."

Foreign Affairs Committee Chairman Hamilton said a group of House members planned to go to Moscow the week after the April summit to assess reaction but also to "diversify our contacts within Russia."

**Immediate Impact**

Despite broad congressional support for helping Yeltsin; it was unclear how members would respond to the package Clinton is expected to unveil.

Some lawmakers have warned that they are not willing to spend much more money unless they are convinced the aid programs will have some immediate, tangible impact.

Many are frustrated that so little has been spent of the $417 million in economic and technical aid and the $800 million in demilitarization assistance that Congress approved last year for the former Soviet republics. Most of those funds have been stuck in the pipeline due to upheaval in Russia and bureaucratic obstacles in Washington. *(Weekly Report, p. 614)*

Sen. Nancy Landon Kassebaum, R-Kan., said she thought members were unlikely to approve more bilateral assistance unless they got a better accounting of what had been accomplished with last year's funds.

"I think more money would be wasted until we know what's happening there politically," she said.

Sen. Richard G. Lugar, R-Ind., a leader in the effort to provide Western assistance to the former Soviet Union, said that disbursement of funds has been slowed considerably because Congress attached so many conditions to the aid. Saying that he fears the same thing will happen again, Lugar suggested that the administration focus its efforts on multilateral assistance.

"On paper, the Russians will think they're going to get $700 million, but at the end of the year, they will have gotten $25 million," Lugar said.

But former U.S. ambassador to Russia Robert S. Strauss told two House Foreign Affairs subcommittees March 24 that aid should go forward despite what he called the Catch-22 that has hindered the effort so far.

"There's a desperate need for the Russians to get themselves in shape to receive the kind of assistance we'd like to give them," he said, noting that they lack the financial, legal and political structures that attract outside investment.

R MICHAEL JENKINS

**At top, Speaker Thomas S. Foley and Russian Foreign Minister Andrei V. Kozyrev meet. Above is Strobe Talbott, Clinton's nominee to oversee U.S. policy toward the former Soviets.**

But, he said, they cannot get into shape without help. "It's going to take real creative thinking," said Strauss.

The administration's proposal is expected to include some programs similar to those approved last year in the Freedom Support Act, including technical assistance to promote joint U.S.-Russian private ventures.

In a speech March 22 to the Chicago Council on Foreign Relations, Christopher said U.S. assistance to help Russia repair thousands of aging oil wells and pipelines could provide "a lucrative source of foreign exchange that could do a great deal to stabilize their economy." *(Text, p. 778)*

He also endorsed an idea promoted by Sen. Bill Bradley, D-N.J., and several other members to bring thousands of Russian students and others to the United States in exchange programs.

Christopher has also said that the administration will supply technical assistance to provide housing for the Russian military. The lack of housing has slowed the withdrawal of Russian troops from the Baltics and other former Soviet republics, increasing tensions.

The administration has also said it will try to speed the expenditure of funds to help Russia and its neighbors dismantle the Soviet nuclear arsenal. Those efforts have been stymied partly by Ukraine's failure to ratify the START I treaty because of uneasy relations with Russia, and by Russia's reluctance to disarm until Ukraine ratifies the pact.

Potentially most controversial — especially in light of the ongoing debate over cutting U.S. domestic spending — is a proposal to provide direct "social safety net" assistance, such as jobless benefits, to help Russians weather their economic storm.

"Teaching Russians how to spend more of someone else's money is pure folly for everybody, especially for the taxpayers of the United States," Sen. Jesse Helms, R-N.C., told Talbott.

To a large extent, the prospects for additional direct aid will depend on developments in Congress' budget debate, as demands are made on a limited pool of federal funds. While Russia's unrest has contributed to members' desire to help, it also has made some lawmakers uneasy about Clinton's proposed defense budget cuts.

"He wants to cut it far too much," Senate Minority Leader Bob Dole, R-Kan., said on CNN on March 21. "I think we just have to be alert. After all, there are troubles around the world, and we can't act as if everything's going to be at peace for the next 30, 40, 50 years."

But others thought the impact on the defense budget will be marginal, in large part because there is virtually no prospect that the massive Soviet threat could be quickly reconstructed.

"I think we have still presented a responsible defense budget," Clinton said March 23. ■



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# The Right Stuff for Russia

By Bill Bradley

WASHINGTON

The need to clarify U.S. policy toward Russia has been heightened by the political crisis in Moscow. Our long-term interests there can be promoted by practical aid and people-to-people programs.

Boris Yeltsin's solution to the impasse between a popularly elected President and a Parliament that, under the Constitution, is the supreme organ of the state shows he believes the answer to the problems of emerging democracy is more democracy. He has cast his fate on the seas of his own waning but still significant popularity.

In an atmosphere in which individuals regularly switch opinions and sides, the U.S. should not try to intervene in Russia's day-to-day politic concerns such as: Should the Parliament impeach Mr. Yeltsin in light of the Constitutional Court's ruling yesterday that his announcement of emergency powers violated the Constitution? Should concessions be made for the support of Vice President Aleksandr Ruskoi? Russians, not Americans, will decide these problems. But Washington ought to keep open the lines of communication to all sides.

Beyond the political drama are the large issues that Russian society is debating: whether it should seek integration with the West or exist apart from the West. Whether it will focus inward on its gargantuan economic, environmental and ethnic problems or look imperially toward the former republics of the Soviet Union and beyond.

Whether free enterprise and private property will be actively promoted or barely tolerated. Whether more power should be dispersed to the oblasts and autonomous republics of the Russian Federation or exercised exclusively from Moscow.

Whether Russia should adopt a model of economic development that is economically and politically liberal or one in which, like China, it would seek Western capital, technology and markets but deny individual freedom while preserving collectivist controls.

If Russia opts for the Chinese model, America and Europe could end up espousing open trade, free markets and democracy but be unable, in the 21st century, to advance our values and compete freely in a vast area from Kaliningrad to Shanghai that plays by different rules and starts from different cultural principles.

Igor Kopachinsky

I hope President Clinton thinks about the long term. Since August 1991, America has moved at a dangerously slow pace, giving Russians who want to retard reform an opportunity to blame us for our empty promises.

To play a more constructive role, we need to see America's relationship with Russia beyond tomorrow's headlines and with emphasis on improving the lives of American and Russian citizens.

With the defeat of Communism, there is no ideological conflict between our nations. We should make it absolutely clear that we support both Russia and our own values. This means respecting the human rights of the 25 million Russians who live as minorities in the former Soviet republics, avoiding encouragement to the movements for self-determination in the 20 autonomous republics of the Russian Federation such as Checheno-Ingush and Tatarstan, and giving Russian history and culture the respect they deserve.

Such actions will make clear to all Russians that we are not anti-Russian. It was the expansionist Communist system, not Russian culture, that we opposed.

America's values and interests are served by helping Russia become a democracy with a market-oriented economy that raises its living standards, with a smaller defense establishment, with a firm commitment to guarantee individual human rights and with the acceptance of free-flowing capital, trade and ideas.

In other words, our objective should be to normalize relations with Russia and the other former Soviet republics and to bring them into the international system as full members.

Russia's main worry lies to the east, where an emerging Chinese colossus with a booming economy and a modernizing military maintains its territorial claims on Russia, and to the south, where the peoples of Islam, full of religious fervor and rapid birth rates, yearn for greatness. A strong U.S.-Russian relationship can reassure Russia and hedge against changes that would injure U.S. interests in Europe and Asia.

The Clinton Administration should adopt a tangible and nonbureaucratic program that has a permanent effect and not only helps Russia but also Ukraine, the Baltics, Kazakhstan and the other former republics on the road to reform.

With U.S. leadership, the West should reduce the burden of foreign debt on the economy accumulated during the Communist years by rescheduling it and promoting debt-equity swaps, replace the 17 Chernobyl-type reactors that are time bombs threatening Europe and the world with radioactive emissions, and send far more humanitarian aid (medicine, food, infant formula, syringes) for suffering pensioneers and children.

In addition, the World Bank should provide insurance coverage (similar to that offered by the Overseas Private Investment Corporation) to private investors in the farming and energy sectors. We need to push multilateral financing for trade in oil and gas equipment, and provide additional assistance to nuclear scientists and scientific institutes to convert from military to civilian pursuits.

We should help Russian refugees from the former Soviet republics get resettled and started in private farming by giving the green light to lending by the World Bank, and should combine help for a social safety net with radical monetary reform that could stabilize the ruble, provided that Russia caps its money supply and controls inflation.

In addition to its support for international financial institutions, this program would cost the U.S. $3 billion to $5 billion a year: between 1 and 2 percent of our defense budget.

The most important long-term consideration is to maximize the personal ties of Russians, Ukrainians, Balts, Kazakhs and others with Americans. A Russian friend in Moscow said: "In the 1930's, when the Soviet Union was building Stalinist Communism, thousands of Americans came to Russia to help. Now, when we're trying to build a market-oriented democracy, few Americans offer to help. Why?" I did not have a good answer.

We should begin a large-scale exchange program bringing tens of thousands of Russians here annually. Last year, there were nearly 50,000 Chinese in our colleges, as there has been for a decade, and 127,000 students from Taiwan, Japan, India and Singapore. There were only 1,200 Russians.

Nothing short of a large-scale sharing of ideas, people and training will accomplish our goals of economic prosperity and political security for Russia, its neighbors and ourselves.

I hope that President Clinton encourages Americans to reach out generously toward the peoples of Russia, Ukraine and the other republics. There should be 30,000 Russian high school students living with American families for a year, 10,000 Russians in small business in towns across America, 10,000 college students at our universities and thousands of former military officers learning modern banking, finance and accounting in the West.

## Reschedule debt, replace reactors, invite students.

We can help young people learn what life in a market-oriented democracy with a heart is all about. They will see America's openness, generosity and pride at work. Their experience would bring our peoples together in countless ways, creating bonds that would last a lifetime. As the Russians get ready to decide their future in the streets or, preferably, at the ballot box, we should step forward on many fronts with solid help for

*Bill Bradley, Democrat, is senior Senator from New Jersey.*

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# Buying a Costly Peace in Russia

By WILLIAM NEIKIRK

WASHINGTON – President Clinton's billion-dollar aid package for Russia is going to be a hard sell. To many people, the man elected to take care of the domestic economy is sounding more and more like George Bush every day.

The new wrinkle is that, if Mr. Clinton has his way, the United States is going to pay for housing for Russian troops, rather than having them live in tents and becoming surly supporters of the old hard-liners.

And if Boris Yeltsin can prevail and bring inflation under control by halting the printing of so many rubles, then American and other allied assistance will flow to farmers, entrepreneurs and others who support democracy and a market economy.

Why is it that the new president is taking such a keen interest in the economic revival of Russia? It's not because Western firms see a massive market there any time soon, given the political and economic uncertainty that will be around for a long time.

A senior administration official put it in terms of our own money, saying that it will enable Mr. Clinton to reduce the defense budget with confidence.

"If you can get the Russian soldiers out of the Baltics peacefully, if you can reduce the number of patrols by submarines by 80% because the Russians have reduced their patrols, you don't need all the resources for the defense budget and that money comes home," he said.

**What price Boris Yeltsin? It's a billion-dollar insurance policy, a policy against nuclear blackmail. Like it or not, America is still paying for the Cold War. It may be over everywhere else on the globe, but here in the United States we will be fighting it for several years more.**

But U.S. troops will be coming home, too, and there will not be a government-financed house waiting for every one of them, much less a job.

Mr. Clinton's defense conversion plan sounds ambitious when he talks about it, but when it's stripped to its bare essentials, there's not much there. It looks grand only by comparison to George Bush's plan, which was zero.

What price Boris Yeltsin? It's a billion-dollar insurance policy, a policy against nuclear blackmail. All this stuff about democracy and free markets in Russia is nothing but a smokescreen. Economists know that it will take years, perhaps decades, for capitalism to emerge in Russia.

Like it or not, America is still paying for the Cold War. It may be over everywhere else on the globe, but here in the United States we will be fighting it for several years more. That's because the administration fears the hard-liners will try to use their nuclear weapons to push their weight around again.

Our sole warrior against a reprise of the Cold War is Mr. Yeltsin. If he can ensure a stable Russia, the administration argues, the aid will flow like milk and honey from the West, and so will new economic opportunities for both countries. And he will be a good guy with the nukes, which is the real reason for our open pocketbook.

The striking thing about the summit with Russia is that Mr. Clinton seems to be making this depressed, inefficient, unworkable country the No. 1 focus of U.S. foreign policy. This was true during the Cold War, for sure, but not any more.

When Mr. Clinton ran for the presidency, he spoke of the economic challenge being the nation's key concern domestically and internationally. He stressed making the nation competitive again and having free but fair trade.

Now, in an apparent effort to try to prove his manhood as commander-in-chief, he has fallen back into the same old syndrome that Mr. Bush did: have a summit with the Russians and use our tax dollars to try to revitalize an economy that is still in the dark ages.

This is not to say that the Russians aren't important, but surely they are not the No. 1 foreign policy challenge for the United States in this new era. Our security lies in our own economic strength. And that depends on how we trade and invest.

There's something ironic about the fact that we would consider building housing for Russian troops when so many Americans are homeless in our cities. Everyone knows why: these unfortunate people are not high profile in this administration. They have no guns. They cannot threaten rulers.

If Bill Clinton saves Boris Yeltsin and Russia, that would be a nice foreign policy accomplishment — but sort of old-fashioned and ultimately not the most important thing on America's agenda.

*William R. Neikirk is a senior writer for the Chicago Tribune, based in Washington.*

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*Robert B. Oakley*

# Mission Accomplished in Somalia

The leadership of the international effort to save Somalia is passing from the United States to the United Nations. Although this country continues to provide unusually strong military, political and humanitarian support to avoid any loss of momentum from the progress made under the leadership of U.S.-led forces (UNITAF), a new structure is now being put in place.

The U.N. Security Council finally has begun consideration of a resolution creating a new, much more muscular peace-keeping force for Somalia (UNOSOM II) with a tougher mandate for disarmament and maintaining security, and calling on the secretary general and his special representative to carry out a number of nation-building activities.

The new special U.S. representative, retired Admiral Jonathan Howe, arrived last week in Mogadishu to assume his duties, as did the UNOSOM II Commander, Lt. Gen. Cevit Bir of Turkey and Bir's American deputy. Meanwhile, a U.N.-sponsored conference on Somalian political reconciliation is taking place in Addis Ababa.

President Bush announced early last December the U.S. intention to protect humanitarian activities and stop mass death in Somalia with an international military coalition—a goal that the U.N. Security Council endorsed. Former Defense Secretary Dick Cheney and Gen. Colin Powell explained that the United States would deploy substantial military forces for this initial task, which they expected to be completed within two to three months, and then turned over to a U.N. force for broader, more conventional peace-keeping purposes—with continued U.S. participation.

This original limited mission for the United States has been accomplished on schedule. The paroxysm of Somalis killing Somalis by the tens, even hundreds of thousands, in a seemingly unstoppable conflagration of clan hatred, naked personal power grabs, rapacious looting, famine and disease has been ended.

The United States applied what could be likened to a heavy, smothering blanket of military and political power, drawing upon its military might—proven in Desert Storm—its aura as a superpower and its manifest determination to stop the killing. In retrospect, the original, more traditional U.N. peace-keeping mission for Somalia might be compared to a garden hose—ineffectual for the situation on the ground. The concept, mandate and amount of forces under the U.S. plan have clearly proven effective for the mission.

In the UNITAF area of operations, key ports and hundreds of miles of roads have been repaired, reopened and protected. Large quantities of food and medical supplies have been moving, with only minor interruption, deep into the interior for distribution by an international community of highly committed relief workers. One million people a week are visiting feeding centers in Mogadishu run by Somali women. Death rates from war, disease and malnutrition have been drastically reduced; in many areas farmers and herdsmen have resumed nearly normal activities.

Dozens of schools and clinics have been reopened by Somalis with help from foreign nongovernmental organizations, and more are coming.

***Death rates from war, disease and malnutrition have been much reduced.***

There is thriving, albeit small-scale, commerce in Mogadishu and regional centers. And some sporting events have resumed, particularly soccer: The Somali-UNITAF championship in February drew a happy, peaceful crowd of 30,000. The cooperation between the dedicated, disciplined military forces of the United States plus a dozen different countries and the international relief community has been unprecedented.

Since the Marines landed on Dec. 9, there have been a few attempts to resume Somali-style civil war, notably in the Kismayu region. They were easily put down and the major forces responsible disarmed and consigned to remote areas to await demobilization. Despite continued deep-seated hostility among rival clans and militias, there has been no other serious conflict. There have been some attempts at political intimidation of Somalis and anti-UNITAF agitation by leaders of militias who see their power and perquisites eroding. But these have not stopped the steady progress by UNITAF in collecting heavy weapons and keeping all arms off the streets.

Nor have they stopped the combined effort by UNITAF military forces and international relief workers to end an era in which political power was exercised at gunpoint. The goal has been to gradually empower Somali women's groups and nongovernmental organizations, clan elders and religious leaders, intellectuals and others by involving them in community development (e.g. food distribution, reopening schools and clinics etc.) while stopping forceful intimidation. This double-barreled approach has already achieved enough success that the political conference meeting in Addis includes as many representatives from these "new" civil society groups as from the old "factions." (Two months ago, at the previous political conference, the factions had the only representatives.) This is a source of real hope for the future.

The United States, its partners in UNITAF and the international relief community have set the stage for a more structured U.N. program of nation building led by Special Representative Howe, backed up by UNOSOM II. However, before it can advance, there must be urgent efforts during the transition—while UNITAF is alongside UNOSOM II—to complete the collection of heavy weapons, to develop and start implementing a plan for demobilization and disarmament of the various militias, to strengthen the interim security forces already established by the former police with UNITAF help in several cities (including 3,500 in Mogadishu) and to build up the fledgling court system.

The combination of demobilization, disarmament, and new security forces and courts is essential to deal with the sharp upsurge in small-scale armed banditry. As militias have been unable to fight or loot, their sources of sustenance have dried up, and many of their members have become armed bandits, partly because of the lack of plans for demobilization and the absence of jobs. Relief workers and journalists are obvious targets, because they have more of value to steal.

The international community has been making clear to Somali representatives that for large-scale help to continue the nation must develop a determined consensus to put violence and the settlement of disputes by force behind it and to embark on a practical, cooperative program of rebuilding the country.

Progress has been made, and we hope there will be concrete results from the Addis conference on the creation of meaningful, representative political and administrative structures. A realistic outcome at this time would be the establishment of regional administrations, perhaps modeled on the clan/regional political system that existed before the tight, strongly centralized government imposed by Siad Barre, in which one single clan/party dominated all. The next step could be some sort of loose national authority.

*The writer, a former ambassador to Somalia, was recently U.S. special envoy to that country.*

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American Enterprise Institute for Public Policy Research

On the Issues

# Balance of Power in Bosnia

By Joshua Muravchik

Secretary of State Warren Christopher has stated eloquently America's interests and goals in the conflagration in Bosnia, but the actions he has announced are not commensurate. He was right to reject the Vance-Owen plan, which so clearly favored the aggressors that its authors wanted Washington to force it down the throats of the Bosnian victims. But the imbalance in the Vance-Owen plan was not the result of bias or some kind of diplomatic error; rather it reflected faithfully the realities on the ground. The heavily armed Serbs enjoy a decisive advantage over the Bosnians, who have been kept disarmed by virtue of a misguided UN weapons embargo.

The Vance-Owen calculation was easy to understand. A deal that satisfies the stronger party more than the weaker stands a chance of success. The stronger party has a stake in the deal, and if the weaker party violates the agreement it is more easily put down. Hence, Vance-Owen's proposed force of 20,000 or 40,000 UN peacekeepers might suffice to police compliance by the Bosnians. But it could scarcely suffice to police compliance by the Serbs. We have been told that for outsiders to handle the Serbs in Bosnia would require hundreds of thousands of troops.

The flaw in the Vance-Owen approach is the assumption that the Serbs, unchecked militarily, would rest content with half (or two-thirds) of a loaf. The Serb gunmen of Bosnia are not just out for autonomy, they are out to build a "greater Serbia." Since the ten cantons into which Vance and Owen would divide Bosnia are heterogeneous, the Serbs surely would proceed to ethnically cleanse the ones in which they predominate (as indeed they commenced to do as soon as the design was unveiled). Other groups might do likewise where they predominate. It is hard to imagine that the Serb and Croat provinces of this mutilated state would refrain from trying to link up with Serbia and Croatia or from seizing vulnerable pieces of neighboring cantons.

No wonder Christopher rejected this plan. It would make the Bosnian Muslims, and perhaps other Bosnians too, wards of the American military. And it would put American troops in harm's way on the most awkward terms: under the UN flag and in the role of policemen rather than soldiers.

Christopher's alternative is to seek a settlement different from the one proposed by Vance and Owen, one that satisfies all parties to the point where they will want it to hold. Although Christopher stated his readiness to contribute U.S. troops as peacekeepers, the heart of his approach is to find an agreement that is largely self-enforcing because none of the sides will want to subvert it. That is why he disavows any "American plan" and emphasizes the need for an agreement hammered out by the parties themselves.

Alas, this is a chimera. No such common ground exists. The Muslims and others loyal to the government of Bosnia want to preserve their state, and the Serbs want to dismantle it. Both sides cannot be satisfied.



Vance and Owen split the difference by tilting strongly toward the Serbs because the Serbs hold most of the cards—or rather, the guns. And even this the Bosnian Serb forces have not accepted, although their rejection has been less categorical than that of the Bosnian government.

There is no way to square this circle, except by creating a balance of power in Bosnia. To do this requires arming the Bosnians and bringing Western air power to bear against the guns that rain terror on civilians. Christopher has ruled out these options on the grounds that UN peacekeepers would be endangered. But is the role of peacekeepers to protect themselves? The foreign minister of Bosnia has said that if forced to choose between arms and the peacekeepers, he would forgo the peacekeepers. The only military action Christopher contemplates is to enforce the no-fly zone. This, in itself, would be only a symbolic gesture. If the Bosnians were better armed, however, then denying the Serbs air superiority would take on military significance.

If, and only if, the Bosnians were able to hold their own militarily against the Serbs, then a genuine compromise might be reached. It would rest not on diplomatic artistry nor on UN peacekeepers but on the firmer ground of military stalemate. That is the only kind of agreement imaginable in this situation that would be to some degree self-enforcing. Sure, it sounds risky to supply arms and exert U.S. air power, but that is a prudent, self-restrained alternative to sending U.S. troops to police an unstable agreement. That is what Vance and Owen would have us do, and Christopher, for all his demurrals, is headed down the same path.

[from the *Washington Post*, February 15, 1993]

Joshua Muravchik is resident scholar at the American Enterprise Institute.



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The Wall Street Journal February 18, 1993

# The Other Clinton Test: Intervention in Bosnia

By George Kenney

Many people wrongly tell President Clinton that Bosnia would ruin his presidency if he were to initiate military intervention for political ends, just as Vietnam ruined Lyndon Johnson's. According to that view, no matter how horrible the war in the former Yugoslavia becomes, it will remain confined to the Balkan region. No U.S. interests are at stake. Not a single American life should be sacrificed for Balkan peace. If we intervene anyway, the costs are prohibitively high. So there is no alternative to a negotiated settlement.

Yes, Bosnia could indeed ruin Mr. Clinton's presidency. But it is far more likely to do so if Mr. Clinton does not rise to the challenge and exercise leadership on the world stage. So far, he is off to a mixed start. On the positive side, he and Secretary of State Warren Christopher have clearly identified most of the stakes—that is far more than Mr. Bush and Mr. Baker ever did. On the negative side, he does not have even the semblance of a plan. He has given us "Bush-plus." Mr. Clinton will make negotiations his main priority yet he is not prepared to use force to back them up. Thus he continues to leave the initiative to Serbian strongman Slobodan Milosevic.

The U.S. should be concerned to try to resolve this crisis now. Much is at stake apart from worthy humanitarian concerns. The war threatens the survival of multilateral security arrangements, perhaps world peace. If the war spins out of control into the wider region—and soon it will without U.S. leadership to manage it—the disease of nationalism will spread throughout the continent. European countries will discover that they have to fend for themselves as Europe returns to the politics of race. We experienced that phenomenon in two world wars; we would be foolish to allow history to repeat itself again. Especially so, when a breakdown of multilateral systems would also facilitate the proliferation of nuclear weapons and the technology to make them. It is not outlandish to think that Mr. Milosevic could one day acquire weapons of mass destruction.

The West has tended to seriously underestimate another issue at stake, namely that citizens of Islamic countries are enraged by the Western failure to stop Serbian aggression directed primarily at Muslims. Many in the Islamic world are quick to point out the double standard when the West bombs Saddam Hussein but ignores Bosnia's plight. On a pragmatic level that may mean an end to the cooperation of Mideast states regarding Iraq. In turn, that could jeopardize our energy security.

Unfortunately, the Vance-Owen plan, the only plan under serious discussion now, is likely to result in an unmitigated disaster. Its most significant aspect is its abolition of the Bosnian government, to be replaced with a council of nine—three Croat, three Serb, three Muslim—having a rotating presidency under some form of United Nations supervision. In this arrangement, Bosnia would be but a short step from having the war criminal Radovan Karadzic as president! We have been fortunate up to now to have had moderate Bosnian leaders whom we could help; without them, it would be infinitely more difficult to assist the victims of Serbian aggression.

To beat a plan, you need a plan. One reason Mr. Clinton has had trouble coming up with one is that he has relied heavily for his "complete policy review" on the people who produced Mr. Bush's approach. These officials—at the National Security Council, the State Department and the Pentagon—are churning out the same paper, with the same recommendations. At State, in particular, career diplomats have tended to exaggerate the difficulty of getting European allies to back stronger action.

The European powers must have our help, and they know it. Mr. Clinton's first task should be to tell them in ringing terms that Serbian thuggery is a threat we cannot ignore, and the U.S. will engage in a solution, but only on our terms—which include the use of force to confront Serbia—or Europe will have to go it alone.

We should try to get the U.N. or NATO to approve intervention, but if they won't we must form an ad hoc coalition around American leadership, including allies outside Europe. Our strategic goals should be simple: Roll back Serbian forces in Bosnia and Croatia; recognize Macedonia and provide economic and security assistance; and be prepared to contain Serbian aggression indefinitely, while pressing strongly for democracy and human rights in Kosovo.

To do this we should arm the Bosnians, use air strikes against Serbian positions in Bosnia, give Croatia support to oust Serbian occupiers, and send limited Western forces (no more than 50,000) for missions such as lifting the siege of Sarajevo, liberating concentration camps and sealing off Serbian resupply. We must be ready to attack centers of gravity within Serbia if the operation escalates to war. This is a moderately difficult and possibly costly operation that we could be assured of winning.

To undertake any effort in Bosnia—diplomatic or military—Mr. Clinton could do worse than turn to the Congress for help. A surprising bipartisan consensus is emerging that the U.S. should uphold fundamental principles in the Yugoslav war, despite the cost. Several resolutions are circulating in the House and the Senate calling for intervention. It is possible that the Senate Foreign Relations Committee will introduce a resolution authorizing the use of force, just as it did before the Gulf War.

Politically, American calculations may be more Byzantine than the Balkans. Critics of intervention claim the American people would never support it: They wouldn't understand or wouldn't care. And intervention could not work without a strong consensus behind it.

The last statement is true. But such critics may go too far in second-guessing the public. Some opinion polls show that an unusually large proportion of Americans are concerned and informed and would support stronger action. This journalist, in an unscientific survey of thousands of people across the nation, has found a majority favoring intervention. Indeed a favorable climate likely exists for the president to lead the way in shaping a consensus to act. Over the next several weeks we shall see whether Mr. Clinton has what it takes to be a world leader.

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*Mr. Kenney is a consultant to the Carnegie Endowment for International Peace. He resigned as Yugoslav desk officer at the State Department in August 1992, to protest the Bush administration's policies.*

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*Lionel Rosenblatt*

# Last Chance In Bosnia

Even by the vile standards of the war in Bosnia—now a year old—something extraordinary is happening there now. The Serb forces have been closing in on the towns of eastern Bosnia, one after another. These are towns that have been besieged for almost a year and weakened by hunger and shelling. They are in the Muslim zones of the Vance-Owen map—that is, designated as Muslim areas for the future. But unless the Serbs are stopped, there won't be any Muslim-controlled towns left to protect under the peace agreement.

The Serbs appear determined to clean out eastern Bosnia before they sign the agreement. Only three towns remain—Zepa, Gorazda and Srebrenica. The U.N. Security Council's decision to impose the no-fly ban with force is at least a symbolic step in the right direction.

The fact that Srebrenica has not surrendered to the Serbs is largely because of the U.S. air drops of food, which have been surprisingly effective, and to one man's willingness to take a stand with the victims on the ground there.

U.N. force commander Philippe Morillon—in an act of singular courage—went to Srebrenica and vowed to stay there until the relief convoys were allowed through by the Serbs. Gen. Morillon, by putting himself in harm's way, finally prompted the Serbs to permit a relief convoy with food and medicine to reach civilians who had reportedly begun to die in the streets.

The towns are in very fragile condition. Local residents have lost confidence in the United Nations, and understandably the supply trucks leaving Srebrenica have been mobbed by civilians trying to flee the effects of a yearlong siege. Many are refugees from other towns that have fallen, and they have no proper shelter. The Serbs prevented the U.N. high commissioner for refugees from bringing in tents for these displaced people, some of whom have been sleeping in the snow. It is not surprising that many people are trying to board the U.N. trucks in a desperate rush to leave. Some have died in the crush, but this is slight compared with the loss of life that will ensue from renewed Serbian attacks.

If the towns of eastern Bosnia and their capital city of Sarajevo are to survive, the international community must act now. The United States should lead the way with several urgent actions:

- Muster all available diplomatic and economic pressure against the Serbs to sign the peace agreement and permit the United Nations to send adequate convoys in by land. Unless this occurs, other measures are immediately necessary.
- Expand U.S. air drops of relief supplies and move them lower in daylight hours if this would improve accuracy. They should be escorted by U.S. or NATO aircraft empowered to suppress hostile ground fire.
- Resume the U.N. airlift into Sarajevo—now suspended because of the threat of antiaircraft fire—with U.S.-NATO air cover.
- Bring relief supplies in by helicopter (again with tactical air cover) to Srebrenica and other besieged towns in eastern Bosnia.
- Carry out the badly wounded by helicopter. There are almost no surgical facilities, anesthetics or drugs in the area.
- Air strikes should be used to counter artillery and ground fire aimed at civilian populations if these measures do not demonstrate to the Serbs the world's commitment to protect the remaining Muslim towns in the east.

None of these measures would put U.S. or NATO soldiers at risk on the ground. There is a risk of aircraft being shot down, but the Serbs are not likely to fire on foreign aircraft.

With thousands of lives at stake, this humanitarian mission demands that we take some risks. This is Gen. Morillon's daring and desperate call from Srebrenica.

It is said that the United States and the international community are determined to draw the line in Kosovo. There will be no credibility in Kosovo—or for the United Nations to oversee a peace agreement in Bosnia—if we leave the towns of eastern Bosnia to be starved and shelled into oblivion after almost a year of valiant resistance.

We are at a turning point that historians will call a fateful lost opportunity if the world fails to act. U.N. Secretary General Boutros Boutros-Ghali, President Clinton and NATO heads of state should heed Gen. Morillon's message and act now to end the siege of civilians in eastern Bosnia and Sarajevo.

This is the last chance to show that human decency can prevail over barbaric chaos. Hesitation could result in a world torn asunder repeatedly by war lords.

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*The writer is president of Refugees International. He recently returned from eight weeks in Bosnia and Croatia working for the Soros Humanitarian Fund for Bosnia-Herzegovina.*

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# DEVELOPMENT STRATEGIES

## DEVELOPMENT STRATEGIES

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IFAD update

Bulletin of the International Fund for Agricultural Development of the United Nations

Issue No. 7

# THE STATE OF WORLD RURAL POVERTY

**Three years in preparation, IFAD's major study, The State of World Rural Poverty, was officially released on 23 November 1992. Based on the Fund's almost fifteen years of experience designing 337 projects in 96 developing countries, it calls for a new approach to rural development, one that directly and effectively addresses what is perhaps the gravest issue of our times, the growing number of rural people now living on or below the poverty line: one billion - a fifth of the planet's entire population - close to 60% of whom are women.**

The traditional approaches to rural development, well-intentioned as they have been, have not worked, for they have assumed that growth will automatically "trickle down" to the poor and have tended to overlook that, with their skills, their knowledge and willingness to work, the poor are a vital force for betterment. Small producers are the core of most rural economies and women major contributors to food production and family income so must not be neglected; if their enormous potential can be tapped, if their access to resources and services can be improved, if they can be helped to preserve the natural resource base, significant increases in output and income will occur. Revitalization of rural micro-economies can "trickle up" to strengthen a country's macro-economy.

Through the use of a broad variety of indicators, the report provides a comprehensive profile of rural poverty in the developing world. It also presents a detailed analysis of the complex factors that cause and perpetuate poverty, factors that function to varying degrees from region to region, from country to country, even from locale to locale. Unless these factors - policies on such issues as land tenure, credit requirements, the orientation of extension services and training, pricing and investment; population pressures that reduce holdings and force the poor into ever more marginal land; environmental deterioration; biases against women and particular ethnic groups; exploitation by landowners, money lenders and traders; international financial trends - are recognized and taken into account, sustained and sustainable development is impossible.

The IFAD study devotes the bulk of its pages to demonstrating, through a host of case studies, how the matrix of these factors must and can become the guidelines for development efforts. Each national programme must be geared to overcoming the major constraints that hobble the nations' rural poor; each individual project must be tailored to meet the needs and interests - and to draw on the skills and knowledge - of those it intends to assist.

Development is not a generic but a specific process. It takes place in particular countries, in particular localities, with particular peoples. The obstacles faced by the rural poor in the flood plains of Bangladesh are not identical to those confronted by small farmers on resettled land in Indonesia or who cultivate the steep slopes of the Andean highlands of Colombia, by nomadic herdsmen in the deserts of Mali or artisanal fishermen in Sao Tome.

One section of the report focuses on the essential problem of access to land through a discussion of land reform, adjustments in land tenure systems and practices, and resettlement. Another deals with the problem of how to provide the rural poor access to farm technology (including irrigation), extension services, adaptive research, markets, education and health care - yet another deals with the question of employment off the family farm.

Major attention is given to the question of credit - IFAD's experience has shown that credit can play a key role in poverty alleviation. One of the traditional assumptions has been that the rural poor are poor credit risks, yet project after project has demonstrated that, with appropriate mechanisms, loans to the poor - even without collateral - can be economically viable, with repayment rates of 90% or more. This is a crucial finding, for small loans, put to productive use, can make a big difference in the welfare of a family and community.

Certainly one of the most important features of the report is the stress it gives to the crucial contributions of rural women and to the importance of providing them with the support they need to realize the legitimate harvest of their labour. Women produce at least half of the food consumed in the developing world, and the income they earn often makes the difference in family survival. Yet their productive potential is even more constrained than that of men, for they have less access to land, to extension services, credit and education. It is the report's contention, witnessed by a wealth of data, that rural development cannot succeed unless women are included as full and equal partners in the development process.

Other sections of the report deal with the crucial issues: environmental preservation and rehabilitation, and the challenge of balancing long-term conservation and the immediate productive needs of the poor; strategies for assisting special groups such as the rural landless, artisanal fishermen, nomadic pastoralists, indigenous peoples and displaced persons; and the importance of fostering active cooperation among local governments, NGOs, external agencies and the people themselves.

The report was officially launched at a meeting in the UN Building in New York and attended by the Secretary General Dr. Boutros Boutros-Ghali who emphasized that the study contains a mine of information and added that "the eradication of

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*Launching of "The State of World Rural Poverty" in New York, 23 November, 1992.*

poverty - improving the lives of one billion of our fellow human beings - is a moral and political imperative." The New York meeting was followed by a seminar in Washington D.C with representatives of the World Bank. On 19 November, a pre-launching seminar to discuss the report's findings was organized in conjunction with FINNIDA in Helsinki (Finland provided substantial financial support for the Study), while a meeting on the study was held in London 20 November, attended by Parliamentarians, NGOs, journalists and development experts. A third seminar bringing together development experts from around the world, was hosted by the Ministry of Local Government and Rural Development with the Ministry of Finance, Government of Pakistan on 6 December in Islamabad

The following is a list of experts who gathered from different regions along with two of the authors of the Study, Mr. Idriss Jazairy, President of IFAD and Mr. Mohiuddin Alamgir, Director, of the Policy and Planning Division of IFAD, to discuss the findings of the study and what it advocates

**In Helsinki:**

Prof. Jacques Chonchol, Associate Professor and Director of the Institute des Hautes Etudes d'Amerique Latine, Universite de Paris III.

Mr. Solon Barraclough, Consultant for UN organizations.

Prof. Azizur Rahman Khan, Professor at the Department of Economics at the University of California.

Prof. Vijay Shankar Vyas, Director of the Institute of Development Studies in Jaipur

**In Islamabad:**

Prof. Paul Streeten, Former Director of the World Development Institute at Boston University, and former Special Advisor to the Policy Planning and Programme Review Department of the World Bank.

Prof. Rehman Sobhan, former Adviser to the President of the Government of Bangladesh.

Dr. Godfrey Gunatilleke, Vice Chairman and Director of the Marga Institute, the Sri Lankan Centre for Development Studies.

Mr. Shri Krishna Upadhyay, Member of the National Planning Commission of the Government of Nepal.

Mr. Manuel Otero, Director of Planning and Evaluation at the Inter American Institute for Cooperation on Agriculture (IICA).

**In London:**

Ms. Deborah Kasente, Chairperson of the Uganda Association of University Women

Lord Frank Judd, former Head of OXFAM.

Mr. Paul S. Zuckerman, Chairman of the Intermediate Technology Development Group Committee.

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# World Bank Steps Up Lending for Social Sectors As Part of Attack on Poverty

*The World Bank has been the main source of financing for projects designed to improve education systems in the developing world and has contributed heavily to the development of many other social services in borrowing countries. In an address to the United Nations on February 17, Armeane Choksi, World Bank Vice President for Human Resources Development and Operations Policy, describes how the Bank has in many cases tripled its lending for the development of social services.*

Poverty reduction is now at the top of the World Bank's agenda.

Although the proportion of the worldwide population living in poverty has fallen slightly since 1985, the absolute number of poor people has risen.

The World Bank has been studying the complex, interrelated problem of poverty for a long time. In the World Bank's *World Development Report 1990*, the Bank's present approach, based on earlier experience and recent findings, is best developed. The report proposes a two-part poverty-reduction strategy.

First, the strategy recommends that countries put in place macroeconomic policies that encourage a pattern of economic growth that uses labor—labor being poor people's only asset.

Second, countries should provide basic social services for the poor, namely basic health care, primary education, family planning, and nutrition programs—not only for human reasons, but to make it possible for the poor to increase their share in the fruit of economic growth.

The history of human development assistance at the World Bank began modestly 30 years ago and has been overshadowed by investment loans in more traditional Bank sectors, such as infrastructure, energy and agriculture.

Current investment lending for human resource development has quintupled since the early 1980s—from 5 percent of total Bank lending about a decade ago to 14 percent today.

Over the past two decades, the bulk of human resource development has been for education, which tripled during the past decade. The Bank has long been the largest source of external funding for education for the developing countries. Average annual lending is now almost $2 billion a year.

**Within three years after health lending was approved, the Bank became the largest lender for developing country health projects.**

**—Armeane Choksi**

The Bank has made a special effort to integrate "women in development" programs in all the socials sectors: education, family planning, health, nutrition...and agriculture and rural development.

For the past two years, about 40 percent of approved projects have contained significant "women in development" actions.

Nutrition lending has multiplied eighteen-fold since 1987: from $50 million in total project costs for fiscal 1987-89 to $900 million in fiscal 1990-92.

Within three years after health lending was approved, the Bank became the largest lender for developing country health projects. Bank lending for health has tripled since 1986 to more than $1.5 billion.

Preventing the tragedy of maternal death is the goal of the Safe Motherhood Initiative, which the World Bank staunchly supports and sponsors.

And, World Bank lending for AIDS prevention and control now totals more than $200 million in 40 projects.

Poverty reduction is a unifying theme for the entire development community. The closer we work together by making best use of our comparative strengths, the more the poor will benefit. □

UNICEF/Sean Sprague

Forty percent of Bank human development assistance includes "women in development" programs.

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# *GO-BETWEEN* SPECIAL INSERT NO. 25

## The State of the World's Children 1993

***The necessary task of drawing attention to human needs has unfortunately given rise to the popular impression that the developing world is a stage upon which no light falls and only tragedy is enacted. But the fact is that, for all the set-backs, more progress has been made in the last 50 years than in the previous 2,000. Since the end of the Second World War, average real incomes in the developing world have more than doubled; infant and child death rates have been more than halved; average life expectancy has increased by about a third; the proportion of the developing world's children starting school has risen to more than three-quarters; and the percentage of rural families with access to safe water has increased from less than 10% to almost 60%.***

***Over that same time, much of the world has also freed itself from colonialism, brought apartheid in all its forms to the edge of extinction, and largely freed itself from the iron grip of fascist and totalitarian regimes.***

***In the decade ahead, a clear opportunity exists to make the breakthrough against what might be called the last great obscenity - the needless malnutrition, disease, and illiteracy that still casts a shadow over the lives, and the futures, of the poorest quarter of the world's children.***

Amid all the problems of a world bleeding from continuing wars and environmental wounds, it is nonetheless becoming clear that one of the greatest of all human aspirations is now within reach. Within a decade, it should be possible to bring to an end the age-old evils of child malnutrition, preventable disease, and widespread illiteracy.

As an indication of how close that goal might be, the financial cost can be put at about $25 billion a year. That is UNICEF's estimate of the extra resources required to put into practice today's low-cost strategies for protecting the world's children. Specifically, it is an estimate of the cost of controlling the major childhood diseases, halving the rate of child malnutrition, bringing clean water and safe sanitation to all communities, making family planning services universally available, and providing almost every child with at least a basic education.

In practice, financial resources are a necessary but not sufficient prerequisite for meeting these basic needs. Sustained political commitment and a great deal of managerial competence are even more important. Yet it is necessary to reduce this challenge to the denominator of dollars in order to dislodge the idea that abolishing the worst aspects of poverty is a task too vast to be attempted or too expensive to be afforded.

To put the figure of $25 billion in perspective, it is considerably less than the amount the Japanese Government has allocated to the building of a new highway from Tokyo to Kobe; it is two to three times as much as the cost of the tunnel soon to be opened between the United Kingdom and France; it is less than the cost of the Ataturk Dam complex now being constructed in eastern Turkey; it is a little more than Hong Kong proposes to spend on a new airport; it is about the same as the support package that the Group of Seven has agreed on in 1992 for Russia alone; and it is significantly less than Europeans will spend this year on wine or Americans on beer.

Whatever the other difficulties may be, the time has therefore come to banish in shame the notion that the world cannot afford to meet the basic needs of almost every man, woman, and child for adequate food, safe water, primary health care, family planning, and a basic education.

If so much could be achieved for so many at so little cost, then the public in both industrialized and developing countries might legitimately ask why it is not being done.

In part, the answer is the predictable one: meeting the needs of the poorest and the least politically influential has rarely been a priority of governments. Yet the extent of present neglect in the face of present opportunity is a scandal of which the public is largely unaware. On average, the governments of the developing world are today devoting little more than 10% of their budgets to directly meeting the basic needs of their people. More is still being spent on military capacity and on debt servicing than on health and education.

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Perhaps more surprising still, less than 10% of all international aid for development is devoted to directly meeting those most obvious human needs. According to one study, for example, as little as 1.5% of all bilateral aid goes to primary health care, 1.3% to family planning, 3.2% to "other health care", and only 0.5% to primary education. Because national aid programmes are not broken down into common or comparable categories, such figures can only be approximate; but 10% is probably a generous overall estimate of the proportion of bilateral aid allocated to such purposes. And as total bilateral aid from the Western industrialized nations is approximately $40 billion a year, this means the amount given for nutrition, primary health care, water and sanitation, primary education, and family planning comes to about $4 billion a year. This is less than half as much as the aid-giving nations spend each year on sports shoes.

It could fairly be said, therefore, that the problem today is not that overcoming the worst aspects of world poverty is too vast or too expensive a task, it is that it has not seriously been tried.

With the beginning of the 1990s has come new hope that the age of neglect may be giving way to the age of concern. The evidence for this new hope, amid all the seismic shifts in the political and economic landscape of recent years, is a series of quieter changes which have not made the nightly news but which have affected the daily lives of millions of people.

The first of these changes is the entirely new priority that has been given to the task of immunizing the world's children. For a decade, national health services, UNICEF, the World Health Organization (WHO) and many thousands of individuals and organizations have struggled towards the goal of 80% immunization coverage in the developing world. In 1990, that goal was reached. The result is the saving of over three million children's lives each year, and the protection of many millions more from disease, malnutrition, blindness, deafness and polio. Second, the number of child deaths from diarrhoeal disease has been reduced by over one million a year by empowering one third of the developing world's families to use the technique of oral rehydration therapy.

The significance of these achievements goes beyond even the extraordinary numbers of lives saved and illnesses prevented. Eighty percent immunization means that approximately 100 million children are being reached by a modern medical technique on four or five separate occasions during their first year of life.

Other advances in knowledge and technique are now lining up outside the door that immunization has unlocked ...

These advances, and the extraordinary potential they have revealed were the principal concern of the **World Summit for Children,** held at the United Nations in September 1990. The Summit was attended by approximately half the world's Presidents and Prime Ministers and resulted in a set of specific commitments which, if implemented, would indeed mark the beginning of a new era of concern.

These commitments, designed to reflect the potential of the new knowledge and the new technologies now available, were expressed as a series of specific goals to be achieved by the end of the present century. These goals include: control of the major childhood diseases; a halving of child malnutrition; a one-third reduction in under-five death rates; a halving of maternal mortality rates; safe water and sanitation for all communities; universally available family planning services; and basic education for all children.

To give these commitments a more permanent purchase on political priority, all the countries represented at the Summit, and many more who have subsequently signed the *Declaration and Plan of Action*, also agreed to draw up national programmes for reaching the agreed goals. As of September 1992, such plans have been completed in over 50 countries and are nearing completion in more than 80 others.

It is clear that these promises made to the world's children have now established themselves on the international political agenda. Over the leat two years virtually every major summit meeting of the world's leaders - the Ibero-American, the Islamic States, the francophone countries, the non-aligned movement, the Commonwealth, the Organization of African Unity, the South Asian Association for Regional Cooperation, the League of Arab States, and finally the UN Conference on Environment and Development - has formally confirmed the commitment to achieving the basic social goals that were agreed at the **World Summit for Children".**

February 1993

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This ***Go-Between*** Special Insert has been extracted from the introductory sections of ***The State of the World's Children 1993,*** recently published by UNICEF. The 90-page report is available from Oxford University Press, at the price of £4 net in the UK and $7.50 in the USA.

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HIID Research Review

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HIID Harvard University, One Eliot St., Cambridge, MA 02138

# Local Capacity Building in International Health Research

JAMES TROSTLE

*James Trostle.* Introduction: "RESEARCH CAPACITY BUILDING IN INTERNATIONAL HEALTH: DEFINITIONS, EVALUATIONS, AND STRATEGIES FOR SUCCESS"

*James Trostle and Jonathan Simon.* "BUILDING APPLIED HEALTH RESEARCH CAPACITY IN LESS-DEVELOPED COUNTRIES: PROBLEMS ENCOUNTERED BY THE ADDR PROJECT"

*In James Trostle, guest ed.,* BUILDING RESEARCH CAPACITY FOR HEALTH SOCIAL SCIENCES IN DEVELOPING COUNTRIES *Special issue of* SOCIAL SCIENCE AND MEDICINE, *Vol. 35, No. 11, Dec. 1992.*

*(Other ADDR consultants who authored papers in this special issue include: Robert Black, Mary-Jo Del Vecchio Good, Julio Frenk, Patricia Rosenfield and Bonita Stanton.)*

Any sustainable development effort, whether in agriculture, education, or health, must build local capacity if it is going to succeed. Capacity building in research is one important component of successful development in the health sector. Capable health researchers and supportive research institutions must have the ability to identify problems and predict new ones. They also must have the skills to assess or propose local and international solutions. As programs to build research capacity focused on health have proliferated, interest in knowing their methods and outcomes has increased. A special issue of *Social Science & Medicine*, entitled "Building Research Capacity for Health Social Sciences in Developing Countries," was edited by James Trostle to review such programs.

The impetus for this publication comes from HIID's Applied Diarrheal Disease Research Project (ADDR), a USAID-funded project to build research capacity in developing countries. Since 1985 ADDR has provided financial and technical assistance to about 140 research projects designed and run by developing country scientists in 14 countries. To better understand and evaluate its own experimental approaches to assisting these projects, ADDR chose to join with other health research capacity-building programs to examine the process of supporting research, rather than reporting research results. The findings of this effort are reported in this special journal issue.

***Projects designed to build research capacity must also address whether they seek to create independent leaders of scientific projects or responsive implementors of the designs of others.***

In the introduction to the issue, Trostle points out that capacity building is difficult to define and evaluate. "Capacity" itself is a subjective and context-sensitive attribute. In part this is because capable researchers are mobile, and institutional quality is dependent on the local political and economic environment. Capacity in developing countries, therefore, can be short-lived and fragile.

In an attempt to overcome this issue, evaluators must review and analyze patterns related to numbers of degrees granted, persons trained, institutions built, or, in the case of research, publications produced. But they must go beyond this and study more difficult capacity-building measures such as career duration, research quality, career trajectories, and local research incentives or disincentives. For example, their reviews should specify whether a researcher's conversion to management is defined as a loss or an extension of capacity.

Trostle's introduction makes three important points. First, projects designed to build research capacity must also address whether they seek to create independent leaders of scientific projects or responsive implementors of the designs of others. Second, if that independence is a major goal of capacity building, it is more likely to emerge if additional emphasis is placed on how to formulate problems, do applied research, and disseminate results. Finally, the discussions of research capacity building in developing countries can provide important lessons about the structure of research in industrialized countries.

Trostle's own contribution to this special issue is coauthored with HIID's Jonathan Simon. Their article, entitled "Building Applied Health Research Capacity in Less-Developed Countries: Problems Encountered by the ADDR Project", argues that research capacity building is a development goal subject to structural constraints and cultural impediments among both donor and recipient communities. Three levels of constraints (those of donors, recipient institutions, and recipient individuals) are identified. These help focus attention on the causes of recurrent problems in capacity building and help funding agencies and governments recognize the limits faced by single initiatives. Most important, understanding the impact of these constraints helps identify which problems are inherent in the present structure of development assistance and which are limited to particular goals, projects, and personalities.

Trostle and Simon identify a number of constraints that affect the success rate of donor-funded capacity building projects. These typically include an imposed seasonality of disbursements, a preference for large grants, and a need to spend funds rapidly. Such constraints make management of such projects more difficult for research institutions. Success rates are also affected when donors change topics of research too quickly, seek to show results within politically meaningful time periods, or compete too aggressively for the services of science research talents. If too many donors try to fund too few researchers, reputations and costs are likely to become inflated, with increasing likelihood of damages to projects and to scientific reputations.

The article also demonstrates how recipient institutions are constrained by rigid and overburdened financial management systems. The fact that these institutions are often required to budget in foreign currencies allows them to escape local financial obstacles. But it also makes it more difficult for their projects to be sustained by local institutions afterward. Many

*(continued on page 8)*

*A Research Associate at HIID,* **James Trostle** *has a Ph.D. in Medical Anthropology from the University of California at Berkeley and at San Francisco.*

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*(International Health from page 2)*

donors do not provide significant overhead funds, thus limiting local institutions' abilities to develop self-administered funds and to increase local autonomy, control, and flexibility. Just as in industrial countries, communication between health sector research institutions and implementing organizations is often poor in developing countries. Poor communication limits the applicability and perceived relevance of scientific research to policymakers and program planners.

Trostle and Simon demonstrate the multiple constraints faced by individual grant recipients seeking to carry out quality research. Those reviewed include low salaries and multiple job commitments, limited local technical support to maintain their research equipment, absence of institutional incentives or resources to publish their work, and promotion to administrative positions that make carrying out research difficult. In addition, uncertainties about receiving future funding often prompt them to create unnecessarily complex designs, as though a lifetime of research questions must be answered in one project.

ADDR has experimented with a number of strategies to confront these constraints. They include developing and promoting a phased model of research support, running 10 to 14 day proposal development and data analysis workshops, promoting local and regional networking by sending investigators to conferences and meetings, using funded investigators and local scientists as consultants, providing extensive bibliographic and editorial assistance, and distributing materials to explain how to publish scientific materials and communicate with policy makers. These strategies are spelled out in the article. ■

AFRICA RECOVERY

United Nations Vol. 6 No. 4 December 1992 – February 1993

# Positive steps to combat AIDS

By Nii K. Bentsi-Enchill

In an African continent that "already has the international image of disaster and hopelessness," the slogan "Living positively with AIDS" is a strong and necessary message for individuals and communities, argues Ms. Noerine Kaleeba. She brought this message of hope as an invited speaker at World AIDS Day at the UN in New York on 1 December, 1992, relating the efforts of The AIDS Support Organization (TASO) to prevent and control the spread of the disease in Uganda.

*Noerine Kaleeba*

Ms. Kaleeba is a founding director of TASO, an organization established in late 1987 in response to personal experience — many of the 16 founding members had AIDS (including Ms. Kaleeba's late husband) or were HIV-positive — and developed with a deep commitment to overcoming limited resources, low public awareness, and shattered health services in a country emerging from 20 years of war. A 1988 survey recorded 1.5 million Ugandans with HIV and 35,000 with AIDS, a figure that could be multiplied by six, says Ms. Kaleeba.

While acknowledging the importance of malaria as an old and persistent scourge, she notes the still more alarming fact that AIDS has struck five times as many women as men in the crucial 15-25 year-old age group, with recorded HIV incidence among pre-natal mothers rising from 6 per cent in 1987 to 30 per cent in 1992. These figures, she told *Africa Recovery*, strengthen her belief that women must assert their right to say no to sex, and that "the power to control AIDS is within us."

### Networks of care

TASO has managed to mobilize 15,000 families and build a network of educators, counselling centres and support systems that have helped AIDS victims live 8-10 years without anti-viral medication, and carry people through personal devastations to regain self-respect. TASO's counselling, day-care, vocational training and community education work has changed the attitudes of health workers and community leaders, and helped reduce the stigma of AIDS, which often threatens the basic supportive role of the family unit, Ms. Kaleeba stresses the importance of individuals with HIV taking responsibility for protecting others, which itself feeds the mutual concern and caring about each other's lives. Such community support must also stretch to Uganda's estimated 100,000 orphans, as AIDS has overtaken war as the major cause and orphanages "produce troubled citizens."

She admits passing through the top-down approach, but noticed villagers focusing more on her city clothes and style than on the AIDS-prevention message. TASO is a facilitator, she says, working with grassroots training groups of locally selected and respected figures (healers, birth attendants, etc.) who spread the factual message of prevention and support in order to overcome myths and misperceptions.

The urgency of AIDS prevention and control has led TASO to stress abstinence, then monogamy and fidelity, and the targeted promotion of condom use (especially among single and HIV-positive people). Its main offices in Kampala, Masaka, Mbarara, Tororo, Mbale, Jinja and Entebbe offer counselling, especially to young people, and constantly face the problems of limited supplies and the mounting recurrent costs of condoms which make for less-than-optimum conditions for promoting their constant use: a worker may afford enough for the week, but what about the weekend?

### Spreading the message

TASO, part of the African Council of AIDS Service Organizations, works closely with non-governmental organizations in Kenya, Tanzania, Zambia and Zimbabwe. Ms. Kaleeba has herself visited Ghana and Gambia, where she says people are some six years behind Uganda on AIDS issues. She makes a point of praising Ugandan government efforts towards AIDS prevention — she sits on Uganda's AIDS Control Commission — as well as support from external official and NGO donors. She also insists that "one big reason for the spread of AIDS is people not telling the truth." Individuals and communities must not wait, she says, before declaring that "we have a problem," and dealing with it positively and together. ■



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# Unequal race to the top

***The statistics agree: all over the world men hold the highest management positions. Regardless of regional particularities or scale of responsibilities, two other factors are also clear: the inequalities between men and women are greater, the closer they get to the top of the hierarchy; but the inequalities have also begun to lessen in recent years.***

According to ILO estimates, women represented 36 per cent of the working population of the world in 1990: 41.4 per cent in the industrialized nations and 34.3 per cent in the developing world. In the majority of countries, women hold only a small proportion (between 10 and 30 per cent) of management positions, and even fewer (less than 5 per cent) of the very highest posts.

The statistics generally confirm what is obvious to almost everyone: women are clearly under-represented at the highest levels of the occupational hierarchy.

From this point on, however, in more detailed analysis or in international comparisons, a large degree of caution is required.

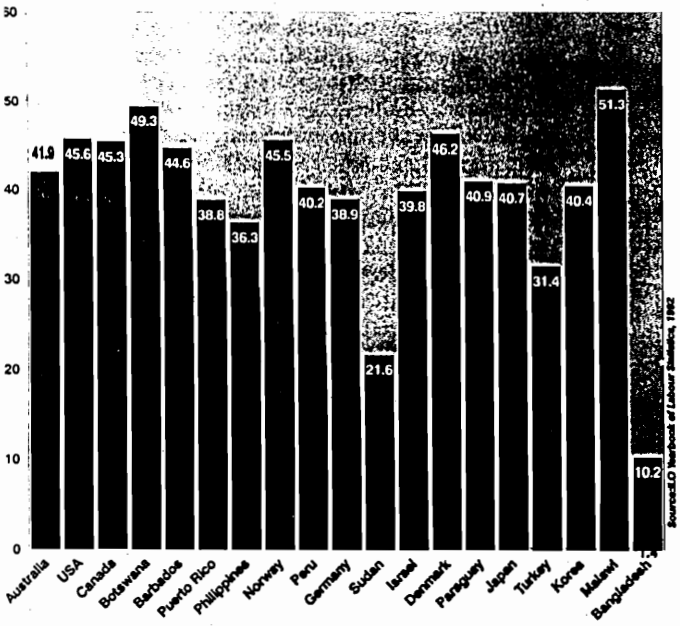


Table 1: Percentage who are women in
■ in management ■ in total employment

Note, for example, Table 1: how is it that women represent more than 40 per cent of managers in Australia, Canada and the United States, and less than 15 per cent in Denmark?

The fact is, everything depends on the definition of the terms "management" and "manager". While many countries include only the directors of large companies and high-ranking officials in this category, other countries include directors of small and medium-sized enterprises as well as middle managers. A large proportion of women at the head of small and medium enterprises – which tends to be more and more frequent, in the United States for example – can thus give the impression of a relative equality between men and women managers.

If, bearing this in mind, the figures in Table 1 must necessarily be viewed in a relative way, it is nonetheless clear that this Table also reveals an obvious gap between the level of women's participation in the workforce and their numbers in management positions (whatever the definition) in countries as different as Japan, Turkey, the Republic of Korea, Malawi and Bangladesh.

Another obvious point is illustrated in Table 2: between 1985 and 1991 there was an increase nearly everywhere in the percentage of women managers. More precisely, of 41 countries for which figures were available, 39 reflected this trend. The number of women directors and managers declined only in Paraguay and Greece.

Statistics available to the ILO from other sources* make it possible to complete the general picture, with specific observations on regional and national tendencies.

Taking the industrialized countries together, the percentage of women managers is highest in North America and Northern Europe, and lowest in Australia, Japan, New Zealand and Southern and Western Europe. In addition, the higher up the career ladder of management positions, the fewer are the numbers of women to be found.

In the United States, for example, women make up nearly 41 per cent of directors and managers of all categories, but represent only 11 per cent of high-level directors and managers and no more than 3 per cent at the "top level" of management of large companies in the private sector. In the German Federal Republic in 1986, only 1.5 per cent of the "top brass" of industry were women. In Spain, where the number of women workers has increased very rapidly, they now make up 39 per cent of all public service employees, but only 8 per cent of high-level managers.

The large regions of the developing world show similar tendencies, with of course regional and national particularities.

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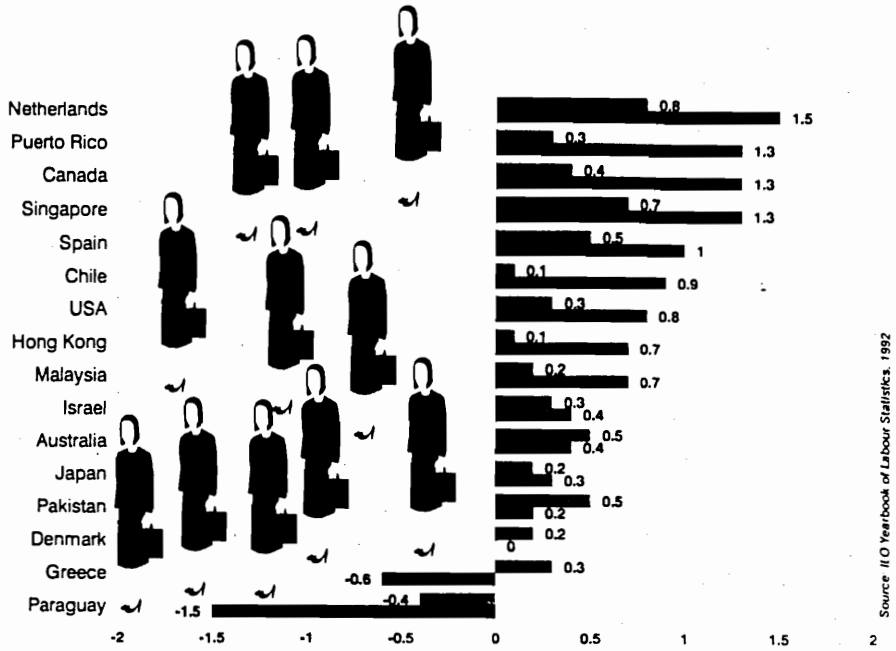
In *Africa*, where the agricultural and informal sectors predominate, few women are to be found in positions of responsibility and fewer still among decision-makers. In the public sector, African women occupied only 13 per cent of administrative and managerial jobs during the last decade. And this figure is double the number of African women managers in the public services sector during the 1970s.

In *North Africa* women hold even fewer management positions. In the Sudan, where the vast majority of women work in agriculture, they represent only 10 per cent of all public sector employees. In Egypt the situation is much the same.

Women's access to management positions in *Asia and the Pacific* varies according to the vastly complex economic, political and social conditions of the region. In 1987 women reportedly held some 10 per cent of administrative and managerial positions in southern and western Asia (another figure which had doubled since the 1970s).

In Thailand, figures for the 1980s show that women held 6 per cent of top executive positions and 26 per cent of administrative and management jobs in the civil service. The trend in Thailand suggests that women government officers will eventually outnumber their male colleagues, and that there will be more women middle managers in the long term.

The *Latin America and Caribbean* region had the highest proportion of women in administrative and managerial jobs during the 1980s, some 20 per cent, a good many of them in the public sector. In Argentina, they account for 28 per cent of public administration posts, and 12 per cent of jobs with public enterprises.




Source: ILO Yearbook of Labour Statistics, 1992

**Table 2: From 1985 to 1991, change (%) in proportion of women:**
**■ in total employment ■ in management**

*Sources: Year Book of Labor Statistics (ILO), 1991. The World's Women 1970-1990: Trends and Statistics (United Nations); UN International Research and Training Institute for the Advancement of Women, INSTRAW News, No. 17, Spring 1992.*

Jacques Maillard

## BARRIERS TO WOMEN IN THE USA

*As the 21st Century grows nearer, women are playing increasingly more important roles in the U.S. workplace, but a disproportionate share are still locked in lower-paying jobs. Black women, who are more than twice as likely to be unemployed than white women, face even greater obstacles.*

*A U.S. women's advocacy group estimates that it will be as much as a hundred years before women gain equity in the nation's labor force. According to* The American Woman 1990-1991: A Status Report, *of the Women's Research and Education Institute (WREI), "It is estimated that at the current rates of change, it will take women from 75 to 100 years to achieve complete occupational integration in the workforce."*

*There are signs of progress, though virtually every close observer of the status of American working women sees a long road toward equality. While a little more than half the workers in professional specialty occupations and 40.6 per cent of workers in managerial jobs in the US are women, they also account for four of every five employees in administrative-support jobs (clerical, secretarial), according to the Labor Department's Bureau of Labor Statistics (BLS).*

*Women made "important gains" in managerial and professional occupations between 1972 and 1991, with the proportion in executive, administrative or managerial occupations rising to 11 per cent in 1991 from 5 per cent in 1972, the BLS reports. Over this 19-year period the proportion of women lawyers rose from only 4 per cent to 19 per cent, while a little more than 20 per cent of doctors were women in 1991, nearly double the 1972 proportion, according to the BLS.*

*The data also show that the pay gap between men and women is narrowing. In 1991, full-time women in wage and salary jobs had average earnings that were 74 per cent of men's, up from 63 per cent in 1979. However, the WREI survey reported that, among full-time workers, the average woman college graduate still earns less than the average male with no more than a high school diploma. The average black woman college graduate in a full-time position receives less than 90 per cent of her white counterpart's salary, WREI points out.*

*"The most significant change in the U.S. workforce over the past 40 years," the AFL-CIO states, "has been the tremendous increase in the number of working women. Despite this growth...working women do not enjoy a similar growth in economic status. Women continue to face pervasive economic and social discrimination."*



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GUEST ARTICLE

# The Economic Woman in Africa

*An African commentary from a sociological perspective*

Ali A. Mazrui
*Albert Schweitzer Professor in the Humanities, State University of New York at Binghamton*

In many traditional African cultures there is a belief that God made woman the custodian of fire, water, and earth. God Himself took charge of the fourth element of the universe—the omnipresent air.

Custody of fire entailed responsibility for making energy available. The greatest source of energy in rural Africa is firewood. The African woman became disproportionately responsible for finding and carrying huge bundles of firewood, though quite often it was the man who chopped down the big trees.

Custody of water involved a liquid that was a symbol of both survival and cleanliness. The African woman trekked long distances to fetch water. But where a well needed to be dug, it was often the man who did the digging.

The custody of earth has been part of a doctrine of dual fertility. The woman ensures the survival of this generation by maintaining a central role in cultivation—and preserving the fertility of the soil. She ensures the arrival of the next generation in her role as mother. This is quite apart from the more universal role of women as homemakers and as child rearers.

These responsibilities have weighed heavily on African women, and perhaps on women in other traditional societies. Yet, men have played a disproportionate, though by no means exclusive, role in running societal organizations and economies. As African economies ran into difficulties, attention has focused on the participation of African women in these economies.

*Professor Mazrui, from Kenya, is currently Director, Institute of Global Cultural Studies at SUNY, Binghamton. He is also Albert Luthuli Professor-at-Large at the University of Jos (Nigeria), and the Andrew D. White Professor-at-Large at Cornell University (United States). He was the host of an acclaimed television series "The Africans: A Triple Heritage" (BBC and PBS, 1986).*

## Changes in role

What has happened to the doctrine of triple custody in the period since the colonial days?

Among the factors that increased woman's role on the land was wage labor for men. Faced with an African population reluctant to work for low wages, colonial rulers had already experimented with both forced labor, "vagrancy" laws, and taxation as a way of inducing Africans (especially men) to join the colonial workforce. After the Great Depression and World War II, migrant labor and conscription of males, compounded by the growth of mining industries, left a relatively small proportion of men working on the land.

In southern Africa, the number of men migrating to the mines increased dramatically over time. From the 1930s onward, women, left to manage the farms, became more deeply involved as "custodians of earth." By the 1950s, a remarkable bifurcation was taking place in some southern African societies—a division between a male proletariat (industrial working class) and a female peasantry. South Africa's regulations against families joining their husbands at the mines exacerbated this tendency toward gender-apartheid, the segregation of the sexes. Many women in the "Front Line States" (bordering South Africa) had to fulfill their triple custodial role of fire, water, and earth in greater isolation than ever.

The wars of liberation in southern Africa from the 1960s took their own toll on family stability and the traditional sexual division of labor. Some of the fighters did have their wives with them. Indeed, liberation armies in southern Africa often included significant numbers of women soldiers, some of them high ranking. But on the whole, these conflicts disrupted family life and the traditional sexual division of labor.

After independence, there were "counter-revolutionary wars" in some of the Front Line States. In addition to the usual disruptive consequences of war for the family, these conflicts damaged the transport and communications systems, so that many migrant workers never got home to their families between their contracts with the South African mines.

It is not completely clear how this situation has affected the doctrine of "dual fertility" of African women. One possibility is that the extra long absences of the husbands have reduced fertility rates in parts of some countries, for example, Mozambique. The other scenario is that the pattern of migrant labor in southern Africa generally has initiated a tendency toward *de facto* polyandry. If the more widespread pattern is that of declining fertility, the woman's involvement in matters pertaining to the fertility of the soil may have been increased.

## Impact of technology

Other changes in Africa during this period that affected relationships between men and women included the impact of new technologies on gender roles.

Mechanization of agriculture in Africa has tended to marginalize women. Their role as "custodians of Earth" is threatened by unwar



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ranted male prerogatives in new and more advanced technologies. It is true that greater male involvement in agriculture could help reduce the heavy burdens of work undertaken by women on the land. On the other hand, there is no reason why this relief in workload for women should not come through better technology. Cultivation with the hoe left the African woman centrally involved in agriculture. But cultivation with the tractor was often a prescription for male dominance, as men received financing to purchase tractors and only men operated them. In brief, new technology produced new threats to the role of women in economies.

Another threat to the central role of African women in the economy has come from the nature of western education. The westernized African woman in the second half of the 20th century has tended to be more free but less important for African economies than the traditional woman in rural areas. We define a westernized African woman as one who has successfully completed western-style secondary education plus at least two years of post-secondary training or education in a western-style institution (as distinct from Islamic or indigenous forms of education). More highly westernized African women are usually those who have completed university education or professional training in the western tradition.

The great majority of African women who have successfully completed secondary education neither return to the land nor enter comparably productive professions in cities. They settle for jobs as clerks, telephone operators, secretaries, and teachers. The balance of the female role shifts into the services sector. Nevertheless, it may be worth noting that Liberia has had a woman president of the university, while Uganda has had a woman foreign minister—jobs that are still not commonly held by women even in developed economies.

It is true that the westernized African woman is usually more mobile and has more freedom for her own interests than her traditional sister. But a transition from custodian of fire, water, and earth to keeper of the typewriter is definitely a form of marginalization for African womanhood. This is not necessarily a case against western education for women. The imperative is to ensure that female westernization does not result in functional marginalization.

The third threat to the role of the African woman in this period has come with the internationalization of African economies. When economic activity in Africa was more localized, the African woman had a decisive role in local markets and as a trader. But the colonial and post-colonial tendencies toward enlargement of economic scale have increasingly pushed the women to the side in international decisionmaking. It is true that Nigerian women especially have refused to be completely marginalized, even in international trade. But on the whole, the Africans who deal with international markets and sit on the boards of transnational corporations are overwhelmingly men. At the meetings of the Organization of Petroleum Exporting Countries (OPEC)—where Muslims predominate—there are additional cultural inhibitions about having even Nigeria represented by a female delegate.

## Policy implications

While Africa does need to modernize and mechanize rural production, it must find ways of doing this without adversely affecting women. The triple custodial role of women needs to find modern equivalents in the productive sector. What can be done to build on the African woman's traditional roles and responsibilities so that she may play a greater role in economic activities? Women as custodians of earth have traditionally emphasized food cultivation. Their greater involvement in the production of cash crops for export could be one way of linking tradition to modernity—and preventing Africa's economic internationalization from resulting in the marginalization of African women. The export trade need not be so male dominated.

But support for traditional market women in food production and local trade need not suffer as a result of this approach. Credit facilities should be made available in such a manner that there is equity, not only between men and women but also between westernized and nonwesternized females. Currently, traditionalist nonwesternized women are often at a disadvantage when assessed for creditworthiness, often because they are also nonliterate. Peer-lending schemes in Nigeria are a step in the right direction.

A higher proportion of nonwesternized women are involved in agricultural production than are their westernized sisters. Indeed, cultural westernization of women—though improving their creditworthiness—tends to decrease women's direct involvement in economic production. Highly westernized African women farmers are almost unknown in many African countries—though there are exceptions in Kenya, Nigeria, and more recently Zimbabwe. Nonwesternized women farmers are the rule all over rural Africa. A balance has to be struck between the two categories of women in relation to both access to credit and role in production. Preventing technology from marginalizing women is yet another imperative. Mechanization is no excuse for sexism. Special programs for women in technical training—from driving tractors to repairing a lorry engine—should be inaugurated.

Women as custodians of fire are the greatest users of firewood in the continent. But shouldn't women also be centrally involved in forest management and reforestation? Wood should increasingly be approached as an integrated industry, bearing in mind the needs of environmental protection and ecological balance. Women as the greatest users of firewood should also become among the leading planters of trees for reforestation.

Carpentry and furniture making are crafts that cry out for much greater female involvement than has been achieved so far. Culturally, women are often the selectors of furniture and the trustees of the domestic infrastructure of the family. Yet, it is an anomaly that African women have played such a limited role in designing furniture or making it.

As traditional custodians of water, do women have any special role in this era of faucets and dams? Africa's women, as we indicated, still trek long distances in some rural areas for their water. But water-related industries are surprisingly still male dominated. This includes the whole infrastructure of water supply in urban areas. Even commercial laundry and dry cleaning for the elite and for foreigners in African towns is still usually owned and managed by men, even when women do most of the washing and ironing.

The future of the continent depends upon a new sexual equation in the whole economic process, involving a cultural rather than a purely economic structural adjustment. On the gender question, Africa needs a cultural reformation—"Seek ye first the cultural kingdom, and all else will be added unto it."

But classical privatization and laissez faire would simply permit worsening conditions of marginalization for women. Progress toward female entrepreneurialization would be aborted or retarded. This is a major reason why Africa needs an activist and enlightened state role in support of gender economic equality. ■

***Guest Articles represent the views of the authors and not necessarily the views of the IMF or the World Bank. We invite readers' comments—Editor.***

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# State of the World 1993

## by Lester R. Brown

Many people have long understood, at least intuitively, that continuing environmental degradation would eventually exact a heavy economic toll. Unfortunately, no global economic models incorporate the depletion and destruction of the earth's natural support systems. Only now can we begin to piece together information from several recent independent studies to get a sense of the worldwide economic effects of environmental degradation. Among the most revealing of these are studies on the effects of air pollution and acid rain on forests in Europe, of land degradation on livestock and crop production in the world's dryland regions, of global warming on the U.S. economy, and of pollution on health in Russia.

These reports and other data show that the fivefold growth in the world economy since 1950 and the increase in population from 2.6 billion to 5.5 billion have begun to outstrip the carrying capacity of biological support systems and the ability of natural systems to absorb waste without being damaged. In country after country, demands for crops and for the products of grasslands, forests, and fisheries are exceeding the sustainable yield of these systems. Once this happens, the resource itself begins to shrink as natural capital is consumed. Overstocking grasslands, overcutting forests, overplowing, and overfishing are now commonplace. Every country is practicing the environmental equivalent of deficit financing in one form or another.

Perhaps the most visible environmental deficit is deforestation, the result of tree cutting and forest clearing that exceeds natural regrowth and tree planting. Each year this imbalance now costs the world some 17 million hectares of tropical forests alone. Over a decade, the destruction of tropical forests clears an area the size of Malaysia, the Philippines, Ghana, the Congo, Ecuador, El Salvador, and Nicaragua. Once tropical forests are burned off or clear-cut, the land rapidly loses its fertility, since most of the nutrients in these ecosystems are stored in the vegetation. Although these soils can be farmed for 3-5 years before fertility drops and can be grazed for 5-10 years before becoming wasteland, they typically will not sustain productivity over the long term. Clearing tropical forests is, in effect, the conversion of a highly productive ecosystem into wasteland in exchange for a short-term economic gain...

Land degradation is also taking a heavy economic toll, particularly in the drylands that account for 41 percent of the earth's land area. In the early stages the costs show up as lower land productivity. But if the process continues unarrested, it eventually creates wasteland, destroying the soil as well as the vegetation. Using data for 1990, a U.N. assessment of the earth's dryland regions estimated that the degradation of irrigated cropland, rainfed cropland, and rangeland now costs the world more than $42 billion a year in lost crop and livestock output, a sum that approximates the value of the U.S. grain harvest...

Excessive demand directly threatens the productivity of oceanic fisheries as well. The U.N. Food and Agriculture Organization (FAO), which monitors oceanic fisheries, indicates that 4 out of 17 of the world's fishing zones are now overfished. It also reports that most traditional marine fish stocks have reached full exploitation. Atlantic stocks of the heavily fished bluefin tuna have been cut by a staggering 94 percent. It will take years for such species to recover, even if fishing were to stop altogether...

As overfishing of the North Atlantic by U.S., Canadian, and European fleets decimated stocks there during the seventies, the ships turned to the South Atlantic, particularly to the fisheries off the African coast. Unable to control fishing in the 200-mile Exclusive Economic Zones granted by the 1979 Law of the Sea Treaty, some African countries saw their fisheries decimated. Namibia, for instance, watched the catch in its zone fall from nearly 2 million tons in 1980 to less than 100,000 tons a decade later. After banning European ships from its waters in 1990, stocks started to recover.

*Lester R. Brown, president and founder of the Worldwatch Institute.*

Inland fisheries are also suffering from environmental mismanagement—water diversion, acidification, and pollution... In the United States, pollution has severely affected the Chesapeake Bay, one of the world's richest estuaries. Its fabulously productive oyster beds, which yielded 8 million bushels per year a century ago, now produce scarcely a million bushels. Elsewhere, fish have survived, such as in the U.S. Great Lakes and New York's Hudson River, but many species are unsafe for human consumption because of pollution with PCBs and other toxic chemicals. Half the shellfish-growing areas off Nova Scotia in eastern Canada have been closed because of contamination.

The rising atmospheric concentration of greenhouse gases is potentially the most economically disruptive and costly change that has been set in motion by our modern industrial society. William Cline, an economist with the Washington-based Institute for International Economics, has looked at the long-term economic effects of global warming. As part of this study he analyzed the effect of a doubling of greenhouse gases on the U.S. economy, which could come as early as 2025. He estimates that heat stress and drought would cost U.S. farmers $18 billion in output, that increased electricity for air conditioning would require an additional $11 billion, and that dealing with sea level rise would cost an estimated $7 billion per year. In total, Cline estimates the cost at nearly $60 billion, roughly 1 percent of the 1990 U.S. GNP...

Every society is paying a price for environmental pollution. Contamination of air, water, and soil by toxic chemicals and radioactivity, along with increased ultraviolet radiation, is damaging human health, running up health care costs. An assessment of urban air quality jointly undertaken by the World Health Organization and the United Nations Environment Programme reports that 625 million people are exposed to unhealthy levels of sulfur dioxide from fossil fuel burning. More than a billion people, a fifth of the planet's population, are exposed to potentially health-damaging levels of air pollutants of all kinds. One study for the United States estimates that air pollution may cost the nation as much as $40 billion annually in health care and lost productivity...

New data from Russia, Europe's largest country, show all too well the devastating effect of pollution by chemical and organic toxins on human health. At an October 1992 news conference, Vladimir Pokrovsky, head of the Russian Academy of Medical Sciences, shocked the world with his frankness, "We have already doomed ourselves for the next 25 years." He added: "The new generation is entering adult life unhealthy. The Soviet economy was developed at the expense of the population's health." Data released by the Academy show 11 percent of Russian infants suffering from birth defects. With half the drinking water and a tenth of the food supply contaminated, 55 percent of school-age children suffer health problems. The Academy reported that the increase in illness and early death among those aged 25-4[illegible] was particularly distressing. The bottom line is that Russian life expectancy is now falling.

Another source of higher future health care costs is stratospheric ozone depletion. Epidemiologists at the U.S. Environmental Protection Agency (EPA) estimate that the upward revision in early 1991 of the rate of ozone loss could mean an additional 200,000 skin cancer fatalities in the United States over the next five decades. Worldwide, this translates into millions of deaths. The number of people with cataracts would also increase dramatically in a world where people are exposed to greater doses of ultraviolet radiation than ever recorded. Other associated health care costs include a projected higher incidence of infectious diseases associated with the suppression of immune systems, the economic costs of which are difficult to even estimate.

In addition to the environmental deficits the world is now experiencing, huge environmental cleanup bills are accumulating. For example, the estimated costs for cleaning up hazardous waste sites in the United States center on $750 billion, roughly three fourths the 199[illegible] U.S. federal budget. And a national survey in Norway has discovered some 7,000 hazardous waste sites, the product of decades of irresponsible dumping. Cleanup is estimated to cost tiny Norway $3-6 billion.

There is no reason to believe that these bills for the United States and Norway are very different from those of other industrial countries. In a world generating more than a million tons of hazardous waste a day, much of it carelessly disposed of, the costs of cleanup are enormous. The alternative to cleaning up these sites is to ignore them and let toxic wastes eventually leak into underground aquifers. One way or another, society will pay—either in cleanup bills or in rising health care costs.

In addition to toxic chemical wastes, damaging nuclear waste is also a threat to human health. National governments in countries with nuclear power plants have failed to design a system for safely disposing of their wastes. At present, radiated fuel at most plants is stored in pools of cooling water at the site itself. No one has yet put a price tag on safely disposing of nuclear waste and decommissioning the nuclear power plants that generate it. Coping with the health problems associated with nuclear waste is being left to future generations, a part of the nuclear legacy.

Several military powers face the related threat of radiation wastes generated at nuclear weapons manufacturing facilities, which are released into the surrounding areas. In the United States, the cleanup bill for all these sites, including some of the more publicized ones such as Rocky Flats in Colorado and the Savannah River site in South Carolina, is estimated at $200 billion. For the former Soviet Union, where the management of radioactive waste has been even more irresponsible, the costs are likely to be far greater. Again, the question is not whether society will pay the bill for nuclear wastes, but whether it will be in the form of cleanup or in rising health care costs in exposed communities.

The environmental deficits and debts that the world has incurred in recent decades are enormous, often dwarfing the economic debts of nations. Perhaps more important is the often overlooked difference between economic deficits and environmental ones. Economic debts are something we owe each other. For every borrower there is a lender; resources simply change hands. But environmental debts, especially those that lead to irreversible damage or losses of natural capital, can often be repaid only in the deprivation and ill health of future generations.

*Excerpted with permission from* State of the World 1993, *the tenth anniversary report from the Worldwatch Institute, published by W.W. Norton & Company.* State of the World 1993 *is available to ZPG members who renew at a gift of $30 or more.*

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WORLD BANK NEWS

March 18, 1993

PUBLICATIONS

# Increasing Educational Opportunities for Girls Results in Lower Fertility Rates

A new World Bank study confirms earlier research showing a link between educating girls and lowering fertility rates in developing countries.

According to *Social Gains from Female Education: A Cross National Study*, fertility rates decline in countries that have higher enrollments of girls in secondary schools. Fertility falls even further when actions to increase educational opportunities for girls are combined with measures to improve family-planning and health services.

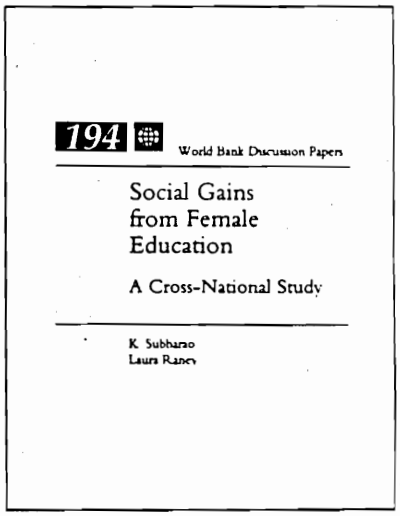
"Expansion in female education reduces fertility substantially, and even more when family planning services accompany it," say authors Kalanidhi Subbarao and Laura Raney. Subbarao is a senior economist in the World Bank's Education and Social Policy Department. Raney is a consultant to the same department.

"In countries where the female secondary education base is low, this research suggests that the expansion of female secondary education may be the best single policy lever for achieving substantial reductions in fertility," the study says.

The authors say that for a sample of 65 developing countries covered in the study, a doubling of female secondary-school enrollments in 1975—from an average of 19 percent to 38 percent—would have reduced the average fertility rate from 5.3 births to 3.9 births.

Increasing girls' access to education has other benefits too, the study concludes, drawing from previous research carried out by the World Bank and other organizations. "Female education increases the value of women's time in economic activities by raising labor productivity and wages, with a consequential rise in household incomes and a reduction in poverty," the study says. "Female education also produces social gains, by improving health (the woman's own health and the health of her children), increasing child schooling and reducing fertility." □

Girls attending school in Nouakchott, Mauritania.




*Social Gains from Female Education: A Cross-National Study* is priced at $6.95. Journalists may receive complimentary review copies by writing on company letterhead to the World Bank, Office of the Publisher, Marketing Unit, Room T-8054, Washington, D.C. 20433, U.S.A. Fax: (202) 676-0579.

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# INTRODUCTION

## 1992 Population Picks & Pans

The 1990s represent the critical decade for making progress toward a stable world population. Currently, more than 90 million people are added to the world's population each year—a number that will continue to rise throughout this decade as record numbers of women and men enter their reproductive years. While family planning services continue to expand, more than 300 million couples still lack access to safe and effective contraception.

In 1990, Population Action International (formerly the Population Crisis Committee) launched its Report Card series on world progress toward population stabilization. Recognizing that universal access to voluntary, high quality family planning programs is a critical element in reaching this goal, Population Action International is again highlighting the success or failure of 10 countries in its 1992 *Population Picks & Pans*.

Together, the 10 countries being recognized as the 1992 *Population Picks & Pans* contribute one out of every seven people added to the world population each year, more than 13 million people. Their progress—or lack of progress—in providing access to family planning will help determine the quality of life and environmental sustainability of our planet for future generations. Also important are the individual experiences of these 10 countries: each provides valuable information on what makes for success or failure in providing family planning and reproductive health care services.

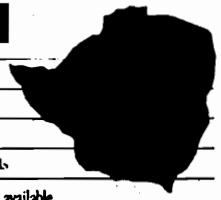
**Indonesia, Bangladesh, Iran, Peru, and Zimbabwe** are the five countries being recognized for their recent progress toward universal access to family planning and population stabilization. These five countries offer proof that family planning services can be provided—and will be used—in very diverse social, economic, and cultural settings.

The five countries selected for their lack of progress (or regression) on reproductive health are **Russia, Pakistan, Poland, Iraq,** and **Ireland**. All represent tragic examples of countries unresponsive or actively opposed to the desires of women and men for greater control over their reproductive lives.



# ZIMBABWE

| | |
|---|---|
| 1992 population: | 10,500,000 |
| 1992 natural increase in population: | 3,[illegible]/500,000 people |
| Change in fertility (TFR) 1978-88: | 6.6 to 5.[illegible] children (-15 to [illegible]) |
| Contraceptive use (CPR): | 1[illegible]% total/36% modern methods |



*1988 estimate

*Status of abortion/menstrual regulation:* Safe abortion not widely available, although legal in the case of rape, incest, or serious health problems for the woman or fetus.

## African Pacesetter Triples Contraceptive Use in Less than a Decade, Challenges Long-standing Pessimism about Family Planning in Africa

With strong and vocal political support, Zimbabwe has emerged as one of Africa's pacesetters in expanding access to family planning services. Slowing population growth and strengthening preventive health services have been top priorities for Zimbabwe's leaders—including President Robert Mugabe—since gaining independence in 1980. Use of contraceptive methods (both modern and traditional) has risen dramatically, from just 14 percent of married women in 1979 to 38 percent in 1984 and 43 percent in 1988. A very large jump in the use of modern contraception between 1984 and 1988, from 27 percent to 36 percent of married women, reflects in part a decrease in the proportion of couples using less effective traditional methods in favor of effective methods like the pill.

While family size has not yet fallen as swiftly as contraceptive use has risen, the average family in Zimbabwe has five or six children, compared with seven in most sub-Saharan African countries. Moreover, this initial decline in fertility appears to be accelerating. The rapid expansion of family planning services over the past decade under the Zimbabwe National Family Planning Council (ZNFPC) has played the most important role in expanding

# ZIMBABWE

CONTINUED

contraceptive use. The government has also made great strides in improving access to basic health care and education and in strengthening women's legal rights, all of which work with family planning services to bring down birthrates.

Access to contraception in this predominantly rural country depends on the outreach efforts of community-based distribution agents, mostly local women, backed by stationary health clinics. These outreach workers, selected by their communities for training, are responsible for educating other village women about family planning, distributing condoms and pills (following appropriate screening), and referring clients to health facilities for other methods.

Innovation has been key to Zimbabwe's success, including groundbreaking projects to counter conservative male attitudes toward family planning. One such effort featured a radio show "Akaruma Nechekuchera" ("You reap what you sow"), that highlighted the trials of Jonas, a poor villager with two wives and 15 children. In combination with workshops and printed materials, the educational campaigns have had impressive results, raising levels of awareness and public support for family planning.

Since the appointment of a new health minister in 1990, Zimbabwe has also led the way on AIDS education in Africa, crucial given that an estimated five percent of the population may be infected with the HIV virus. The campaign focuses on promoting "mutually faithful, lifelong partnerships" and curbing AIDS transmission among high risk groups by vastly multiplying the distribution of condoms—from just half a million in 1986 to a projected 65 million in 1992.

In recent years, the government has funded over half the ZNFPC's budget, with international donors contributing the rest. However, the devastating effects of the 1992 drought on an already struggling economy mean that Zimbabwe has scarce resources for family planning and will require significantly more donor assistance to maintain its record of rapid program expansion.

Moreover, Zimbabwe still faces massive population growth ahead. At the current rate of growth, Zimbabwe's population would double in less than 25 years. To achieve population stabilization some time in the next century will require substantially increased efforts to encourage later age at marriage and first childbirth and to make women more equal partners in the country's economic development. The Zimbabwe government will also have to improve further the quality of health and family planning services, in particular, by expanding the range of contraceptive options beyond the current emphasis on oral contraceptives and condoms, and by dealing with the problem of unsafe abortion.

# RUSSIA

| | |
|---|---|
| 1992 population: | 149,300,000 |
| 1992 natural increase in population: | 0.2%/300,000 people |
| Change in fertility (TFR) 1980/81-92: | no net change (1.9 children) |
| Contraceptive use (CPR): | 22% modern methods* |

*Status of abortion/menstrual regulation:* Abortion available on demand.

*1991 estimate

## Lack of Contraceptives Reinforces Reliance on Abortion; Women's Health Needs Ignored

Family planning and reproductive health care, historically mediocre, have suffered enormously during the past several years in Russia's transition to a free market economy. Beleaguered with economic and social problems, the Russian government has not considered family planning or women's health a high priority.

Russians have virtually no access to modern contraceptives. Factories recently stopped producing condoms and intrauterine devices (IUDs) because the country lacked hard currency to import latex and because the IUDs were of such poor quality. The government has imported no contraceptives from the West since 1990, and reports from Russia indicate that in the few places where contraceptives are still available, commercial prices make them unaffordable for most people. Therefore, although 22 percent of married women were recently estimated to be using modern contraceptives, this figure is now probably too high.

Despite the lack of access to contraceptives, fertility rates have been declining—from an estimated 2.2 children per woman in 1987 to 1.9 children or less at present. Population experts believe that economic hardship in Russia has been a major factor in declining fertility. Housing is crowded and most families need two breadwinners to make ends meet. Day care costs are prohibitive for most families. In many respects, women seem to be bearing the brunt of the economic recession, as patterns of discrimination





in hiring and wages reemerge; 70 percent of the newly unemployed are women.

Russian women have little choice but to rely on abortion as their primary method of birth control. At least four million abortions are performed every year, roughly two abortions for every live birth. Abortions are typically performed under primitive conditions, usually without anesthesia. Although legal abortions in most industrialized countries are associated with few complications, abortions in Russia lead to a myriad of reproductive health problems, sometimes including infertility, and are the primary cause of relatively high maternal mortality rates (an estimated 55 maternal deaths per 100,000 live births).

Family planning in Russia has been hampered by a cultural reticence to discuss sexual issues. Many physicians lack training in family planning and are misinformed about the specific risks and benefits of modern contraceptive methods. Ignorance about contraception among the general population is widespread. The pill, called "the hormone," is often associated in the public mind with male hormones and is believed to have many dangerous side effects. Widespread fears about the pill exist in part because the former Soviet Union traditionally imported high-estrogen pills from Eastern Europe, brands which do indeed have more serious side effects than low dose brands marketed in the West. The unpopularity of condoms can also be blamed in part on poor quality. Crudely-made Russian condoms were so thick and loose fitting that they were nicknamed "galoshes."

Despite the appalling condition of reproductive health care in Russia, there are rays of hope. In December of 1991, a national Russian Family Planning Association was established to campaign for improved access to contraceptives, a national program of sex education, and safer abortion. The volunteer association is supported by the International Planned Parenthood Federation in London, with which it is affiliated.

Family Planning International Assistance, the international division of the Planned Parenthood Federation of America, is also providing assistance through factory and university-based health clinics in Moscow and part of Siberia. Other family planning organizations from the United States and Europe have also started small programs in Russia. Finally, the Russian government itself has devised a plan to deliver family planning services along with existing maternal and child health services. And family planning is now (at least nominally) included in the medical curricula. But these efforts are still a drop in the bucket given the huge unmet need throughout Russia for quality reproductive health care, including the need to totally reeducate the public and many health care providers about modern family planning methods.

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WORLD BANK ENVIRONMENT PAPER NUMBER 2

# Sustainable Development Concepts

## An Economic Analysis

John Pezzey

## Abstract

This paper attempts to analyze sustainability concepts, such as sustainable growth, sustainable development and sustainable resource use, in terms of the conventional neoclassical theory of economics. It then tries to analyze why free market forces may not achieve sustainability, and how policy intervention may help or hinder sustainability.

Several different definitions of sustainability are reviewed. Most require that the "quality of life" should not decline over the long-term future. Many can also be interpreted in terms of maintaining an economy's capital stock. However, a relevant definition of capital stock still has to be chosen, and this means judging how significant, essential or substitutable are the various natural and man-made resource inputs to the economy's production processes.

A number of simple models of the economy and the environment are used to explore these issues. One model uses comparative static analysis to explain why different tradeoffs may be made between consumption and environmental quality at different stages of economic growth. Other models use optimal control theory to examine sustainability over time in the context of both non-renewable and renewable resources. Such models may not achieve much realism, but they should help to clarify conceptual thinking about sustainable development.

The main results suggested by these simple models are that, if non-renewable resource inputs are essential, then inadequate technical progress and open access to environmental resources may be the key factors that cause unsustainability. Government intervention, in the form of resource conservation subsidies or depletion taxes, is shown both to correct the open access problem and to improve sustainability; conversely, government subsidies for resource depletion aimed at encouraging development will harm sustainability. But improving sustainability by slowing down resource depletion also may mean lower initial levels of consumption and utility.

The suggested implications for policy are that conventional environmental policies may also improve sustainability, making a separate sustainability criterion redundant in practice; and that politically difficult short-term sacrifices may be needed to reach optimal and sustainable growth paths. "Conventional environmental policies" need not always mean making the polluter pay for externalities. More important is that property rights over the environment are first defined and enforced, if this is possible.

A simple model with renewable resources shows how population growth can threaten sustainability, and how poverty and environmental degradation can be linked, establishing the case for development assistance. The role of a more equal income distribution as part of sustainable development is briefly discussed. Giving environmental property rights to the poor may both reduce poverty and improve the environment. This is true whether the poor are the polluters (by being so poor that they degrade their own land and cause floods, siltation, etc elsewhere), or the pollutees (by suffering air and water pollution in cities).

If improved environmental policy alone is not enough to achieve sustainability, so that a separate explicit sustainability policy is necessary, one must ask how it can be applied at both the system and project level. At the system level it is fairly clear, at least in theory: aggregate constraints (either economic or regulatory) must be imposed to control the depletion of whatever resources have been determined to be important for sustainability. Such constraints should drive up the price of such resources to whatever level is necessary to induce the required conservation efforts throughout the system. Such efforts are equivalent to intergenerational compensation investments. An example of this kind of process is already under way with international agreements to reduce the use of CFCs.

Making sustainability operational at the project level is much harder, even conceptually. System sustainability cannot be disaggregated into project rules in the simple way that system optimality can be disaggregated into cost-benefit rules for project appraisal. Many writers suggest that sustainability will be assured, if "intergenerational compensation" projects are required for any group of projects that has a harmful overall effect on environmental resources. This is an attractive and fairly operational concept, but it is not clear how groups of projects should be defined, how compensation should be paid, and who should pay it, particularly in the private sector.

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# Population, Agriculture, and the Environment in Africa

*These elements interact in vital ways for sustainable development*

Kevin Cleaver and Götz Schreiber
*Division Chief* *Principal Economist*
*Africa Region, The World Bank*

Over the past 30 years, most of Sub-Saharan Africa has seen very rapid population growth, poor agricultural performance, and increasing environmental degradation. Why do these problems seem so intractable? Are they connected? Do they reinforce each other? If so, what are the critical links? These are the questions a recently completed study in the World Bank sought to answer. The approach was to review the literature and available country data to test the hypothesis that there are strong interrelationships between population, agriculture, and the environment. The findings suggest that this nexus is very much at work in Sub-Saharan Africa and that development efforts would be far more effective if their design reflected this.

## The nexus

Key links are found in traditional crop and livestock production methods, land tenure systems, women's responsibilities, and methods of forest resource utilization. The traditional systems and practices were well suited to people's survival needs when population densities were low. As populations grew slowly, they evolved in response. But with the acceleration of population growth in the 1950s, these traditional ways came under increasing strain—eventually to the point of being overwhelmed. The result has been the triad of problems noted at the outset.

***Shifting cultivation and pastoralism.*** Shifting or long-fallow cultivation and pastoralism were appropriate responses to abundant land and limited capital. The key was mobility: people moved when crop yields declined or forage was depleted, allowing soil fertility to be restored through natural vegetative growth and decay. Where population density increased slowly, land use systems gradually became more intensive—as in the East African highlands. Where land was abundant, more could be gradually brought into the farming cycle. But with rapid population growth, people are increasingly compelled to remain in place—yet their farming techniques have not evolved sufficiently to permit sustainable permanent farming. As a result, soil fertility and structure deteriorate, crop yields decline, and soils erode. Extreme cases can be observed in Rwanda, the Central Plateau in Burkina Faso, and parts of Nigeria.

Although one of the conditions that led Asian farmers to adopt "green revolution" technology—abundant labor relative to cultivable land—is emerging in parts of Africa, technological innovation has been very slow. Ineffective agricultural research and extension is only part of the reason. Poor transport infrastructure severely blunts farmers' incentives to switch from subsistence to market production, and from extensive to intensive farming. Inappropriate price, exchange rate, and fiscal policies have reduced the profitability of market-oriented agriculture, prevented significant productivity gains, and contributed to the persistence of rural poverty and increasingly destructive traditional land use practices.

***Women's responsibilities and time.*** The multiple roles of women in rural production and household maintenance systems and the heavy demands on their time are key aspects of the nexus. In addition to bearing and rearing children, most African women have heavy responsibilities for foodcrop production, working on men's fields, post-harvest processing, fuelwood and water provision, commodity porterage, and household maintenance. In Zambia, farm women contribute more hours daily than men to farm work (8.5 hours versus 7.4 hours) and to nonagricultural tasks (5 hours versus 1.1 hours). Moreover, the burdens on rural women are increasing. Growing numbers of men leave the farms for urban and industrial jobs—in the Congo, for example, 70 percent of farm household heads are now women. With increasing environmental degradation, women must walk further to fetch fuelwood and water. They also face severe constraints on access to extension advice, institutional credit, and improved production, processing, and transport technology.

***Demand for children.*** Underlying the persistence of very high fertility rates is low demand for fewer children. Environmental degradation, food insecurity, land tenure systems, and cultural traditions all help stimulate demand for children. So do the heavy work loads and severe time pressure faced by women, as they increase the need for child labor. In the short term, children can produce more than they consume. But the cycle is a vicious one. Women's time constraints and water and fuelwood scarcity negatively affect infant health and mortality and, hence, attitudes toward family planning. Girls kept out of school to help with domestic tasks tend to marry young and have many children during their adult life. Where survey data are available, the percentage of married women who demand contraception to limit family size ranged from a low of 6.4 percent in Mali to a high of 33.9 percent in Kenya, compared with 30–50 percent in North Africa, 36–55 percent in Asia, and 40–60 percent in South America.

***Land tenure systems.*** Traditional tenure systems, with communal land owner-

*This article is based on a forthcoming World Bank Monograph by the authors.*



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ship, provide considerable tenurial security on land farmed by community members. With slow population growth, these systems were able to accommodate the emerging need to move toward *de facto* permanence of land rights assignments. Problems have arisen, however. Rights to trees are often separate from other land use rights; the development of valley bottoms for farming constrains the mobility of herders who have traditionally depended on this land; and increasing rural-rural migration is causing conflicts over land ownership and use.

Many governments have responded by nationalizing land, and then allowing customary rules to guide the use of some land, while allocating other land to private investors and public projects. Some, such as Kenya, have issued individual land titles, generally ignoring the prior existence of customary tenure arrangements. In most cases, the results have differed considerably from the stated intent. Often, the well-connected have succeeded in wresting land from its customary owner-occupants. Governmental interference has almost always reduced tenurial security, accelerated the breakdown of customary land management systems, and, especially in forest and range areas, spurred the emergence of *de facto* open-access conditions that are inimical to private investment in land improvement or resource conservation. In Côte d'Ivoire, for example, nationalization of most land, combined with some land titling, *de facto* recognition of traditional tenure arrangements except when it suits government interests not to do so, and massive immigration from the Sahel, has created an open-access situation in forest areas where anyone can exploit the land but no one can claim ownership. This has contributed to the destruction of the forests.

***Forest and woodland exploitation.*** The heavy dependency on woodfuels has combined with rapid population growth to contribute to accelerating forest and woodland destruction, especially around major urban centers. Since fuelwood is generally considered a free good, taken largely from land to which everyone has access, efficient markets for fuelwood have not developed, despite its increasing scarcity. Commercial logging has been directly responsible for only 10 to 20 percent of forest destruction in Sub-Saharan Africa, but it usually leads to a second phase of destruction: logging roads provide access for settlers who continue the deforestation the loggers have begun. The degradation and destruction of forests and woodlands accelerates soil degradation and erosion and harms local and regional climates and hydrological regimes, which in turn negatively affects agriculture. The worsening fuelwood and water supply situation also forces women and children to spend more time collecting these necessities.

## What is to be done?

Clearly, new approaches are needed. But what form should they take? The study strongly suggests that future efforts must build on the crucial cross-sectoral links and synergies of the population-agriculture-environment nexus. They should also place far more emphasis on promoting effective demand for environmentally benign intensive farming, family planning, and resource conservation. Simply put, successful agricultural development necessitates adequate attention to demographic and environmental concerns—just as preventing further environmental degradation requires intensifying agriculture and lowering fertility rates and population growth.

If the nexus synergies are harnessed, it should be possible to meet a number of key demographic, agricultural, food security, and environmental objectives within the next 30 years. Indicative targets for Sub-Saharan Africa as a whole illustrate the magnitude of the effort required. Agricultural production needs to grow at about 4 percent per annum. By the year 2010, daily per capita calorie intake should be raised from the present average of 2,095 to about 2,400. Deforestation needs to be slowed and the area of forests, woodlands, and wilderness gradually stabilized. This will require that the further expansion of cropped land be limited—necessitating rapid agricultural intensification. And the average total fertility rate needs to be lowered by 50 percent over the next 30 years, so as to reduce population growth to 2.2 percent per annum.

***Fertility rates.*** It is essential to increase demand for family planning. Boosting girls' school enrollment rates is critical. Easing women's work loads will reduce the need for child labor. Better health care and access to safe water will improve child survival rates. So will dynamic agricultural development and improved food security. Where demand for reducing fertility rises, it must be met with effective family planning services.

***Women's time.*** Work is needed in many fields to ease women's time constraints and improve their productivity. Much can be learned from nongovernmental organizations—in establishing water supply systems, developing locally appropriate fuel- and time-saving stoves, providing better tools and techniques, facilitating access to land and credit, improving local transport infrastructure, and providing suitable transport aids.

***Environmentally sustainable agriculture.*** Research and extension services need to focus on environmentally benign and economically viable agricultural techniques (e.g., contour farming, intercropping and crop rotation systems, and water harvesting), along with the promotion of increased fertilizer use and farm mechanization. Creating demand for intensive and resource-conserving agriculture requires appropriate marketing, price, tax, and exchange rate policies, as well as investments in rural infrastructure, health, and education facilities. Creating conservation areas and protecting these against encroachment will be important. If know-how and inputs are available, land scarcity induces agricultural intensification. Tenurial security stimulates land conservation and tree planting.

***Resource ownership.*** Eliminating open-access systems is of utmost urgency. Where traditional tenure systems are evolving toward explicit recognition of individual ownership and transfer rights, they should be protected by law and supported by appropriate administrative arrangements. State ownership of farm land should be eliminated. Where possible, forest and range lands should be assigned to traditional users or local communities, with use rights linked to the responsibility for conservation. Where traditional systems have collapsed, individual titling is likely to be needed, but it should be provided only on demand and to the customary owners. Women need the same rights to land and tenurial security as men.

***The fuelwood problem.*** Effective agroforestry activities can have a major impact on the environment, farming, the rural energy economy, and women's time. Woodfuel markets will develop more rapidly if open access to fuelwood is eliminated, people can freely market wood from their own land, and communities and farmers have uncontested ownership of local forests and woodlands.

***Environmental resource conservation.*** Protecting forests and other conservation areas stabilizes local and regional climate and hydrology, stimulates agricultural intensification, and ensures the provision of forest products and environmental services. Appropriate targeting of urban and infrastructure development can be a powerful tool to guide settlers into environmentally resilient areas with agricultural potential and keep them out of fragile areas. Regional and local land use plans can go far in reconciling objectives of natural resource management, population and settlement policy, and agricultural and infrastructure development. The local people need to be directly involved in formulating and implementing such plans. ■



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# Implications of Policy Intervention in African Land Tenure

MITZI GOHEEN and PARKER SHIPTON

*Parker Shipton and Mitzi Goheen.* Introduction: "UNDERSTANDING AFRICAN LAND-HOLDING: POWER, WEALTH, AND MEANING."
*Parker Shipton.* "DEBTS AND TRESPASSES: LAND, MORTGAGES, AND THE ANCESTORS IN WESTERN KENYA"
*In Mitzi Goheen and Parker Shipton, guest eds.,* RIGHTS OVER LAND: CATEGORIES AND CONTROVERSIES
*Special issue of* AFRICA *(Journal of the International African Institute), Vol. 62, No. 3, 1992.*
*(Also contains articles by Sara Berry, Mitzi Goheen and Pauline Peters.)*

Africa is the region with the sparsest overall population, but to infer that the continent has no problems of land shortage would be quite wrong. Mitzi Goheen of Amherst College and Parker Shipton of HIID have edited an issue of the journal *Africa*. The articles in this issue focus on disputes and negotiations over land south of the Sahara — not just about particular tracts or holdings, but about the uses and the very meanings of land itself, the changing customs by which humans relate to it, and the implications for policy.

***With the belief that private land titles should help enable Africa's small-scale farmers to borrow by providing a new form of collateral, several African governments have begun trying to title farm land as private property. Shipton's research shows how inappropriate the freehold-mortgage approach proves to be for one particular African setting.***

Shipton's and Goheen's introductory article summarizes classic and contemporary theories about property in Africa, proposing a new framework in which social groups, networks, and categories all come into play along with individuals. The collection's articles show people using land for many purposes: not just to produce the material conditions of survival and enrichment, but also to gain control over others, and to define personal and social identities. Individual rights do not simply solidify with social "evolution": rather, they become aligned and realigned with some kinds of social grouping (for instance lineage, ethnic group, district, or nation) against other kinds. Policies must consider the rights of subordinate, conditional, or partial landholders and users, as well as those of some supposed family head or senior rightholder.

In an article entitled "Debts and Trespasses: Land, Mortgages, and the Ancestors in Western Kenya", Shipton addresses an urgent policy issue in a case study. Often believing that customary African landholdings were collectively held and organized, economic development planners have long held a theory about how to advance African agricultural production. This is that Africa's small-scale farmers need credit to adopt new crops, inputs, and techniques, and that private land titles should help enable them to borrow by providing a new form of collateral for mortgages. With this belief as a central rationale, and with foreign advice and funding, several African governments have begun trying to title farm land as private property, and others are gearing up to join their number. But their zeal is increasingly coming under question. Shipton's article, based on intensive field research in western Kenya in 1980-3 and 1991-2, shows how inappropriate the freehold-mortgage approach proves to be for one particular tropical African setting.

Kenya's land titling program, launched under British rule in the mid-1950s and still continuing under the independent government, has been the bellwether for land titling in Africa south of the Sahara. The first of nationwide scope, this attempt to transform complex systems of interlocking individual and group rights into alienable individual property on a European model has been closely watched. A mounting body of evidence shows that the program has failed to achieve most of its economic and agronomic goals and in some ways yielded results opposite to those intended. The experience of nearly three million Luo-speaking farming people and other large neighboring farming groups of the Lake Victoria basin, as documented by Shipton, illustrates why the titling process is so difficult and why tying credit to liens on land creates difficult, often unexpected problems.

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The reasons are cultural, economic, political, and sometimes agronomic. Like most peoples south of the Sahara, western Kenyans were never truly communalistic or individualistic in landholding. With a system based on patrilineal kinship, hosting of in-laws, and other principles, Luo men tend to live among relatives, and women move to live with their husbands after marriage. Farmers justify land claims mainly by labor, by the presence of ancestral graves, and by the kin group membership these represent. Individually held farmland reverts to community use for grazing after harvests. Titling rural land as individual property, even where it has become scarce, renders landholding allocation less flexible. Adjudicating competing claims to a plot can take years and open up old disputes while potentially preventing others.

Kenya's land registration places legal ownership almost exclusively in the hands of men farmers. As a result, women, herdowners, and dependents tend to lose important rights. Despite new paper titles and a new government land register, farmers continue to rely on local witnesses to support their claims. They almost never report to the government their inheritances, subdivisions, loans, swaps, or sales of land as the draftsmen of the titling legislation and program imagined. This is partly because the process is costly and time-consuming and the trust in central government almost non-existent. Shipton's research shows that the register quickly obsolesces. The market in paper titles becomes detached from real rights and obligations in land. Double dealing proliferates.

Because western Kenyan farmers tend to live surrounded by kin, lenders who take land as security have found it nearly impossible to foreclose on defaulters. Relatives of the dispossessed have many ways to prevent just anyone from taking over the land to farm. Sometimes it happens violently, even right at the auction.

Shipton's research also identifies a number of other problems in conventional exogenous finance. Credit means debt. It also means patronage — whether at international, national, or local levels. Neither public nor private financial institutions have overcome the great cultural, political, or pragmatic difficulties of lending to small farmers for staple food cropping or most other farm activities. These people have important debts and obligations of their own already, some quite subtle and long-term. Rainfed agriculture south of the Sahara, and in the drier zones in particular, tends to be too risky to allow reliable repayment of institutional loans and interest. Lenders shy away from smallholders. The promise of credit proves largely illusory. Aid strategies based on saving and investment, and on nonfinancial interventions, hold more promise.

In summary, Shipton's contribution to the journal issue he and Goheen edited suggests that farm credit is not the answer to rural poverty, and that land titles are not the key to farm credit. The dream of a mortgage system for rural East Africans, an imported model with little local basis, mirrifies neither the

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BY ALEX DE WAAL

# THE SHADOW

Somalia is now a universal symbol of an African basketcase. In fact, despite official statistics showing the country to be in a state of chronic disaster throughout the 1980s, the economy was thriving. But it was not the easily measurable economy. Instead, it was a hidden economy—comprising black marketeering, smuggling, corruption, stolen food aid, most of it in the hands of various elites—and it is prospering today as the political and social structures of Somalia continue to disintegrate.



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A decade ago, a group of international consultants studying the Somali economy wrote that the common perception of Somalia was that it "is widely regarded as a hopeless case...The formal economy has been in crisis since at least 1978, the Somali indigenous private sector is generally regarded as inefficient and static...Agriculture in Somalia is generally considered to be inefficient, environmentally destructive and more or less permanently in a state of crisis."

Such prophets of doom may believe they have been vindicated by Somalia's recent catastrophic famine and political collapse. They would be utterly wrong. For a start—as acknowledged by the group of consultants brought together by Boston University—the "doomed economy" scenario was false. In fact, Somalia's economy was dynamic and relatively wealthy—but largely outside the formal sector. The cause of the current disaster was not the poverty of the country, but instead the way in which economic dynamism was forced underground. An alternative economy grew up, centered on a small elite group with close connections to the president, operating like a mafia, relying on secret and nonlegal dealings, family connections, and the sanctions of violence. Deeply intermeshed with the abusive and dictatorial regime of former President Siad Barre, this shadow economy prospered while the country disintegrated. It continues to thrive, remarkably unchanged and intact.

The evidence for a vibrant economy was on display in Mogadishu and the other main towns throughout the 1980s. New Toyotas jammed the streets. The shops were full of consumer goods, such as Western clothes and household electronic appliances. Salaried officials whose

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official pay packets would scarcely cover a month's staple food could be seen living in relative affluence, apparently enjoying the fruits of a full-scale if somewhat erratic economic boom.

In the rural areas, official statistics pointed to a chronic disaster: a life expectancy of 41 years, an infant mortality rate of 177 per 1,000, and calorie consumption grossly inadequate for healthy living. The nomadic pastoralists, who comprise the majority of the population, were characterized as particularly badly off: lacking housing, schooling (education expenditure averaged a miserable $2 per head), and facing starvation if the rains failed. However, again, visible appearances indicated that the pastoralists were well-nourished and even prosperous. Rather than the dejected and desperate people one would have imagined from the picture implicit in the statistics, rural Somalis were enterprising and hopeful, busy with a range of productive and trading activities.

The answer to this paradox is now well-documented. The official statistics failed to capture the most important and dynamic elements in the Somali economy.

The income figures for pastoralists were particularly low, often below $100 per annum per head. As the economist Vali Jamal pointed out, "some of the figures advanced are so bizarre that a sizable percentage of the population fails even to obtain sufficient calories to sustain basal metabolic rate." Jamal revised these figures by the simple expedient of adjusting the official figures for milk production by animal herders to bring them into line with the amounts known to be consumed by those herders. Milk production estimates instantly rose six and a half times, and pastoral incomes more than doubled. Total gross domestic product rose 68 percent.

This was only a beginning. A second revision required taking into account the earnings of the estimated 200,000 to 250,000 Somali migrants in the Arabian peninsula. The importance of the remittances of these people, and the consumer goods they imported into Somalia on the franco valuta system (whereby traders were given the freedom to import consumer goods using their own foreign

exchange) had long been recognized, though not incorporated into official statistics. Vali Jamal, using very conservative estimates, calculated that two-thirds of urban Somali income originated from remittances from abroad, amounting to about 40 percent of GNP.

The multiplier effect of these unrecorded transactions also needs to be taken into account. The income from remittances and "illicit" trade was a major source of employment. The Boston University group estimated that the value of wage labor in the Somali economy was underestimated by between four and 20 times.

The aggregate impact of revising our picture of the Somali economy to take account of these mismeasure-

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*The food needs of the destitute should be met by buying food inside Somalia*

ments is quite staggering. Jama's calculations suggested that the 1982 GNP per head was over $400—higher than the official figure for Kenya, which is often pointed to as an economic success story in Africa.

Another important facet was foreign aid. After Siad Barre was abandoned by the Soviet Union in 1977 and decamped to the Western bloc, Somalia became the largest recipient of foreign aid per capita in sub-Saharan Africa. Much of this consisted of exceptionally generous food aid, intended for refugees from Ethiopia. The Somali government put the refugee numbers at 1.3 million—in fact, half that number would have been a more realistic estimate. However, full rations were provided for the inflated number for most of the 1980s. The extra went into the pockets of government officials, traders, the military, and the guerrillas of the Western Somali Liberation Front. The WSLF was fighting the Ethiopian government until 1983 and thereafter acted largely as a counter-insurgency militia on behalf of Siad Barre. A report by the U.S. General Accounting Office in 1986 estimated that under 20 percent of the food was actually consumed by the refugees. Other assistance was provided for ambitious development projects, most of them located in the main cities and the southwest. At its peak, this aid matched the amount of the entire formal economy. When included in the calculations for national income, it is possible that Somalia would have then broken the $500 per head barrier and count as a "middle income country."

This wealth should have ensured the country's prosperity. Unfortunately, it contributed to disaster. A small elite benefitted hugely from this booming hidden economy, while others did not. This elite engaged in non-legal and unsustainable commercial activities. When harder times came, with recession, drought, and a cut-off in foreign aid, they could only preserve their incomes by resorting to corrupt and violent practices.

One of the most important illicit activities was cattle smuggling to Kenya. This became particularly important after Saudi Arabia banned the import of cattle from Somalia in 1983 because of (unfounded) fears of rinderpest. During 1987 and 1988, it is estimated that unofficial cattle exports to Kenya ran at a level six times as high as official exports through Kismayo port, amounting to about 50,000 head of cattle. Moreover, the returns to middlemen for the illicit export of cattle were about twice those for official exports, and also well above earnings for sale to Mogadishu. As in all forms of illegal or semi-legal trade, organization was founded upon the twin principles of family membership and the ability to enforce contracts through force of arms. Competition between the Maxamad Zubeer subclan of the Ogaden clan and the Harte of Kismayo was particularly intense, laying the basis for the violence between these groups in 1992-3. As the profits in the cattle trade slumped after 1983, acquiring and maintaining monopolistic control over cattle exports became increasingly essential, and competition became harsher.

Other forms of smuggling were also extremely profitable, especially after restrictions were imposed on the franco valuta system in the early 1980s. These consisted


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of both bringing in consumer goods and exporting or transiting ivory and gems.

Throughout the 1980s, there was fast-growing demand for food, especially vegetables, in Somalia's urban centers. The best land for cultivation was occupied by the Rahanweyn, Digil, and Bantu—traditionally disadvantaged and often despised groups, who had little access to state power. Though farming incomes certainly increased substantially during the late 1970s and early 1980s, with the economic crisis of 1983-84, more powerful groups were eager to take advantage of the opportunities for profit provided by farming, especially in irrigated areas. This was a time of large-scale land grabbing. According to the 1975 land reform, all land had to be registered with the central government for ownership to be proved. This was an extremely expensive and time-consuming business with no guarantees of success, unless one happened to be wealthy or well-connected in the ministry of agriculture.

The Rahanweyn, Digil, and Bantu faced great difficulties in registering the land they had cultivated for generations; Marehan kinsmen of Siad Barre and other powerful groups were able to register large tracts of land with ease. If these lands were already cultivated, then the existing farmers were frequently forced off at gunpoint. For example, 43 families inhabiting the village of Hufey in the upper Juba valley were dispossessed of about 150 hectares of land by a group of armed Marehan in July 1983, and forced to cultivate a mere nine hectares nearby. The new Marehan owners established a cooperative farm, registered in their name as "Nasibwant," which translates as "lucky break."

Violent tactics and trickery were also used to ensure that the marketing of vegetables and other produce from farms was kept in a few hands. The supply of essential inputs—irrigation, pumps, trucks—was controlled by a relatively small number of urban-based merchants, most of them from the Marehan, Hawiye, or Harte, who protected their oligarchy vigorously. The non-legal import of the stimulant khat was also a source of profit.

The authority to issue trade licenses and other concessions—including the printing of money—was an important source of income for those in government.

Control of foreign aid was another route to self-enrichment. The massive diversion of food aid has already been mentioned. Development aid was no different.

An excellent example is the Baardheere dam. This was envisioned as the centerpiece of Somalia's economic development, to irrigate up to 200,000 hectares and supply electricity to Mogadishu and other cities. No matter that soil scientists warned that the irrigated farmland would rapidly become saline and useless, and that economists calculated that the electricity generated would be far in excess of Somalia's total national demand, with no prospect of exporting to neighboring countries, while substantial areas of fertile farmland would be flooded. The dam's contribution to national development was almost certain to be negative. The real value of the project lay in its cost—over $750 million—to be borne by foreign donors, who would thereby provide lucrative contracts to Somali, Italian, and other companies, and massive payoffs to government officials. World Bank objections to the scale and cost of the project were overridden in March 1986 when the Italian prime minister, Bettino Craxi, visited Mogadishu and the relevant government department was upgraded to become the ministry of Juba Valley development. The monumental environmental, economic, and social disaster that would have been the Baardheere dam was prevented only by the war.

Similar practices operated to broker deals for factories in Mogadishu, plantations in the lower Juba Valley, etc. Even these central elements of the formal, measured economy were, for the Somali government and businessmen, essentially facets of the shadow economy.

The economic policies forced upon Somalia by the Western donors aggravated the situation. The IMF analysis of the economy was based upon the official figures, which were grossly misleading. IMF analysis implied that the central problems were excessive government expenditure and regulation, an imbalance on the current trade account, and inflation caused by a fast-increasing money supply. This is a typical diagnosis of the ills of an African economy. The medicine prescribed was familiar—a structural adjustment program, with severe deflationary consequences for the formal economy, and repeated devaluations of the Somali shilling.

This remedy was harmful. Given that the majority of the foreign exchange transactions involving the Somali shilling were carried out by expatriate Somalis and currency dealers, any attempt by the government to reestablish control over the value of the currency was doomed to failure. Moreover, deflating the formal economy merely drove entrepreneurs into the informal economy. Ordinary people were also driven to engage in illegal or semi-legal activities. While prices rose by a factor of 35 between 1970 and 1986, government salaries hardly rose at all—a recipe for forcing employees to look elsewhere for income.

A more realistic set of economic policies would have been based on legalizing—and taxing—the profitable sectors of the economy. In fact, the reverse occurred. The late 1970s and 1980s saw most of the profitable business in Somalia removed from a public, legal, and accountable arena to a shadowy realm where mafia-like cartels operated, using governmental connections, family loyalties, and the sanction of violence, to make large amounts of money. The beneficiaries of this process were largely those with access to government offices and foreign currency.

The losers were the politically marginal. Important groups of losers were the Rahanweyn, Digil, and Bantu. These groups are farmers living in the fertile area between the Juba and Shebele rivers. Between 1980 and 1985, they succeeded in doubling grain production, and


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putting the country on the road to self-sufficiency in food. This, however, merely made them prey for better connected and better-armed commercial predators.

By the late 1980s, the state and the commercial elites associated with it were obtaining their wealth, not through production, but by expropriation. This ranged from price gouging by controlling trading licenses to outright forcible dispossession of assets. Commentators quipped that Somalia was no longer a state—it was a process of commercial predation.

When Siad Barre was driven from power in January 1991, little changed except that the main government-centered options for obtaining wealth were unavailable. The smuggling of cattle and other goods has continued. The extortion of money and food from aid agencies has continued. Protection rackets have continued. The most extreme form of forcible asset transfer—looting—has also intensified.

Looting is not a random occurrence, though its perpetrators plan to be as unpredictable as possible, to make defense as difficult as possible. Looting is organized. In the cities, looting takes the form of systematic commercial acquisition of goods with a resale value—starting with electronic consumer goods, moving on to furniture, light industrial goods, then metals (for instance copper wiring and aluminum). Much of this has gone for export, to Kenya, Sudan, and the Arabian peninsula. The most comprehensive and profitable looting was carried out immediately after the flight of Siad Barre, with subsequent bouts whenever there has been a new round of fighting, as each militia loots property belonging to the others.

The option of small-scale freelance banditry means that militia commanders and financiers do not need to pay their gunmen when they do not need them for military action or commercial looting. Ironically, banditry often decreases when organized fighting takes place.

In the rural areas, looting has consisted chiefly of armed roadblocks for extorting payment from merchants, and organized night-time attacks on villages. Most looting is carried out when there is no armed combat between militias—it is not an offshoot of fighting, but how the militias and their leaders sustain themselves. The Juba Valley and the Bay Region have suffered the most from looting by militias. This has been due to the numerous waves of occupying forces that have crossed the area, including Siad Barre's Somali National Front, several factions of the Somali Patriotic Movement, and Gen. Aidid's United Somali Congress. None of the local groups has been well-enough armed to resist. The massive systematic looting carried out by Siad Barre's forces in March-April 1992, on the eve of their military defeat by Aidid, was the final factor in creating the famine that has ravaged the area.

Just as in the 1980s, the diversion of food aid remains an important source of income for armed groups—only this time without the tacit consent of the donors.

Meanwhile, competition for the possible future benefits of state power intensified. Government office is a license to print money. It is no accident that two of the main clashes between interim President Ali Mahdi Mohamed and Gen. Aidid were sparked by incidents in which Ali Mahdi tried to bring in planeloads of bank notes. Ali Mahdi's huge number of ministerial appointments (over 80) owes as much to the need to offer the prospect of future economic rewards to his allies as the need to build clan alliances.

This degeneration of the Somali economy into commercial predation has profound implications for the future rehabilitation of the country.

It is now widely understood that the politics of warlordism in Somalia is no more than a logical extension of Siad Barre's methods of wielding power. There is a pressing need for a process of national reconciliation, but a top-down process based upon reconciling warlord politicians who are widely reviled as war criminals risks reestablishing the same sort of authoritarian clientistic rule as existed before.

Similarly, the economics of looting, smuggling, and extortion are no more than a continuation of what has gone before. The process of a shrinking formal economy and an expanding hidden economy has reached its logical conclusion—Somalia has no national accounts and no official gross national income at all, but the markets are well-stocked, most people can obtain the essentials of life, and some are continuing to prosper—while the weak starve.

There is an urgent need for economic reconstruction. But most donors envisioned this as awarding big aid contracts to rehabilitate the physical infrastructure of the country, to restart the large "development" projects together with token aid to smallholder farmers and poor pastoralists, and to continue shiploads of free food. Everyone will doubtless call for "more aid." But Somalia is no aid virgin: quite the reverse. Aid to Somalia has been part of the problem, not part of the solution.

The reconstruction of Somalia calls for a degree of imaginative thinking that is rarely found in the aid world. Certainly, the foundations for a new economic system should be sought from the bottom up. Regulation of trade should not be placed in the hands of a central government, but in local, accountable leadership. Planning development projects should also be decentralized. The process of building a national economy can proceed from there. This may make it difficult for aid agencies—but the exercise is not designed for their benefit.

It is important that free food aid be stopped as quickly as possible. The famine-stricken areas are almost exclusively the farming areas, where people rely on selling food for an income. The moment there is a prospect of a harvest—and experience of other famines suggests that this will come much sooner than anticipated—food relief should be reduced as much as possible. The food needs of the displaced and destitute should then be met by buying food inside Somalia, helping the farmers rehabilitate themselves. ○



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# Africa focuses on internal weaknesses

By Salim Lone in Dakar

Africa's marginalization in world affairs is primarily a result of its proliferating internal conflicts and diminishing capacity to manage its own affairs, a conference of African leaders, scholars and senior UN officials concluded. Almost all participants asserted that as long as Africa remained heavily dependent on the outside world and was unable to put an end to the strife which was claiming the lives of tens of thousands and threatening the survival of nations, it could not hope to expect the world to pay it more attention.

There also was agreement among the participants that Africa needed to look to its own traditional mechanisms for answers to its multiple challenges.

Despite the conference's focus on Africa's internal factors and responsibilities in the continent's renewal, the role of the World Bank and the International Monetary Fund (IMF), were the subject of contentious debate.

The conference was convened in Dakar, Senegal in November by the African Centre for Development and Strategic Studies (ACDESS), a major new African "think tank" founded by Professor Adebayo Adedeji, former Executive Secretary of the UN Economic Commission for Africa (ECA), and presided over by Mwalimu Julius Nyerere, the former President of Tanzania who is now Chairman of the South Commission.

The themes the participants focused on included self-reliance as the only basis on which Africa could hope to become a respected player on the world stage; the importance of Africa's precolonial heritage in the search for durable strategies for democratization and for political renewal; the impact on Africa of the rapid changes in the world following the end of the Cold War; and an assessment of the impact of the Bretton Woods institutions' policies and conditionalities in the areas of debt and trade, and on human well-being generally.

### Self-reliance

The tone for the three-day conference was set by Mr. Nyerere, who stressed that Africa's 600 million could not be marginalized if they were self-reliant. "Can anyone imagine a conference on the marginalization of Asia?" he asked. The lack of serious international concern about Africa was rooted in the continent's own weaknesses, he said, and as such began much earlier than the end of the Cold War, an event which merely accelerated the region's "involuntary delinking" from the international mainstream. There was no alternative to self-reliance, Mr. Nyerere asserted, contending that additional external resources were not in any event available. He emphasized that self-reliance should not be confused with self-sufficiency, since no nation could achieve the latter.

He went on to say, however, that while developing countries should stop looking to the outside world for assistance, they should continue to demand a system which does not transfer money from the poor to the rich.

A number of speakers pointed to the need to study carefully the continent's history as a source of sustainable strategies for economic and political revival, a theme pressed by th eminent historian Mr. Basil Davidson in an ir augural lecture. There was severe criticism i this regard of much of the continent's pos colonial leadership, which on the whole ha continued with colonially-imposed politic institutions holding little meaning for mo Africans. For example, the tradition of rule b consensus was ignored by the new leaders.

Another theme that ran through the discu sions was the impact of donor policies, i particular of the World Bank and IMF, o Africa's efforts to overcome its prolonge economic crisis. There was agreement th economic reforms were essential, that finar cial discipline and management had to b strengthened. But most speakers oppose other aspects of donor policies, arguing th they were formulated by o ficials unfamiliar with th political and social realities the countries over who policies they had so much i fluence. There was pa ticularly sharp criticism the donor emphasis on e ports, since it was acknov ledged that the demand ar prices of the commoditi Africa exported would co tinue to be poor. Lack of a tion on Africa's debt, whi now consumed $26 bn a ye to service, was also criticize as was the proliferation conditionalities, which no went well beyond ha macro-economic demands.

Senior officials from the United Natio were, on the whole, not in agreement with th critique, contending that while structural a justment programmes had many weaknesse they were indispensable to the continen economic recovery and to obtaining extern resources for development.

The bulk of the discussion revolved, ho ever, around what Africa itself needed to do it was to reverse the impoverishment of people as well as its marginalization. All pa ticipants agreed that only a human-centr development strategy would succeed in doi this. Hence, governments must reverse th sharp cutbacks in expenditures on heal education and other vital human needs.

Reflecting the candid nature of the discu sions, Dr. Nthato Motlana of South Africa gued that the salaries of many African worke

Ousmane Sack

*Participants at the ACDESS conference included, from left: Mr. Louis Emmerij, Director, OECD Development Centre; Mr. Pascal Gayama, Assistant Secretary-General of the OAU; and Mwalimu Julius Nyerere, ACDESS President.*



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were unrealistically high.

In stressing the need for human-resources development as the key to Africa's economic recovery and transformation, many participants pointed to the continued need to educate policy-makers about the multiple roles women play within the household and community, particularly in agriculture. The best way to meet the priority continental aim of food security was to strengthen women's productive potential.

**Popular participation**

Popular participation by communities in local and in national decisions was an essential first step in ensuring the adoption of human-centred policies. But democratization was not possible without education, without meeting a population's basic needs, and without an independent media. Many participants referred to the African Charter for Popular Participation, adopted in Arusha in February 1990, as a watershed in its time, which had brought democratization into the mainstream of official African thinking.

At the same time, it was pointed out that the democratization and accountability which donors frequently demanded of African states, must also be practised at the international level, including at the United Nations and particularly the Bank and Fund.

Such views were put forth not only by Africans but also most energetically by Mr. Louis Emmerij, the head of the Development Centre of the Organization for Economic Cooperation and Development. Referring to the West's "immobility" in the face of the changes taking place around the world, he said Africa and other developing regions were better at practising (perhaps overzealously) what the North preached on privatization, open trade, etc. Yet, action promised to Africa on debt had still not transpired, and no one even mentioned the issues of deteriorating terms of trade and falling commodity prices.

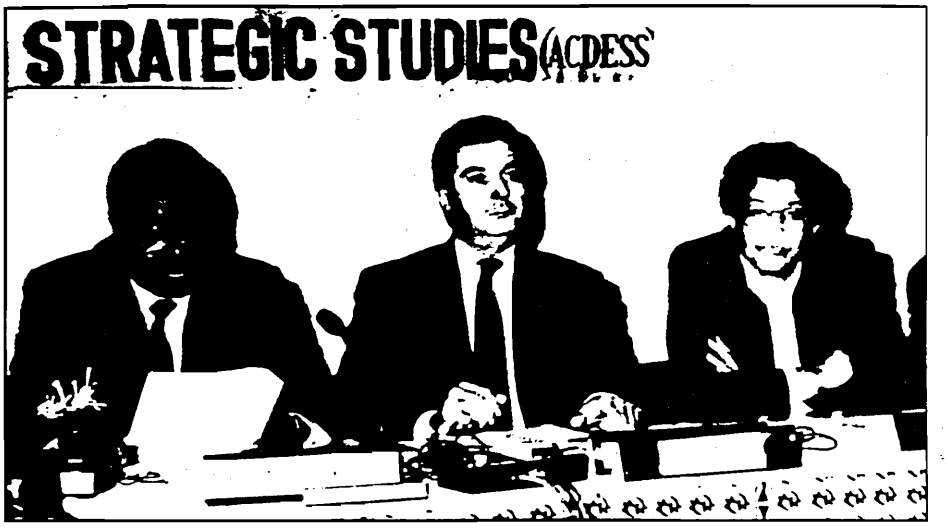
**"Policy-making is being ceded to outsiders because of our diminishing capacity to do things for ourselves."**

Adebayo Adedeji

Effective integration at regional and sub-regional levels was clearly recognized as being essential to Africa's revival. Many states were too small to be economically viable and economic integration would help resolve border disputes as well.

There was recognition that many current economic and development policies were dangerous for the environment, and a more explicit ecological model for African development needed to be formulated.

Finally, the theme of security permeated all discussions. Speakers emphasized repeatedly that the notion of security had to encompass political security, democratic freedoms and development. Each one of these needed the other two elements to be sustainable. An urgent solution to the growing number of inter- and intra-state conflicts was therefore paramount, and the OAU needed to play a much greater role in preventing and resolving conflicts in Africa.




*Prof. Adebayo Adedeji, ACDESS Executive Director, speaking at the conference. To his left are Mr. Layashi Yaker, Executive Secretary of the ECA and Ms. Ellen Johnson Sirleaf, Assistant Administrator (Africa), UNDP.*

A number of participants condemned the attempts, partly fuelled from outside, to abort peaceful democratic change in Angola.

Professor Adedeji in his statement said that Africa's marginalization had been brought about by "our diminishing capacity to do things for ourselves. We have only ourselves to blame for a situation in which policy-making is gradually being ceded to outsiders ... We need a new national order which will not, as at present, be a mirror of foreign values."

In conclusion, it was agreed that sustainable development would come only from within; and that the goal of all policies should be to improve the human condition and develop the continent's human resources. It was meeting the needs of each nation that would provide the engine of growth in Africa, rather that export-oriented strategies. As Mwalimu Julius Nyerere said, "Societies are living things, they grow from the inside."

The conference concluded with strong expressions of support for ACDESS, with many participants saying that it was ideally placed to contribute to the process of African renewal through deeper study of the causes of social, economic and political malaise as well as of the means to reverse it. To achieve this, ACDESS was urged to forge links with, and strengthen, networks among people's organizations and the academic, research and policy-making communities. ■

## South Africa's Impact on Africa

**As part of its overall concern about economic cooperation and integration in Africa, ACDESS is studying the impact of post-apartheid South Africa on the rest of the continent. While there has been widespread interest in how post-apartheid South Africa will influence developments in Southern Africa, no major study has focused on its impact on Africa as a whole.**

**ACDESS will work with the ECA, OAU, the Swedish International Development Agency (SIDA) and four South African institutes which will be represented at the first project meeting in March in Ijebu Ode, Nigeria: the Centre for Southern African Studies at the University of the Western Cape (Prof. Robert Davies); the Africa Institute of South Africa (Dr. Stef Coetzee); the Institute for African Alternatives (IFAA) (Mr. Ben Turok); and the Institute for Democratic Alternatives for South Africa (IDASA) (Dr. Nthato Motlana).**



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# Developing the Chinese Rural Economy: Experience of the 1980s and Prospects for the Future

LU MAI and C. PETER TIMMER

*HIID Development Discussion Paper No. 428-AFP, August, 1992.*

The Chinese rural economy expanded more rapidly in the 1980s than any other in the world. It probably had the fastest sustained increase of any poor rural economy in history. This paper examines the reforms in policies toward the rural sector that began in 1978 and accelerated in the early 1980s. These reforms have transformed rural institutions, improved financial incentives for farm households, stimulated a unique boom in rural industries, and ultimately produced an extraordinary record of economic growth and reduced poverty.

The Chinese rural reforms emerged tentatively as experiments by small groups of farmers, sometimes encouraged by local officials, but often in direct violation of existing directives from Beijing. When the central government gave the green light for this process of experimentation in the early 1980s, the rural reforms gained momentum in several directions. The Office of Experimental Zones was established to study the types of reforms that seemed to work best and eventually carried out experiments on its own. Many of the policy recommendations set forth in this paper emerged from the results of these endeavors.

***The dual price system that permits the government to buy substantial quantities of grain at prices below which peasants could sell it for in the market also acts as a significant disincentive to increase production.***

Establishing a system of land ownership is perhaps the most difficult and controversial area of reform. Although private land ownership is often thought to maximize the efficiency of land use, many peasants feel that equitable redistribution of land assets is necessary as the rural population continues to increase. Complex leasing arrangements with various forms of tenure are being tried in several areas to determine their acceptability to peasants and to assess the impact on land productivity. Whatever forms of land ownership are ultimately implemented, providing a solid legal foundation to the rights of peasants is essential.

Reform of grain price policy also poses difficult problems. In the early 1990s, China had an irrational system for setting grain prices. Procurement of grain by the government in rural markets to supply urban ration shops often destabilizes price formation. The dual price system that permits the government to buy substantial quantities of grain at prices below what peasants could sell it for in the market also acts as a significant disincentive to increase production. A major reform of grain pricing policy and programs is necessary, with specific attention being given to wholesale channels controlled entirely by government agencies. The Chinese case suggests that the goal should be a competitive market structure and a single price that follows the trend in world markets.

**Lu Mai,** *a Research Associate at HIID, is the former director of the Experimental Zones Office in the Research Center for Rural Development, of the Chinese state council.*

**C.Peter Timmer,** *a Faculty Fellow at HIID, is Harvard's Thomas D. Cabot Professor of Development Studies, At-Large. His Ph.D. is from Harvard University.*

If a single market price is established for grain, the system of collecting agricultural taxes could be reformed. The authors' research suggests that the taxation of land is regarded as unfair, in that grain farmers pay 80 percent of the tax but produce only 27 percent of agricultural output. It is reasonable for the government to collect grain taxes in kind to procure supplies needed to stabilize urban markets. But the reforms of land ownership, grain pricing, and the agricultural tax system should be implemented gradually in a coordinated fashion.

The last two areas for policy reform reviewed in the paper are the institutional framework for supporting rural enterprises and the role of rural cooperative organizations. In China the ownership of rural enterprises is nearly always ambiguous. These irregular financial relationships between enterprises and local governments reduce the funding for investment, confuse cost structures and legal status, and offer many opportunities for corruption. A series of steps to clarify this confused situation is outlined by the authors, the most important of which is to establish legal property rights in the form of shares for owners. They suggest that such rights should also spell out economic relationships and managerial responsibilities.

The role of rural cooperative organizations has become unclear since the demise of the People's Communes. Yet many resources that belonged to the communes or their units remain under the control of local authorities because these resources were difficult to divide up among households as part of the responsibility system. In addition, farm households need many services that can best be provided on a collective or common basis, such as construction of rural infrastructure, irrigation management, local schools, and clinics. Local governments do not yet have the authority or responsibility for managing these tasks, nor do they have the financial resources to carry them out. Significant reform of local government is needed to solve this problem, and recommendations are spelled out in the paper.

The degree of support from the central government in the form of public investments, the policy for development of agricultural technology, and efforts to reach poor and backward areas by advancing production are identified by Lu and Timmer as key elements of the broader context for rural modernization. Perhaps not so obvious, but equally important in the longer run, are policies toward reform of state enterprises and the role of rural migration in supplying urban labor markets. Huge losses by state enterprises threaten the positive macroeconomic environment on which the rural economy depends. But opening up the formal urban economy to rural workers might make the task of restructuring even more difficult.

China's step-by-step approach, as reviewed in this paper, is known as "crossing the river by touching the stones." It can be contrasted with the more radical efforts to move immediately to a privatized, market economy in Eastern Europe and the CIS states. In contrast to the economic collapse witnessed in European socialist countries, the Chinese success in stimulating rapid economic growth *because* of the reform process should alert economists to the importance of "time" in the reform process. Time is needed for institutional reforms to be designed and implemented. Equally important, time is needed for socialist governments to learn how to manage a more market oriented economy. The explicitly experimental approach in China provides this learning experience with a minimum of disruption to the economy. ■

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news release

Inter-American Development Bank
1300 New York Avenue, N.W., Washington, D.C. 20577 (202) 623-1000

FOR IMMEDIATE RELEASE February 4, 1993

SEMINAR ON JUSTICE IN LATIN AMERICA AND THE CARIBBEAN OPENS

Forum examines the role of law in the process of economic development

SAN JOSE, Costa Rica — The law must be an instrument of development and a vehicle of justice, today declared Costa Rican President Rafael Angel Calderon Fournier at the opening of the first international seminar on justice and law in the process of economic development and the solution of social problems in Latin America and the Caribbean.

The forum, "Justice in Latin America and the Caribbean in the 1990s. Challenges and Opportunities", is organized by the Inter-American Development Bank in this country's capital, San Jose, from February 4-6. It brings together ministers of justice, supreme court chief justices, magistrates, public prosecutors, attorneys general and other representatives from 25 member countries of the Bank.

IDB President Enrique V. Iglesias also spoke at the event's opening session. Edgar Cervantes Villalta, Chief Justice of the Costa Rican Supreme Court; Elizabeth Odio Benito, Costa Rica's Minister of Justice; and Adrian Vargas Benavides, Costa Rica's Attorney General, also attended in representation of the host country.

President Calderon noted: "On the path to development, the law must serve as both an instrument of change and a vehicle of justice. It must be used not to defend the status quo, but rather to open the door to a new century in which societies are more just and more humane. In short, the law must promote development, not hinder it."

"We have left behind the era of the Cold War and conflict between opposite ideological blocs. Despite the obstacles and problems that persist, throughout the world a new era is being ushered that is characterized by a tendency towards the globalization of economics, politics and culture, the creation of economic zones and the consolidation of more democratic, more developed and more just societies. This new era has now reached our hemisphere --more specifically Latin America," added Calderon.

IDB President Iglesias observed that this forum represents, for all intents and purposes, the first time that the Bank has organized a program about the law and the development process: "But we have not undertaken this endeavor in a haphazard manner nor with little consideration. On the contrary, more than 30 years of experience and the recent evolution of the countries of Latin America and the Caribbean, in particular, have shown us more clearly than ever before, that development does not take place in an institutional vacuum, but that it is closely connected to the nature of the State, how its institutions are organized, and, in a broad sense, to the process of government."



The IDB President added that, in that context, modernization of the law and the administration of justice are vitally important. This seminar, he declared, provides an opportunity to review the main challenges faced by law and justice in Latin America and the Caribbean within a changing social and economic environment, challenges that are immensely varied and highly complex. They include the need to make the operation of the legal system "more compatible with the new conditions of development, the culture of our society and the education of the citizens," he said.

Iglesias added: "The law cannot be dissociated from the emerging trend towards globalization and worldwide interdependence; Latin America's growing openness to the rest of the world; the increasingly active presence of various transnational forces in society and within the economic sphere; the scope and speed of international financial transactions; direct foreign investment; the processes of privatization and deregulation currently underway; the problems posed in turning women and young people into modern society's full partners; and the challenge of enabling vast marginalized populations in Latin America to participate fully as productive citizens."

The IDB President emphasized that another important function of the law in the development process is to help alleviate poverty. "In effect, the latter is largely due to problems that should be regulated by labor law, family law, criminal law, and the rehabilitation of delinquents," he noted.

"Nor must we forget that the law has been instrumental in making integration processes possible throughout the world, particularly in Latin America," he added.

"The majesty of the law, whether through jurisprudence or the courts, requires that it and the institutions that formulate or enforce it have the necessary authority and independence. However, this cannot be taken as an invitation to act in disregard of society. In our present age, citizens make their presence felt throughout the process of modernization, reshaping and flexibilization of the law. It is our hope that this seminar will contribute to creating an awareness and that it will act as a forum for sharing solutions to this challenge," Iglesias declared.

President Iglesias concluded by stressing that the IDB has decided to work more actively in the area of law and justice.

The main topics of the forum will include the administration of justice in Latin America and the Caribbean; legal training and the legal profession; justice and new approaches to economic development; justice and the globalization of law, and international cooperation in the administration of justice.

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OPINION

# Building Democracy for Haitians

By Michael Manley

WITH the advent of a new United States administration and the entry of the United Nations into the negotiating process, it appeared likely that a basis for the return of Haiti's President Jean-Bertrand Aristide would shortly be found.

However, recent events in Haiti have underlined the difficulty in achieving a restoration of constitutional government. The UN special envoy was virtually run out of the country by the de facto government and army. Clearly, it is going to take a lot more pressure than the present, leaking embargo to persuade the powers in place to negotiate seriously.

Furthermore, let us assume that there is the will on the part of the Clinton administration and the UN to exert the necessary pressure to restore President Aristide. There will still be the problem of how to create a viable democracy.

President Clinton has made it clear that he will not recognize any political arrangement in Haiti that does not include Aristide as president. For his part, Aristide has shown a willingness to compromise in the interest of a settlement, and given assurances that he will work for peace and harmony if and when he returns. Of immediate importance to the negotiating process, he has agreed to accept a prime minister from the ranks of the political parties that have opposed him.

On the other hand, the Haitian Army has still to be prevailed upon to accept the prospect of Aristide's return and the presence of a substantial UN observer force. Even if this happens, the danger will remain that the international community will seek a political settlement, restore Aristide, and then pass on to other items on the world agenda. It is even likely that substantial humanitarian aid might be forthcoming after Aristide's restoration. However, it would be a tragedy if the effort were to stop there.

The crisis in Haiti is reflected in both the difficulty of securing the election which put Aristide in power and in the speed with which he was toppled. Neither was an example of some historical aberration. They were symptomatic of a deeper Haitian problem. Nor is it enough to view this crisis as a product simply of the agonizing reality of Haiti's inadequate economy and its poverty.

At the heart of the Haiti's difficulties lies the absence of an adequate institutional foundation for civil society in the modern world. Generations of dictatorship and coups culminated in the extended brutality of Duvalierism.

**Though less dramatic than the horrors of Yugoslavia and Somalia, Haiti's problem can and should be solved. Its solution might provide new models for international cooperation.**

As a result, it has never been possible to maintain any semblance of stability, without which it is impossible to develop the institutions which form the basis o a viable social organization sup ported by appropriate political in stitutions.

The crisis of Aristide's remova and the possibility of his restora tion represent a challenge and ar attendant opportunity which may not quickly come again.

An international assistance program should be directed toward the restructuring, reorganizing, and modernizing of Haiti's institutions. Civil service personnel need training. Haiti has High Court judges of great ability but not the wider body of judges needed. The customs service needs modernization; extension officers are needed to start educating the small farmers and the rural poor before the hillsides are finally destroyed.

The army needs a training program aimed at making it professional, including reorientation away from its traditional role of "king maker" in politics. There is an urgent need for a program aimed at training of a separate police force under civilian control. At present, a wing of the army carries out police functions with all that implies for the abuse of civil rights. And the list goes on.

If a program of institution building is not mobilized and brought to bear there is a real danger that Haitian democracy will prove as fragile and vulnerable in the future as it has in the past. If, in addition to traditional aid, such a program of institutional development is begun, confidence in Haiti's future might emerge.

THERE are thousands of Haitians living in the US, Canada, and France – a reservoir of skill and patriotism. Some will return to help build their country if they feel their own investment in the future is part of a coherent program of development going beyond ordinary economic aid.

Though less dramatic than the horrors of Yugoslavia and Somalia, Haiti's problem can and should be solved. Its solution might provide new models for international cooperation.

Above all, in cases like Haiti the international community needs to commit itself to the "long haul" rather than the "quick fix." In Haiti's case a short-term approach guarantees that the "boat people" will be around for a long time. Now is the time to help a small but proud nation embark upon a path of institutional development without which no democracy can survive indefinitely.

■ *Michael Manley is the former prime minister of Jamaica.*

# A Brief Opportunity for Peace in Guatemala

By Rachel McCleary and Blair Ewing

THE recent repatriation of 2,500 Guatemalan refugees from Mexico signals a willingness on the part of President Jorge Serrano Elías's government to begin to address seriously the problems wrought by 30 years of civil war. An effective policy to assist in reform of the military and support democratic development in the tough case of Guatemala could provide the Clinton administration with an early success in promoting its new foreign policy on democracy and human rights.

External pressure from the United Nations Commission on Human Rights is, in part, motivating President Serrano to revive the peace process. Last year, the commission threatened to place Guatemala on its "gross human rights violators" list unless it took direct steps to address the abuses. Next month, the commission will be meeting in Geneva to reassess Guatemala's progress. In addition to external pressure, Serrano has domestic political reasons for repatriating the refugees. By allowing them to return, Serrano indirectly made concessions to the guerrilla group, Guatemalan National Revolutionary Unity (URNG), without directly confronting the Guatemalan military.

The Serrano government has agreed to international human rights verification, the allocation of land to the refugees upon their return, protection of the refugees from the military and the guerrillas, and protection from the forceable recruitment into the civil militias. The first two issues were key negotiating points for the URNG during the peace negotiations that are now stalled. In addition, Serrano has called for the URNG's participation in a 90-day negotiation at the UN to find a diplomatic solution to the civil war. Serrano further requested UN verification of a cease-fire if no settlement is forthcoming in those 90 days. The military, which believes the refugees are guerrilla sympathizers if not their active supporters, has opposed the repatriation. Last month, the Guatemalan Defense Minister, Brig. Gen. Jose Domingo Garcia Samayoa, threatened to arrest some of the refugees as rebel sympathizers.

GUATEMALA is a hard case for the United States because it is a nominal democracy. Although it has a freely elected president and congress, the society remains in the grip of a strong military that controls many essential political processes. Yet a fleeting opportunity exists to promote peace and human rights. Unless the US works expeditiously with the UN and the Serrano government to find a political solution to the civil war, the moment of opportunity will be lost. Refugees are moving back into areas of the Guatemalan countryside where the Serrano government does not have the means to guarantee their safety. The refugees will be living in temporary settlements until they can either purchase or regain title to their land. Without material support and protection by the international community, the refugees may face continued harassment.

As the most populous country in Central America with the largest armed forces and the most modern economy, Guatemala is an important and timely test case for the Clinton administration's promotion of democracy and the protection of human rights. In conjunction with the UN, the US should support the peace process that Serrano is reviving. By openly supporting Serrano's efforts and providing economic assistance not just to the refugees but to the Guatemalan population living in the region where the civil war has primarily been fought, there may be hope for a lasting peace.

Social reform in such a politically polarized society will naturally take time and patience. US policy toward Guatemala should be primarily designed to strengthen the Guatemalan president, the Congress, the judiciary, as well as other groups vis-à-vis the military. A necessary first step is to appoint a new attorney general who will prosecute human rights abuses no matter who commits them. We should also continue to support economic development coupled with conditioned aid. While recognizing that Serrano is to be applauded for his efforts to reform and professionalize the military, the US should insist that even stronger steps be taken to reduce political interference by the military. These forms of support should not cost the US very much. The key is mutual political will.

■ *Rachel McCleary, PhD., and Blair Ewing work on Latin American issues at the United States Institute of Peace.*

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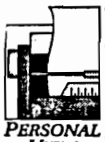
The Financial Times February 5, 1993

# Family emergency at heart of the UN



PERSONAL VIEW

There is a crisis in the international system for responding to humanitarian emergencies. To put it bluntly, when famine strikes, when conflict creates catastrophe, when refugees flee in large numbers, the international community cannot cope.

From the Iraqi Kurds, to the former Yugoslavia, to Somalia, humanitarian crises have provoked an important debate about the role and development of the United Nations. Yet that debate has covered every area except the one most relevant to humanitarian emergencies – the role of the UN's internal "family" of technical agencies.

All too often, the response of these agencies has been slow, bureaucratic and lacking in co-ordination. In the worst cases, they have been fatefully negligent. The recent history of the Horn of Africa provides several examples. When famine hit Ethiopia in 1984, for instance, there were hardly any contingency food stocks in place, because the UN agencies had ignored the previous year's warnings of impending shortage.

In 1988, when refugees from Siad Barre's brutal bombing of northern Somalia arrived in Ethiopia, their presence went undisclosed by local UN officials. Many died before, in the wake of donor pressure, the UN began to give aid. Then, in 1991, the sight of the Iraqi Kurds perishing on mountain sides, and the delays and mistakes that characterised that relief operation, finally moved the UN and its member states to make cautious reforms. However, following the deaths of hundreds of thousands in the Somalian famine, these measures stand exposed as woefully ineffective.

It is the UN agencies' inability to deliver that is at the heart of their failures, not a lack of resources. Unicef, the children's fund, has a $755m budget. UNHCR, which deals with refugees, had around $550m in 1990. UNDP, which has a brief of development but which often finds itself involved in emergency relief, had $1.4bn last year; and the World Food Programme (WFP) can dispose of the same amount in a two-year period.

It is this scale of resources, coupled with their status in the international system, that makes the UN agencies the pivotal element in the response to emergencies. When an emergency hits a developing country, the first line of defence is that country's own skilled workers – its doctors, nurses, engineers and public administrators. But if the country or the affected region is already poor, they may be overwhelmed.

**It is the UN agencies' inability to deliver that is at the heart of their failures, not a lack of resources**

International non-governmental organisations can play a part in "supporting" them, but cannot step in to save whole countries or regions from disaster. In a large-scale emergency it is normal to look to the UN agencies for the requisite scale of relief supplies, logistical capacity and expertise.

The member states of the UN have a right to ask whether they are getting value for the money.

Save The Children, which was closely involved in the emergencies discussed above, believes that a thoroughgoing review of the functions of the UN technical agencies is urgently required.

First, the mandates of these agencies should be re-examined. They were drafted, in many cases, more than 40 years ago, to cover the needs of the cold war era. They need updating both to incorporate increased understanding of the complex causes and dynamics of emergencies, and to cope with an era that, for many parts of the developing world, will bring insecurity, instability and dwindling resources.

Second, co-ordination must be made paramount. The clutter of overlapping responsibilities within the UN system must be cleared away. A single agency should be given the clear lead role in emergencies, and the UN enabled to act as an effective umbrella for the efforts of *all* workers involved.

Third, accountability must be introduced. All too often, failures are covered over, while those who voice criticism to try to improve things are disciplined or discarded.

Fourth, none of the above measures will have an effect unless the practical performance of the agencies in emergencies can be improved and confidence restored to the donors. This means, for example, ensuring that important posts are filled with people of proper competence as leaders and managers. It also means allowing much more autonomy to the good and experienced staff on the ground.

Finally, UN member states must recognise their own responsibility, not only to instigate reform, but to push it along through any obstacles, and to oversee the continuing performance of the technical agencies.

**Nicholas Hinton**

*The author is director general of Save the Children Fund*

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# U.S. AND GLOBAL

# MACROECONOMIC TRENDS

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## U.S. AND GLOBAL MACROECONOMIC TRENDS


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## IMF ACTIVITIES

*Managing Director's Address . . .*

# Camdessus Outlines Global Economic Problems And Opportunities in 1993 and Beyond

*Following are excerpts from an address given by IMF Managing Director Michel Camdessus at the Grande Conférence Catholique, Brussels, Belgium, on March 4, 1993:*

Before I begin my remarks, I would like to ask your permission to pay homage to one of your eminent compatriots who has just passed away. Baron Triffin, first within the International Monetary Fund and subsequently throughout his entire career, was one of the individuals who contributed the most to our understanding of the international monetary system; moreover, he had a profound influence on the evolution of the system in the post-war period.

He was a true European, and, more than this, he was a true "citizen of the world." I am convinced that the emphasis I wish to place this evening on the need for renewed international cooperation would have met with his approval.

I propose to examine with you this evening a strategy for world growth appropriate now, in the early part of 1993.

Let us examine for a moment the range of problems and opportunities before us; perhaps we shall be able then to identify better the paths toward progress: namely, cooperation and solidarity.

**Camdessus: the seeds of opportunity have been sown.**

Problems and opportunities: the first, it must be acknowledged, are more obvious than the second. The problems are with us here and now, and perhaps tomorrow as well if we fail to attend to them; the opportunities, on the other hand, are for tomorrow, but the seeds of opportunity have already been sown and we need only nurture them to maturity. Problems? Let us examine five major problems, which together create a sixth, because they undermine confidence.

The first, obviously, is weak growth in the industrial countries. It is true that in the United States there have been increasingly encouraging signs of a strengthened recovery; but even there, doubts persist about the sustainability of the expansion and the prospects for a reduction in unemployment to more tolerable levels. Meanwhile, recession is now striking Japan and Europe, with unemployment in Europe continuing to increase rapidly. According to our projections, output in the industrial countries will grow by 1½ to 2 percent in 1993. After several years' dismal performance, growth in Europe will be barely positive: below 1 percent. It is hoped, of course, that there will be a turnaround in 1994, but we know full well that from now on, growth alone will create fewer jobs than it once did.

Second, the recent turbulence in exchange markets and destabilization of the European Monetary System (EMS). The exchange market crises of the past six months have disrupted the EMS, raised doubts about progress toward monetary union in Europe, and given rise to broader uncertainties. In recent weeks, tensions within the exchange rate mechanism have eased considerably, but there are still large interest rate differentials, indicating that confidence is far from fully restored.

The third object of concern is increased tensions in international trade. The Uruguay Round remains deadlocked, and while everyone is repeatedly stressing good intentions, the only real news is of countervailing and antidumping measures and voluntary export restraint agreements. At best these are but palliatives, and in some cases are tantamount to out-and-out protectionism.

Fourth, Russia and the other formerly centrally planned economies face problems in their transformation efforts. I am happy to say that several Eastern European countries have been showing early signs of success, and that in Eastern Eu-



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rope as a whole (excluding the former Soviet Union), moderate growth is expected in 1993, for the first time in five years. But because they started their transition later and inherited problems of unprecedented scope and seriousness, most countries of the former Soviet Union still face formidable difficulties. In Russia in particular, hyperinflation and its customary companion in arms, capital flight, are making it particularly urgent to adopt wide-ranging macroeconomic stabilization measures and structural reforms, which are difficult to introduce in the midst of unrelenting institutional debate. Will Russia manage to do what is required, and will the West, severely hampered by its own problems, manage to provide the resources necessary to improve the odds in favor of democracy and peace?

Fifth, the situation in the developing countries is mixed. A number of countries have registered notable successes. Growth in the developing world as a whole picked up last year in spite of the slowdown in the industrial countries, and our projections indicate that developing countries' growth in 1993, again at almost 6 percent, will exceed that of the industrial countries for the fifth straight year. However, this overall performance is attributable in large measure to the vibrant economies of Asia and to the successes of those countries, in Latin America in particular, that have steadfastly pursued structural adjustment programs with the support of the international community. While such successful performances have characterized roughly half of the developing world in terms of GDP, the other half represents what I shall

## Currency Units per SDR

| | FEBURARY | | | | MARCH | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Currency | 23 | 24 | 25 | 26 | 1 | 2 | 3 | 4 | 5 | 8 |
| Deutsche mark | 2.25128 | 2.24051 | 2.25038 | 2.26093 | 2.26966 | 2.26188 | 2.26648 | 2.27329 | 2.27451 | 2.28754 |
| French franc | 7.66438 | 7.62147 | 7.65876 | 7.69102 | 7.69605 | 7.66071 | 7.67796 | 7.67339 | 7.7115 | 7.75968 |
| Japanese yen | 161.578 | 162.366 | 162.32 | 161.967 | 163.1 | 163.096 | 161.743 | 161.312 | 160.748 | 161.52 |
| Pound sterling | 0.953466 | 0.961705 | 0.964902 | 0.964872 | 0.956659 | 0.954267 | 0.950443 | 0.953337 | 0.94901 | 0.951051 |
| U.S. dollar | 1.38634 | 1.38774 | 1.38145 | 1.3761 | 1.37405 | 1.37634 | 1.38242 | 1.3811 | 1.381 | 1.37522 |
| Argentine peso | ... | ... | ... | 1.36234 | ... | ... | ... | ... | 1.37893 | ... |
| Australian dollar | 2.0028 | 1.99761 | 1.99085 | 1.97801 | 1.95762 | 1.95336 | 1.95533 | 1.95153 | 1.9407 | 1.94956 |
| Austrian schilling | 15.8528 | 15.7883 | 15.8176 | 15.9132 | 15.9678 | 15.9174 | 15.9421 | 16.0042 | 15.9947 | 16.0804 |
| Bahrain dinar | 0.521264 | 0.52179 | 0.519425 | 0.517414 | 0.516643 | 0.517504 | 0.51979 | 0.519294 | 0.519256 | 0.517063 |
| Bangladesh taka | 54.0673 | 54.1219 | 53.8766 | 53.6679 | 53.588 | 53.6773 | 53.9144 | 53.8629 | 53.859 | 53.6336 |
| Belgian franc | 46.4944 | 46.2673 | 46.282 | 46.5259 | 46.8001 | 46.5444 | 46.5564 | 46.8642 | 46.8539 | 47.06 |
| Brazilian cruzeiro | ... | 26189.3 | 26751. | 26984.6 | 27284.5 | 27612. | 28017.9 | 28276.4 | 28560.9 | 28729. |
| Canadian dollar | 1.73944 | 1.75161 | 1.73179 | 1.71971 | 1.71688 | 1.7174 | 1.72346 | 1.71574 | 1.72266 | 1.70981 |
| Colombian peso | 1146.95 | 1148.63 | 1143.96 | ... | 1139.01 | 1141.47 | 1147.01 | 1146.4 | 1146.81 | 1142.51 |
| Danish krone | 8.68611 | 8.62203 | 8.60969 | 8.67012 | 8.71697 | 8.66957 | 8.67399 | 8.72855 | 8.72999 | 8.76634 |
| Finnish markka | 8.1331 | 8.16907 | 8.18537 | 8.18835 | 8.22106 | 8.2023 | 8.19623 | 8.24669 | 8.25327 | 8.27594 |
| Greek drachma | 304.896 | 304.054 | 304.789 | 305.859 | ... | 305.823 | 305.584 | 307.233 | 307.238 | 308.764 |
| Indian rupee | 36.3221 | 36.3588 | 36.194 | 36.0538 | 36.0001 | 44.1255 | 43.9748 | 44.0295 | 43.7777 | ... |
| Indonesian rupiah | 2864.16 | 2865.68 | 2854.06 | 2844.4 | 2841.54 | 2846.27 | 2857.46 | 2854.73 | 2854.53 | 2843.95 |
| Iranian rial | 92.3 | 92.3 | 92.3 | 92.3 | 92.3 | 92.3 | 92.3 | 92.3 | 92.3 | 92.3 |
| Iraqi dinar | 0.430954 | 0.431389 | 0.429434 | 0.427771 | 0.427133 | 0.427845 | 0.429735 | 0.429325 | 0.429294 | 0.427497 |
| Irish pound | 0.928125 | 0.92479 | 0.929018 | 0.932001 | 0.932508 | 0.928579 | 0.930985 | 0.931728 | 0.934814 | 0.940707 |
| Italian lira | 2191.69 | 2209.07 | 2174.73 | 2187.59 | 2189.28 | 2158.53 | 2163.47 | 2160.01 | 2160.22 | 2169.27 |
| Korean won | 1103.94 | 1103.95 | 1096.67 | 1094.69 | 1092.23 | 1094.05 | 1096.19 | 1097.28 | 1095.69 | 1090.27 |
| Kuwaiti dinar | 0.423887 | 0.424315 | ... | ... | 0.420803 | 0.421256 | 0.421845 | 0.421443 | ... | 0.419923 |
| Libyan dinar | 0.414286 | 0.414286 | 0.414286 | 0.414286 | 0.414286 | 0.414286 | 0.414286 | 0.414286 | 0.414286 | 0.414286 |
| Malaysian ringgit | 3.64399 | 3.64559 | 3.63114 | 3.62396 | 3.61856 | 3.62253 | 3.62374 | 3.6171 | 3.61477 | 3.60196 |
| Maltese lira | 0.524394 | 0.526836 | 0.526467 | 0.526173 | ... | 0.527131 | 0.526155 | 0.529065 | 0.529637 | ... |
| Nepalese rupee | 69.4972 | 69.5674 | 69.2521 | 69.0114 | 68.9636 | 69.0785 | 69.3837 | 69.3174 | 69.3124 | 69.0223 |
| Netherlands guilder | 2.54282 | 2.52763 | 2.53952 | 2.54689 | 2.55051 | 2.53907 | 2.5449 | 2.54233 | 2.55402 | 2.5729 |
| New Zealand dollar | 2.65277 | 2.64432 | ... | 2.62715 | 2.61973 | 2.60819 | 2.6202 | 2.61622 | 2.60222 | 2.61002 |
| Norwegian krone | 9.62605 | 9.59275 | 9.59003 | 9.63683 | 9.66713 | 9.61305 | 9.61542 | 9.67046 | 9.66079 | 9.8953 |
| Omani rial | 0.533048 | 0.533586 | 0.531168 | 0.52911 | 0.528322 | 0.529203 | 0.53154 | 0.531033 | 0.530995 | 0.528772 |
| Pakistan rupee | 36.4825 | 36.5193 | 36.3538 | 36.213 | 36.1591 | 36.2883 | 36.5179 | 36.483 | 36.4804 | 36.3277 |
| Portuguese escudo | ... | 206.947 | 206.875 | 207.864 | 207.901 | 207.575 | 207.652 | 209.039 | 210.01 | 210.035 |
| Qatar riyal | 5.04628 | 5.05137 | 5.02848 | 5.009 | 5.00154 | 5.00988 | 5.03201 | 5.0272 | 5.02684 | 5.0058 |
| Saudi Arabian riyal | 5.19184 | 5.19709 | 5.17353 | 5.15349 | 5.14582 | 5.15439 | 5.17716 | 5.17222 | 5.17185 | 5.1502 |
| Singapore dollar | 2.27471 | 2.27659 | 2.26655 | 2.26382 | 2.26237 | 2.2638 | 2.26924 | 2.2697 | 2.26987 | 2.26581 |
| South African rand | 4.33301 | 4.34154 | 4.32877 | 4.32371 | 4.33307 | 4.33616 | 4.3567 | 4.3622 | 4.37156 | 4.38214 |
| Spanish peseta | 163.325 | 163.226 | 162.196 | 162.724 | 162.55 | 161.961 | 162.6 | 162.5 | 163.068 | 162.771 |
| Sri Lanka rupee | 64.4648 | 64.6687 | 64.4448 | 64.2639 | 64.2368 | 64.3439 | 64.6281 | 64.6355 | 64.5618 | 64.4291 |
| Swedish krona | 10.6079 | 10.7331 | 10.8232 | 10.7074 | 10.7499 | 10.6123 | 10.6433 | 10.6365 | 10.5861 | 10.5844 |
| Swiss franc | 2.07258 | 2.06815 | 2.08516 | 2.09635 | 2.10296 | 2.09623 | 2.09755 | 2.10549 | 2.10948 | 2.11674 |
| Thai baht | 35.1853 | 35.2347 | 35.1165 | 34.9942 | 34.9971 | 35.0416 | 35.1411 | 35.0799 | 35.0636 | .. |
| Trinidad and Tobago dollar | 5.90667 | 5.91264 | 5.88584 | 5.86305 | 5.85431 | 5.86407 | 5.86997 | 5.88435 | 5.86392 | 5.8593 |
| U.A.E. dirham | 5.08925 | 5.09439 | 5.0713 | 5.05166 | 5.04414 | 5.05254 | 5.07486 | 5.07002 | 5.06985 | 5.04843 |
| Venezuelan bolivar | ... | 114.211 | 113.831 | 113.597 | 113.634 | 113.892 | 114.803 | 114.631 | 114.761 | 114.556 |

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. 2. The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department



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call the continent of woe, where too many countries, particularly in Africa, remain in critical shape, rooted in poverty, and beset by the consequences of poor economic policies.

These are five immense problems, so it should come as no surprise that their combined effect has, in most parts of the world, led to a deep crisis of confidence that is sometimes compounded by a crisis in respect of the credibility of our institutions and our strategies. This, then, is the dark side of the picture, which we know too well.

And the opportunities? Well, if we can turn away from the litany of our misfortunes, and lift our eyes to the outlook for the medium term, the contrast is striking. While I would not be so bold as to say straightaway that the opportunities will win out over the risks, five factors can be identified that point to recovery.

1. First, and of course there is room for debate on this score, there has been an increasing understanding on the part of our leaders that the time for fiscal irresponsibility has passed, and also that if we really want growth and job creation, we have to get back to the drawing board to work out a number of structural reforms in respect of saving and the labor market that in the past have been more or less taboo. While this emerging awareness is an opportunity that has grown out of crisis, it is an opportunity not to be missed.

*There has been an increasing understanding . . . that the time for fiscal irresponsibility has passed*

2. In support of strategies to put government finance back on a sound footing, the opportunities to reduce military spending, and to reduce it everywhere, should make it possible for sound budgetary practices to be restored without, among other things, a negative impact on social priorities, but instead in a manner consistent with correcting the other deficit that was characteristic of the 1980s in many countries, the social deficit and the inadequacy of investment in human resources. (Obviously, I am not overlooking the fact that, in the short term, reducing the size of the military-industrial complex always starts with significant budgetary costs of conversion.)

3. I have mentioned the perils in the area of world trade, but let us not forget the promises held out by the Uruguay Round. The experience of the postwar boom years reminds us that every phase of world trade liberalization has brought with it gains in productivity, growth, and employment throughout the world, and particularly in countries that are extensively involved in international trade.

4. And why would we Europeans forget that the single market, strengthened by economic and monetary union, holds out another set of promises, which I would hope can be repeated in the regional integration efforts now under way in other parts of the world.

5. And, finally, there are what I will call the growth opportunities arising from the *practice of solidarity*, in two areas:

• first, in the developing world: the end of the debt crisis, which has resulted from debt-reduction operations and courageous stabilization and reform programs, is of considerable significance. Thanks to these operations and programs, and to the wisdom and courage of the leaders who have backed them, half the developing world is registering satisfactory growth and is already serving as an engine of growth for neighbors, a process that will strengthen over time;

• second, there is the great potential for medium- and long-term growth in the countries of Eastern Europe and the former Soviet Union, provided we are able to help them integrate successfully into the world economy. The stakes involved here, starting in the unified Germany, are extraordinarily high, and go well beyond economic growth alone. Should not this prospect alone help lift the gloomy spirits of our continent, despite the unavoidable difficulties of transition that these countries, and we ourselves, face?

Thus, there are five opportunities! What can be done, then, to overcome our problems and seize these opportunities?

With regard to *cooperation in a worldwide perspective*, I shall indicate only two major areas of application:

• the multilateral trade negotiations of the Uruguay Round;

• a G-7 [Group of 7] initiative for sustainable growth.

From the standpoint of the world economy as a whole—and particularly, whether this is recognized or not, for Europe, the world's largest trading partner—the number one imperative today is the successful completion of the Uruguay Round without further delay. It is here, in the area of multilateral trade negotiations, that I see the most urgent need for decisive international cooperation efforts. Governments cannot allow themselves either to miss this opportunity or to cede to the protectionist pressures which, as always, arise from weak growth or trade imbalances. Certainly no country, no interest group, can get everything it wants. But we have to look beyond individual interests and see what the world as a whole stands to gain, or to lose in the event of a failure. Improvement in the economic climate—reduced uncertainty, greater confidence, and clear signals for investors, producers, and traders—depends on the successful conclusion of these negotiations. While one can always view such aggregative studies with skepticism, one study by the OECD [Organization for



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Economic Cooperation and Development] estimates the potential gain in world economic activity and efficiency at close to 1 percentage point of GDP. One can quibble about this figure, and commentators have hardly refrained from doing so, but that there would be a significant positive effect is undeniable. Vital issues are at stake, including opportunities for structural reform in the developing countries and the economies in transition. Finally, let us think of the cost in terms of confidence, and delayed economic stimulation, of the hairsplitting and other forms of foot-dragging that have sometimes held up or paralyzed these negotiations. If the negotiations were to fail, there would be an avalanche of trade disputes, reprisals, and counterreprisals, and the inexorable return to protectionism. No one wants to contemplate this possibility, and all are bracing themselves instead for a last hard push. One phrase we often hear is "better no agreement than a bad agreement"; now, however, we should instead say "better an early agreement than a perfect agreement." If there is no agreement in the offing, I must confess that I fail to see what possible credibility there would be to any agreement among the major industrial countries on the concerted revitalization of the world economy. Any "grand design" for the world we live in requires a successful Uruguay Round.

*The number one imperative is the successful completion of the Uruguay Round.*

Cooperation for the resumption of lasting growth, and hence growth with stability, at the initiative of the G-7. This is, of course, the topic of the day. Let us note that the idea of such an initiative is singular in three respects. *First*, its key components are quite well known, even though they have yet to be debated explicitly. Commentators rattle them off every morning. These necessary elements of cooperation have the remarkable characteristic of being essential both for ensuring steady growth in the medium term and for facilitating the reversal of the economic cycle in the short term. There are five such elements.

1. In Europe, short- and medium-term interest rates, the major obstacle to growth, must come down. We all know of Germany's crucial role here. Monetary conditions in Germany have been eased somewhat in recent months, and I consider this to be fully justified by the waning of domestic inflationary pressures. Although price increases in Germany have remained large, the pronounced slowdown in activity, early indications of a sharp decline in monetary growth, and favorable developments on the wage front—most notably the 3 percent public sector pay deal—should soon be reflected in a moderation of inflation. There should therefore be scope for a further significant reduction in interest rates in the near future. Apart from being appropriate to Germany's domestic requirements, this should contribute to a further easing of tensions within the EMS and to an easing of monetary policies throughout the continent, where, as in most other industrial countries, I might add, inflation has now been brought down to historically low levels. We shall have to learn to keep it there.

But we should aim for more than a slow and limited reduction in interest rates in Germany. Late last year, I voiced my desire for a decline in real interest rates on the order of 2 percentage points. For this to be possible there is a need for more effective fiscal consolidation in Germany. Progress in this regard, together with the other elements in the proposed solidarity pact, would both contribute to the lowering of interest rates and improve medium-term growth prospects. Elsewhere in Europe, lower interest rates call for stronger fiscal policies in countries where excessively large public sector deficits have been allowed to develop, and for other policies specifically directed at boosting saving and investment. Let me mention in particular the major challenge of deficit reduction being faced by the Italian Government, as well as the need to cut back the large budget deficit that has recently emerged in the United Kingdom. For these and other member countries of the EMS, fiscal consolidation is of course part of the convergence of economic policies and performance that is essential if credibility is to be restored to the system, and which is required by the Maastricht Treaty.

2. I turn now to the second component of a concerted recovery strategy. In the countries to which I have just referred, and everywhere else that public sector deficits have been allowed to develop—deficits which, owing to the impact on long-term interest rates and the costs of refinancing the public debt, absorb too much saving and stifle growth—it is necessary without delay, and without being haunted by the fear of short-term contractionary effects, to convince the markets of governments' resolve to attack the problem by taking vigorous, immediate measures. In this regard there is an obvious and striking contrast between the United States and Europe. The United States has the good fortune to be able to embark on its fiscal consolidation effort during a period of cyclical recovery, while the European countries are obliged to show their resolve at a time when the cycle is less in their favor. Nevertheless, they cannot delay initiating the correction. For the United States, the program has been announced. Since the U.S. administration has been urged for so long to come to



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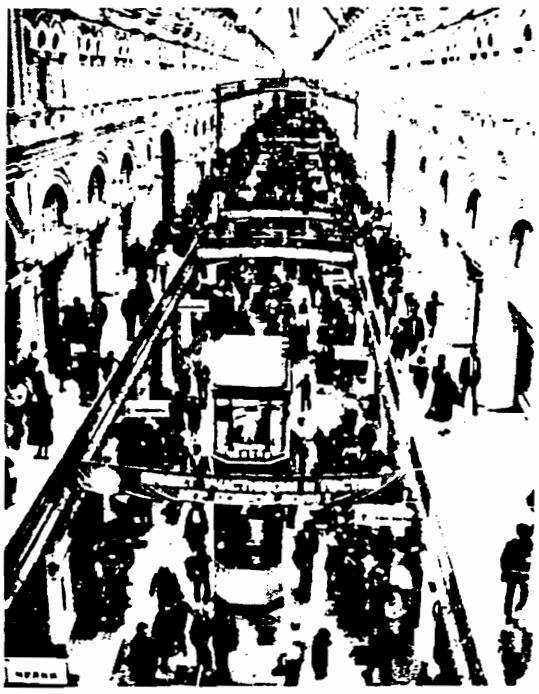
grips with the fact that the only solution to its most urgent problem—the lack of saving and investment—is to reduce its fiscal deficit and, to the extent necessary, to raise taxes, it would be inappropriate to mince words now. The economic program presented by President Clinton represents a considerable effort in this direction. Additional measures will be needed in due course in order to bring about the true fiscal consolidation that is required in the medium term. But by addressing its problems head on, the United States is making an immediate and not insignificant contribution to a global recovery strategy.

3. In Japan, as in the United States, short-term interest rates have been reduced to historically low levels to support demand. But in contrast with the United States, growth in Japan has recently weakened more than expected, and there are no signs of an upturn. Also in contrast with the United States, and indeed most other industrial countries, Japan's successful fiscal consolidation in the period of expansion in the late 1980s has put it in a position to be able to take stimulative fiscal measures. Indeed, a major fiscal package was introduced last August, and some of the stimulus from it is still in the pipeline, owing to delays in implementation. In these circumstances, it is clear that the Japanese contribution to a joint initiative must consist in urgently examining additional fiscal measures that would enable the Government to tackle persistent signs of weakness without delay. Let me add that current plans to recycle a portion of Japan's balance of payments surpluses to the developing countries, particularly the poorest African and Asian countries, should be especially encouraged.



***The GUM department store in Moscow: Russia's economy faces stiff challenges.***

4. Fiscal consolidation, lower interest rates, and stronger growth are not sufficient to create the conditions needed for a substantial and lasting reduction in unemployment, particularly in Europe. All *structural rigidities*, which so seriously weaken the potential of growth to create jobs, must be more vigorously tackled. Bold steps must be taken to initiate far-reaching reforms, to make labor markets more flexible, and to eliminate the large number of regulatory obstacles to free enterprise. Though they might not have any immediate practical impact, these measures can have considerable confidence-raising effects. I am well aware that many taboos are involved here, but were not tax hikes a taboo in the United States? Is it not one of the objectives of international cooperation to help each country abandon its own sacred cows while other countries, with a common purpose, do the same?

5. Finally, here in Europe: strengthen the EMS. Speaking here in Brussels, I think I can be brief. The [European] Community recently took an important growth initiative in Edinburgh, but it must also strengthen the EMS. The September crisis was serious, and it taught us a lot. First, that there is still a lot of ground to be covered between the first and the third stages of Economic and Monetary Union and—a useful reminder—that exchange rates cannot be fixed without a strengthening of the convergence process. Second, it showed us that in globalized markets, where more than a trillion dollars are traded every day, four norms of economic and financial good conduct are vitally important:

- strict macroeconomic policies that support exchange rate parities;
- the overall strengthening of structural policy efforts aimed at greater flexibility, for if unemployment rates cannot be made to converge at lower levels, economic union will always be vulnerable;
- close coordination among monetary authorities; and
- last, timely exchange rate realignments that are carried out quietly and smoothly, to the extent possible, when parities have become too far out of line with the fundamentals.

After this list of essential measures, which are hardly surprising, let us note the other two key features of any proposed growth initiative today:

- One is that, we know that in any event, the measures I have just indicated will be taken sooner or later because the need for them is clear. However, we have everything to lose by taking them too late and as isolated, disorganized initiatives.
- These measures, which are obligatory and which will be taken, must all be implemented without delay in an intense, concerted effort. It is striking how different the impact of fast and highly coordinated action can be in terms of its results and its effects on confidence.



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# World Economic Outlook

## Interim Assessment

January 1993

**A Survey by the Staff of the International Monetary Fund**

INTERNATIONAL MONETARY FUND
Washington, DC

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# Policy Considerations

The continued sluggishness of economic activity in the industrial world has given rise to concerns that the medium-term strategy pursued since the early 1980s is not living up to its promises and that a different approach is warranted. As pointed out in past issues of the *World Economic Outlook*, however, it is inappropriate to conclude that the strategy has failed. The problem, rather, is that key aspects of the strategy have not been implemented. In the fiscal area, the missed opportunity to consolidate budgetary positions in North America and many European countries during the long expansion of the 1980s stands out as a particularly striking policy failure. Progress in the structural area has also been far from adequate. This is especially evident in Europe, where continued high levels of unemployment point to the urgent need for labor market reforms. For many countries there remains a need to change the structure of incentives (especially tax preferences) that may discourage saving and encourage excessive indebtedness by the private sector. There has been far-reaching liberalization of financial markets, but failure to adjust macroeconomic policies and the lack of adequate prudential oversight contributed to asset price inflation and the subsequent, unavoidable process of balance sheet adjustment. Finally, there have been important setbacks in the area of trade, mainly in the form of quantitative restrictions and other nontariff distortions. The unfinished agenda of the 1980s remains a valuable guide for tackling both systemic problems and the challenges facing individual countries.

### Systemic Issues

Since 1990, in addition to the adverse consequences that large structural budget deficits have had for financial conditions and confidence, the industrial countries have been affected by two major economic forces that have led to protracted sluggishness of activity in most countries and have contributed to the recent turbulence in foreign exchange markets. The first and most important is the adjustments made necessary by increases in private sector indebtedness in some countries during the 1980s and by the erosion of balance sheets stemming from the correction of inflated asset prices. The second is the tensions caused by divergences in policies and performances across Europe, which have been exacerbated by the fiscal expansion that accompanied German unification. The policy measures that have been adopted to deal with the resulting difficulties have had some, albeit limited, success in containing adverse domestic repercussions. The lack of coordination of the appropriate policy responses, however, has resulted in a serious mismatch of macroeconomic policies across countries, especially in Europe.

It is difficult to judge how much adjustment is still required to reduce private sector indebtedness to sustainable levels and to overcome the associated financial sector problems. IMF—and most other—analysts have so far underestimated the extent of this problem, and the risk remains that even the revised growth projections for the countries most affected may prove optimistic. Moreover, in those countries where the balance sheet adjustment problems have been less acute, there are increasing signs of economic weakness; in particular, there are now signs of a significant slowdown of growth in Germany. Only North America seems poised for recovery, even though economic slack there may be absorbed only slowly.

The weak short-term prospects for many industrial countries raise the question of which measures, if any, might be taken to strengthen economic performance. Very few countries have room to provide discretionary fiscal stimulus. The persistence of relatively large structural budget deficits in North America and in Europe militates strongly against expansionary fiscal action because of the danger that this would put additional pressure on long-term interest rates, destabilize financial markets, and exacerbate medium-term budgetary adjustment difficulties. Higher interest rates would complicate the private sector's adjustment efforts and further erode confidence. Rather than short-term fiscal stimulus, there is an urgent need in many countries to reduce uncertainty through the adoption of credible budget-consolidation programs to eliminate unsustainable structural deficits over the medium term.

In contrast to the constraints facing fiscal policy, there appears to be a stronger case for further reductions in official interest rates in many of the industrial countries—particularly in Europe, where the tightness of monetary conditions is an important

restraining influence. In addition to facilitating the adjustment process in the private sector by easing cash flow problems associated with large debt burdens, a coordinated reduction of interest rates in countries where this is warranted would undoubtedly help to strengthen confidence by demonstrating the continued commitment to international policy cooperation. A lowering of official interest rates would have the added advantage over fiscal measures of being more easily reversible as activity recovers or if inflationary pressures threaten to re-emerge.

In view of the reduction of short-term interest rates that has already occurred in some countries and the concerns about inflation in Germany, it is important to determine whether a further easing of monetary conditions would be compatible with the goal of sustained noninflationary growth underlying the medium-term strategy. A relatively easy stance of monetary policy under current circumstances of sluggish growth and receding inflationary pressures does appear to be fully consistent with the medium-term objective of price stability. Interest rates have already been reduced significantly in the United States and Japan, but there is no evidence to suggest that this has given rise to increasing inflationary pressures (see the Annex). In Germany, although current inflation is still too high, the restrictive stance of monetary policy that has been pursued for some time is clearly beginning to show its effectiveness. Thus, together with the impact of the recent appreciation of the deutsche mark within the ERM, the weakening of the economy that is now under way can be expected to result in a significant easing of cost pressures and inflation during 1993. In the United Kingdom, the recent reductions in interest rates have improved the outlook for growth somewhat, but the high level of indebtedness remains a restraining influence, and the large margin of slack should continue to contribute to a further reduction of underlying inflation. For most other European countries, there is no doubt that monetary conditions are extremely tight at present, in view of the current and projected weakness of activity and the decline in inflation. Nevertheless, to safeguard the considerable decline in inflation during the past decade and to ensure further progress where prices are still rising too rapidly, the scope for lower interest rates in many countries depends on efforts to reduce excessive fiscal deficits. Moreover, it will be essential to remain vigilant for any indications that inflationary pressures may again be building.

In the EC, in addition to any policy changes that may be appropriate in light of the current economic difficulties, the EMS will need to be strengthened to reduce the risk of a recurrence of the recent tensions. There is also a need for a cooperative effort to re-establish conditions that will permit the return of the pound sterling and the lira to the ERM. The exchange rate adjustments that took place in connection with the September and November crises have reduced tensions for now, but the underlying problems are far from being fully resolved. A key objective is to ensure greater progress toward economic convergence. Despite substantial progress, however, it is unlikely that convergence will be achieved immediately for all EC member countries, and currencies may therefore again become misaligned. This suggests that it may be necessary to undertake small adjustments of parities on a timely basis to avoid the buildup of the pressures seen recently.

More fundamentally, it is important for EC members to consider adaptations of the EMS to changing circumstances and to prepare for the transition to a single currency. The recent experience has demonstrated the crucial importance, for exchange rate stability, of close coordination of fiscal and monetary policies, and of convergence in economic performance. In current circumstances, effective coordination of monetary policy to establish monetary conditions that are appropriate for most if not all of the participating countries would, of course, require greater reliance on fiscal consolidation to control inflationary pressures in Germany, in accordance with the successful experience of other ERM countries that have already achieved a high degree of inflation convergence. In addition to a strengthening of policy coordination, there is also a need to reinforce mechanisms to defend the ERM when the fundamentals do not warrant parity changes—for example, through greater use of partially symmetric, nonsterilized intervention, such as was applied by the Bundesbank and the Banque de France to combat the recent speculation against the French franc. To promote greater monetary cooperation, it would be useful to complement national indicators of monetary conditions and inflationary pressures with ERM-wide indicators in order to ensure that currency substitution effects are correctly interpreted and that monetary conditions are compatible with sustained noninflationary growth in the area as a whole.

Greater efforts are also required in the structural area to increase the benefits from economic and monetary integration in Europe and to promote adjustment without parity changes, in preparation for the introduction of a single currency, which would eliminate the exchange rate as a policy instrument. The completion of the "single market" program of structural reforms constitutes a major step in this direction. Progress in enhancing the flexibility of European labor markets has been disappointing, however, and structural unemployment remains at record levels throughout Europe. A failure to tackle Europe's labor market problems would substantially erode the benefits of economic and monetary union (EMU); it would also increase the need for government subsidies and transfers to economically weaker regions, which could jeopardize fiscal consolidation efforts.[21]

Among the many risks in the outlook, the recent escalation of trade tensions between the United States and the EC is a sobering reminder of the fragility of the global economy. What is at stake is not only the success of the Uruguay Round of multilateral trade negotiations—the failure of which would in itself be a serious setback—but the cooperative trading environment that has underpinned world growth over the past forty years. It is clear that appreciation of the possible consequences of a contraction of trade helped to forge the compromises reached in late November. Although only a small share of trade would have been directly affected, the threat of a spiral of retaliation and counterretaliation would have increased tensions worldwide, thereby harming business confidence and undermining prospects for growth. With some progress in the resolution of the difficulties between the world's major trading partners, decisive further efforts are now needed to complete the global package and bring the Uruguay Round to a successful conclusion.

## Policy Requirements in Individual Countries

In the *United States*, notwithstanding a pickup in growth to about 3½ percent (annual rate) in the third quarter of 1992 and other positive signs, including improved business and consumer confidence, the possibility of a relatively hesitant recovery remains. In particular, it is not yet clear that the process of balance sheet adjustment has come to an end, and export growth seems likely to slow as a result of the weakness of activity in other industrial countries. The substantial easing of monetary conditions that has taken place should ensure moderate growth of about 3 percent in 1993, but the pace at which economic slack is likely to be absorbed may still be unsatisfactory. The new administration taking office in January could therefore be under strong pressure to stimulate economic activity.

The room to maneuver is extremely limited, however. In view of the large fiscal imbalance and high level of real long-term interest rates, early action to ensure substantial budgetary consolidation over the medium term is an overriding priority. A credible medium-term deficit-reduction program would strengthen confidence and ease pressures on long-term interest rates, even in the near term, and would substantially enhance medium-term growth prospects.[22] Fiscal stimulus could provide short-term support for aggregate demand, but it might also jeopardize the achievement of medium-term budgetary objectives. Indeed, to the extent that a fiscal expansion might push up long-term interest rates and increase uncertainty about future policies, there is a considerable risk that it would be counterproductive. Because of this danger, advocates of fiscal stimulus emphasize that any short-term fiscal stimulus should be accompanied by legislation to ensure a rapid return to a path of medium-term consolidation as economic activity picks up. Since repeated attempts during the past several years to legislate deficit control have failed, however, the credibility of any new consolidation plan will be difficult to establish, especially if the large structural budget deficit is allowed to widen further in the near term.

For U.S. monetary policy, a cautious attitude toward further reduction in official interest rates has been appropriate because of the substantial monetary stimulus already in the pipeline and because of the risk of adverse effects on exchange markets. Recent data suggest that the decline in short-term interest rates is beginning to contribute to more robust growth. If the recovery proves stronger than currently expected, appropriate adjustments of mon-

[21] The high rates of structural unemployment now prevailing in many European countries can best be addressed by measures that increase incentives to find and keep employment and that promote better matching between workers and jobs. Reducing minimum wages (especially for young, inexperienced workers), lowering firms' costs of hiring and retaining workers, and limiting the generosity and duration of unemployment benefits would encourage the unemployed to seek work, and firms to hire them. Active labor market policies that promote training and participation in the job market would increase opportunities for employment. In some countries, the structure of collective bargaining may have to be modified to raise the responsiveness of wages to macroeconomic conditions, particularly where institutional arrangements have excessively limited the market influence of outsiders. The next issue of the *World Economic Outlook* will discuss in more detail the importance of labor market policies for the success of EMU.

[22] In its Article IV consultations with the U.S. authorities, the IMF has noted that meaningful fiscal adjustment will involve action on a broad front and has formulated a set of options to illustrate the range and type of measures that would be required. The growth in mandatory expenditures has been particularly rapid, especially outlays on Medicare and Medicaid, suggesting the need for fundamental reform of the system of health-care financing. In addition, a further compression of discretionary expenditures in the areas of defense outlays and subsidies could also contribute significantly to deficit reduction. Options for revenue enhancement include an energy tax (for example, a gasoline tax), the introduction of a federal consumption tax (such as a value-added tax), the elimination of tax deductibility of mortgage interest payments, and the inclusion of employer-provided health insurance benefits in taxable income. In addition to contributing to deficit control, such measures would support an improvement in overall allocative efficiency and growth prospects.



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etary conditions will be essential to prevent an increase in inflationary expectations.

In *Canada*, the deep and prolonged recession has reduced price increases to the point where there can be substantial confidence that the official inflation reduction target will be achieved. A return to a progressive relaxation of money market conditions is therefore appropriate, although pressures on exchange markets could be a constraint. Fiscal policy has remained tight, given the recession, but the structural deficit (despite some progress in tackling this long-standing problem) should again be addressed as soon as economic activity begins to pick up.

In *Japan*, the stimulative policy actions already announced should help to reverse the recent weakness in economic activity and to revitalize growth during 1993. However, there is reason for concern that the pattern of weak recovery experienced by other countries that have been affected by asset price deflation and associated financial problems may also hold for Japan. If the expected recovery does not materialize, there would be scope for an additional easing of short-term interest rates. Following the implementation of the announced stimulus package in the latter part of 1992 and in early 1993, fiscal policy should be adjusted in light of actual and expected economic developments, and the budget position should converge gradually toward its desired medium-term path so as to avoid a sudden large withdrawal of stimulus before economic recovery is firmly established. Nevertheless, further fiscal consolidation will be necessary over the longer term.

In *Germany*, there is continued concern about the rapid growth of M3 and an inflation rate that is still in excess of the authorities' objective. Indicators of future inflation suggest, however, that conditions for a progressive easing of monetary conditions may soon be in place. Indeed, recent declines in short-term market interest rates have been appropriate in light of the weakness of activity, the appreciation of the deutsche mark within the ERM, and the squeeze on profits, all of which should help to ensure a moderate wage round in 1993. As wage and demand pressures abate, further declines in interest rates will be appropriate; this would facilitate growth across Europe and reduce the risk of a further deepening of the recession in Germany. An early, moderate cut in official German interest rates in line with the recent decline in market rates would send a signal that would boost confidence throughout Europe and in the rest of the world.

To permit more significant and sustainable reductions in German interest rates, fiscal policy will need to play a greater role in controlling inflationary pressures. It clearly would have been preferable if stronger steps to contain the budget deficit had already been taken. Although the speed of implementation may now need to take account of the weakness of the economy, there is an urgent need for effective measures to contain the aggregate fiscal imbalance at all levels of government (and for off-budget agencies) through reductions in public expenditure, particularly subsidies. However, if sufficient progress cannot be achieved on the expenditure side, tax increases may also be required. Efforts are also needed to ensure wage moderation in west Germany—for example, by containing public sector wage awards—and to ensure that wages in east Germany develop more closely in line with productivity, since the large divergences that have emerged will delay restructuring of the east German economy and increase demands for public transfers.

In *France*, although the calming of exchange market tensions in October allowed interest rates to fall again close to German levels, the pressures experienced in November and early December led to a renewed widening of the interest differentials vis-à-vis Germany. Despite a low inflation rate and a strong external position, it is likely to remain difficult—at least for some time—for French monetary policy to push interest rates below those in Germany without threatening the exchange rate. Thus, a significant decline of interest rates to promote more vigorous growth depends on parallel interest rate reductions in Germany. As regards fiscal policy, it has been appropriate to allow the automatic stabilizers to operate on revenue while containing the growth of public expenditure. This policy will need to be implemented symmetrically when activity picks up.

In *Italy*, there is no alternative to comprehensive and credible measures to reinforce the process of budgetary consolidation, with the goal of reducing the deficit by at least 2 percent of GDP annually during the next three to four years. Despite recent progress, further measures should be identified as a matter of urgency to offset any shortfalls in 1993; additional major adjustments will be required to meet the government's 1994–95 targets. Large-scale privatization of state enterprises could make a valuable contribution to reducing the level of government indebtedness and would enhance economic efficiency. Also of special importance in Italy is an incomes policy that will appropriately restrain nominal wages; the existing agreement for 1993 must be maintained, and agreement should be reached for subsequent years. Limits on public sector wages and on pensions, together with effective measures to combat tax evasion, are essential features of both fiscal and incomes policy. Meanwhile, monetary policy needs to maintain a firm stance in order to contain domestic inflationary pressures and to limit the depreciation of the lira. The high risk premiums on Italian interest rates relative to those prevailing elsewhere in Europe are unlikely to fall until further deficit-reduction measures have been adopted and their effects have become visible. Further reductions in Italian interest rates, which would directly reduce the cost of servicing the huge Italian public debt, would then be contingent on reductions in the general level of European interest rates.

Italy intends to rejoin the ERM at the earliest feasible date. This requires—in addition to external support, adequate reserves, and the maintenance of a monetary policy geared to inflation restraint—that the fiscal situation begins to improve and that cost and price developments are consistent with conditions in the ERM countries. Markets must have confidence that a sustainable budgetary and debt position will be achieved and that competitiveness will be improved on a durable basis. With its reserves depleted, its credibility impaired, and its maneuverability constrained by a large public debt, Italy cannot afford to let the lira rejoin the ERM at an exchange rate that is likely soon to be challenged in the market, or that is held up only by a substantial and ultimately unsustainable interest rate premium.

In the *United Kingdom*, there are as yet no convincing signs of recovery, but the recent depreciation of sterling and reductions in interest rates should stimulate both export growth and domestic demand. Recent gains in international competitiveness from the depreciation of the pound will prove ephemeral, however, unless inflationary pressures are contained. The easing of monetary conditions since the exit of the pound from the ERM has been appropriate in light of domestic conditions, but further declines in interest rates should probably await evidence over the coming months of the economy's response to the easing of policies that has already occurred. A possible further reduction of interest rates will also depend on a lowering of interest rates in the ERM countries in order to prevent an excessive depreciation of the exchange rate. For fiscal policy, the deterioration in the budget balance since 1989 has exhausted any scope there may have been for supporting activity through fiscal action. Although there clearly are limits to the pace of fiscal consolidation in the midst of a relatively deep recession, it will be necessary to begin the process of consolidation in 1993 in order to contain potential inflationary pressures following the depreciation of the pound and the easier stance of monetary policy. Success in containing the inflationary impact of the depreciation will be essential for rejoining the ERM and for choosing the appropriate re-entry exchange rate and its margin of fluctuation within the mechanism.

In *Spain*, the recent two-step devaluation of the central rate has offset much of the real appreciation of the peseta since Spain joined the EMS in 1989 and provides a needed boost to exports and growth over the medium term. Notwithstanding increasing concerns about the near-term outlook, there is little scope to stimulate the economy, and the priority should be to reduce inflation in order to stabilize the peseta within the ERM. This will require a tightening of fiscal and monetary policy to defend the new central rate. The 1993 budget sets appropriately ambitious targets, but achieving them will be difficult because of rising social security payments, increases in transfers to lower levels of government, and the cyclical slowdown of economic activity, which will increase outlays and reduce the growth of revenue. Monetary conditions, meanwhile, will need to remain tight until there are clear signs that inflation is abating. Inadequate progress in tackling the rigidities in the labor market has been a prime factor behind the persistence of inflation. Hence, intensification of labor market reform is indispensable to rebuilding Spain's competitiveness through wage moderation and an improvement in profit margins. The situation is similar in *Portugal*, where the inflation rate remains too high to prevent further losses in competitiveness. Since monetary conditions are already quite tight, the burden of macroeconomic restraint should fall on fiscal policy. The fiscal retrenchment planned for 1993—the deficit-GDP ratio is expected to fall by 1 percentage point, to just over 4½ percent—is probably the minimum that is required.

The different strategies of the Finnish and Swedish authorities in response to the buildup of tensions in foreign exchange markets in September illustrate the importance both of cyclical conditions and of the relationship between exchange rate objectives and fundamental policy changes. In *Finland*, which has been experiencing a protracted slump stemming from the collapse of exports to the former Soviet Union and from a severe financial crisis, the authorities decided in September to float the markka following a depreciation vis-à-vis the ECU in November 1991. This was an appropriate decision given the high economic costs that would likely have been associated with defending the peg to the ECU. Nevertheless, the Finnish authorities will still need to take vigorous measures to reduce the fiscal deficit (estimated at almost 9 percent of GDP in 1992) to a sustainable level. Clear evidence that the adjustment efforts are successful will also be necessary to permit the currency again to be pegged against ERM currencies.

In *Sweden*, during the September crisis the authorities decided to defend the krona by sharply increasing the rate on overdraft facilities with the central bank. The decision met with broad political approval and helped to forge an essential compromise on fiscal policy. Notwithstanding the successful defense of the krona in September, the prospect of a sharp deterioration in the budgetary position, a likely further increase in unemployment, and severe

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difficulties in the financial sector led to renewed pressures against the krona in November. In view of the subsequent failure to achieve a consensus on additional comprehensive measures to reduce the budget deficit, on November 19 the authorities decided to float the currency until solutions can be found to the country's economic and financial crisis.

In contrast to the markka and the krona, there was little speculative pressure against the *Norwegian* krone in September, perhaps because of the relatively strong external position of the Norwegian economy, largely due to strong oil revenues. However, following Sweden's decision to float on November 19, the Norwegian central bank was forced to take strong measures to defend the currency, and nearly a month later, on December 10, it was decided to allow the krone to float, resulting in a depreciation against the deutsche mark of about 5 percent. Although oil revenues have bolstered both the current account and government revenues and financial assets, the mainland economy (that is, excluding oil and shipping) is still characterized by high costs and structural impediments, including a weak financial sector.

## Economic Confidence and the Need to Strengthen International Cooperation

For all of the industrial countries, restoration of confidence is a critical requirement for returning to the path of sustainable, noninflationary growth. Everywhere in the industrial world, confidence has been undermined not only by the slowdown of activity or recession, but also by the disarray in financial markets and by the apparent collapse of cooperative efforts to address common problems by the governments of leading nations. As previously discussed, individual efforts by national governments will be required to correct the imbalances in national economies and thereby contribute to the restoration of confidence that is essential for a renewal of growth. But the potential for enhancing confidence directly through demonstrations of a new spirit of economic coordination and cooperation among the industrial countries should not be neglected.

It will take time to unwind the financial imbalances that have impaired growth and undermined confidence in many countries, and it will take time to establish the credibility of efforts to correct the large fiscal deficits of a number of countries with poor records of fiscal prudence. In contrast, a successful conclusion to the Uruguay Round—with its prospective longer-term benefits for world trade and its shorter-term benefits for confidence—can be achieved almost immediately. All that is required is the political will to reach a mutually beneficial agreement that is now within the grasp of the negotiating parties.

Similarly, it should be possible—and would be highly desirable—for the industrial nations to demonstrate a new spirit of cooperation in efforts to coordinate their macroeconomic and exchange rate policies for the common good. If, as now expected, the economies of *North America* begin to show more robust growth without resort to large-scale fiscal stimulus, this positive development for the world economy should be recognized and applauded. Along the same lines, *Japan*'s notable efforts to stimulate activity by exploiting the flexibility in fiscal policy it possesses deserve endorsement as an important element of the global strategy to enhance prospects for growth. This support should not be muted if, despite the government's best efforts, growth turns out to be somewhat weaker than is now expected.

For *Germany*, in accordance with recent market developments, the authorities could implement an early, moderate reduction of short-term interest rates. This would no doubt contribute to strengthening confidence (and thus growth) in Germany and in the rest of Europe. The German authorities could also recognize that the present recessionary tendencies throughout Europe call for larger interest rate reductions during the period ahead, and that fiscal policy adjustments together with wage moderation will be needed to permit such interest rate reductions without jeopardizing the outlook for inflation. Symmetrically, for *other European* governments, it is relevant to recognize both the special challenge that German unification continues to present for German economic policy and the importance, for all of Europe, of a convincing reversal of the recent upsurge of inflationary pressures in Germany. Moreover, in the future, greater realism about the need for timely adjustments of exchange rate parities to correct accumulating disequilibria, as well as more cooperative efforts to defend mutually agreed parities, could avoid some of the damage to confidence that inevitably accompanies the disarray and turbulence associated with sharp, market-induced changes in exchange rate policies.

Finally, the challenge of supporting the economic transformation of the *former centrally planned economies*, while continuing to assist the successful development of many of the world's poorer nations, remains a vital area for cooperative endeavors by the industrial nations. Of course, for such support to be effective, it must be complemented by determined adjustment efforts and bold and sustained reform initiatives in these countries. The maintenance of open and expanding markets for the exports of all countries is clearly critical to meeting this challenge, and it is essential that the industrial nations jointly undertake the burden of resisting domestic protectionist pressures. Provision of adequate financial assistance, including debt relief for the poorest nations, is another key element of this challenge. In this context it needs to be widely understood that the industrial nations have a common interest in this regard, with each nation playing its fair and appropriate role. Successful transformation of the former centrally planned economies to market-oriented economies will clearly pay enormous dividends for the entire world economy, and for many important reasons beyond purely economic ones. At the present time, there is probably no public sector investment for which the prospective rate of return is as high as in well-structured, coordinated financial and technical assistance to countries facing the truly daunting tasks of economic stabilization and adjustment.

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TREASURY NEWS

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**STATEMENT OF LAWRENCE H. SUMMERS**
**NOMINEE FOR**
**UNDER SECRETARY FOR INTERNATIONAL AFFAIRS**
**DEPARTMENT OF THE TREASURY**
**BEFORE THE SENATE COMMITTEE ON FINANCE**
**March 18, 1993**

Mr. Chairman, distinguished members of the Senate Finance Committee, ladies and gentlemen:

I welcome the opportunity to appear before you today as President Clinton's nominee to be Under Secretary of the Treasury for International Affairs.

If confirmed for the position of Under Secretary, I will look forward to serving President Clinton and Secretary Bentsen, and to working with you and your colleagues in the Congress to promote and defend the economic well-being of the United States.

President Clinton has committed his Administration to a policy of engaged, enlightened, and hard-headed economic internationalism to go along with his program of domestic renewal. We are living in an era of increasing global economic interdependence, where national economies are interconnected as never before, and domestic and foreign policies are inextricably linked. We have the chance to free up billions spent on national defense, to promote free elections and free economies from Poland to Peru, and to realize the vast potential of global economic integration. The nations of the world have the opportunity to grow and prosper together -- or stagnate and scapegoat apart.

The Under Secretary of the Treasury for International Affairs is charged with helping the President and the Secretary design and implement American international economic strategy. The Under Secretary's responsibilities include the development and implementation of policies in the areas of international macroeconomic policy coordination, exchange rate policy, trade and investment policy, international debt strategy, and U.S. participation in international financial institutions. The Under Secretary also serves as the G-7 Financial Deputy, with primary responsibility for coordinating economic policy with other industrial nations, and as the financial "Sherpa" in preparation for the annual Economic Summit.

There are many aspects to the job, but what I would like to do this morning, Mr. Chairman and Members of the Committee, is outline for you <u>four</u> critical policy areas that will be at the top of my agenda if I am confirmed.

First, we must improve macroeconomic coordination between the United States and its G-7 partners. The U.S. economy is likely to grow far more rapidly than the economies of Europe and Japan over the next year or two. While we can take satisfaction from our recovery, slow growth abroad means slower growth for U.S. exports and rising trade imbalances.

Secretary Bentsen has taken the initiative to revive the policy coordination process -- which is important to the restoration of global growth and employment. The President's economic program has brought us new respect in the international economic arena. And it will strengthen our hand in encouraging our major trading partners to take complementary actions to strengthen growth in their own countries. The Secretary began this effort in London. Both he and the President have made it clear that they hope to see real progress by the time of the Economic Summit in Tokyo.

Second, we must work to promote international economic integration and to insure that its benefits are shared fairly among nations. There is no alternative to economic integration. As President Clinton said at American University, the United States must compete -- not retreat.

This means we must promote exports, because exports are the path to economic growth and to the creation of better jobs in the United States. For America to expand exports, foreign markets must be open. Good Uruguay Round and NAFTA agreements will make a major contribution to the health of our economy and to that of our trading partners.

But concluding trade treaties is not enough. Where serious barriers to U.S. exports remain, we must vigorously enforce existing trade law to remove them. The trading practices of those nations that run chronic and increasing surpluses with most regions of the world are obviously of particular concern.

If confirmed, I will place particular emphasis on promoting financial market liberalization in Asia, Latin America, and Europe. Our financial institutions are world class innovators. They will succeed where they are given the opportunity to compete. I will also work to ensure that American firms are not victimized by exchange rate manipulation. And Treasury will insist on ensuring that just as our market is generally open to foreign friends that wish to invest here, foreign markets will be open to American investment.

Third, we must do what we can to ensure the success of Russia's democratic and economic reform effort. Political scientists offer this critical lesson of history: democracies do not make war on each other. To this important political science maxim, an economist would attach a critical corollary: democracies cannot survive hyperinflation. These twin truths are overriding considerations when we confront American interests in securing the success of the embattled reform effort underway in Russia. Russia is perilously close to hyperinflation, and unless Russia's leaders can reassert macroeconomic discipline, the country could go the way of Weimar Germany or the Junta's Argentina.

The Clinton Administration is already fully engaged in devising and implementing, in cooperation with our allies, an effective economic assistance package for Russia and the other states of the former Soviet Union. The Treasury department brings crucial economic perspectives to the table on matters concerning stabilization policy, debt, technical assistance, and economic restructuring. The task of rebuilding the Russian economy is the greatest economic restructuring job since the Marshall Plan. If confirmed, I will work, under Secretary Bentsen's leadership, with the rest of the Administration and Congress to ensure that the United States does all that it possibly can to support the political and economic transition in Russia at this historic moment.

Fourth, we must work to support sustainable and environmentally responsible development in the developing world. With 1 billion people trying to survive on less than $1 a day, this is a moral imperative. It is also an economic imperative as the developing world represents the fastest-growing market for U.S. exports. And it is a security imperative because prosperous nations are most likely to be peaceful ones.

The Secretary of the Treasury is the U.S. Governor of the International Financial Institutions -- the IMF, the World Bank, and the regional development banks. These institutions afford the United States extraordinary leverage. The World Bank, for example, has committed over $220 billion to the less developed world over the last 40 years, while U.S. contributions to the Bank have cost the taxpayers less than $2.0 billion over the same period.



If these institutions are to serve U.S. interests in the Third World, they must be much more than financial institutions. They must make a real, as well as a rhetorical commitment to helping the poor and protecting the environment. The Treasury Department will break with tradition to ensure that the U.S. representatives to these institutions draw on the expertise of environment and development communities, as well as the financial community.

In his welcoming address to the employees of the Treasury Department, Secretary Bentsen said that as the Departments of State and Defense were the guarantors of <u>military</u> security during the Cold War, the Treasury Department must be the guarantor of America's <u>economic</u> security in the post-Cold War world. It is a distinct privilege and honor to have been asked by Secretary Bentsen and nominated by the President to serve at Treasury during this critical time. Mr. Chairman and members, if confirmed, I look forward to working with you. Thank you.



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A CONSIDERED OPINION

# Clinton's Realistic Economic Vision

BY BRUCE K. MACLAURY

Finally the American people are being treated as intelligent citizens by their president. In his February 17 economic message to Congress, President Clinton laid out forthrightly what we must do to restore self-respect at home and our claim to leadership abroad.

Americans are not fools. It had become obvious that the rhetoric of divided government in Washington was, if not totally cynical, at least increasingly removed from reality. Promises of deficit reduction were appropriately discounted so long as no credible program backed them up. And for anyone who had even a vague sense of budget realities, there could be no credible program without sizable tax increases as well as spending cuts.

Policy wonks, including those at Brookings, had been trying to drive this point home for years. But their call to consume less and invest more fell on deaf ears. Why? Many Americans, especially those with limited education, were already consuming less as their wages fell. In any case, why pay more taxes when government programs were portrayed as either wasteful or ineffective or both? Finally, by definition the benefits of investment (and deficit reduction, or saving) are mostly in the future (that is, beyond the next election).

Indeed, candidate Clinton placed more emphasis during his campaign on the social deficit of American families trapped in welfare, lacking medical insurance, disserved by an overburdened education system, and facing job losses, than he did on remedies for the economic deficit. It fell to Ross Perot, that high-tech guru with his low-tech charts, to dramatize what many instinctively understood: that piling debts on debts was stealing the birthright of his grandchildren—and ours. *And* to tell us we couldn't get out of this mess without a big tax hike—in his case, a gas tax.

Journalists have a lot of fun pointing out how many campaign promises successful candidates break. And to be fair, that's part of their job. The public deserves to know whether a candidate was elected on the basis of dreams and falsehoods. There's no denying that candidate Clinton held out the hope that middle-income Americans could look forward to tax relief, whereas as president, he is now telling them that they too must contribute to deficit reduction. I ascribe this broken promise more to a belated acceptance of reality than to premeditated hypocrisy. But however that may be, the economic program that the nation is now debating would simply not add up without broad-based revenue increases.

Are there worries about what the president has proposed? Perhaps the biggest is that his program, or something like it, is picked apart by those who dislike this or that detail, and thus fails to pass Congress. That would indeed be a tragedy, not because the nation would quickly reach a crisis, but because we would continue to mortgage our future. And future politicians, remembering both Mondale and Clinton, would have even less incentive to try to stop the rot.

A second worry is that far from creating jobs, the drag of fiscal restraint will cut short the expansion that only now seems to be picking up steam. Yet, this risk to cyclical recovery seems small compared with the much greater risk of failing to deal with the economy's structural fatigue. In any case, the short-term stimulus package of investment incentives and jobs programs is a reasonable hedge against this risk.

A third worry is that the president's economic proposals will become hostage to health

care reform in a debate that could derail both. He is certainly correct to warn the American public that without effective curbs on health care costs, there is no hope of keeping future budget deficits under control. And budget reality requires it to be said now that the eventually large costs of providing medical coverage for the millions now uninsured will necessitate yet more tax increases, apart from any projected cost savings. But the complexity of the health care issue, and the lack of consensus on its solution, argues for delaying congressional consideration of health care until the rest of the economic package has had its day in court.

Finally, the president is still talking only about *reducing* the deficit, not eliminating it. If his program were passed as proposed, and if health care reform added no net costs, the 1997 deficit would still be about $200 billion, or 2½ percent of GDP. That's a big accomplishment but far from total victory, especially since we will still be relying on Social Security surpluses to hold down the overall deficit numbers.

Deficit reduction is not just sacrifice, it is sanity. A nation that saves only 2 percent of its income cannot remain a world leader, however lofty its rhetoric and compelling its ideals. Economic growth and social equity demand investment, mostly in the private sector, but some in the public sector as well. Investment is not just a new word for spending. It is an age-old concept that focuses on how we spend and how we pay for it. President Clinton has provided a vision and a program that gives that new focus reality. It is possible to have other visions, but they too must add up to reality. ■

*Bruce K. MacLaury is president of the Brookings Institution and has served in that capacity since 19--.*

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**COLUMN LEFT/**
LESTER THUROW

# U.S. Alone Can't Pull World Train

■ Economic cooperation is the best route out of stagnation.

What the world faces at the moment is not the Great Depression, but something that might be called the Great Stagnation: a period of slow growth that is already very long and threatens to go on for much longer.

Think of the United Kingdom with nine consecutive quarters of negative growth. Or America with fewer people on private payrolls than four years ago. Neither has happened since the Great Depression.

The world is not recovering from just another recession; something much more profound is under way. Historians looking back on the 1980s will see the decade as yet another speculative bubble.

Such bubbles have always ended with financial crashes, and this bubble is no exception. Property prices have crashed in much of the world and in the process have pulled banking down with them. The banking systems of the United States, Scandinavia and Japan have essentially lost all of their equity. Without government support, tens of millions of depositors would have lost their money. If they had lost their deposits, we would now be talking about another Great Depression.

The difficulties of cleaning up the mess at the end of a speculative bubble intersect with another problem. Put bluntly, the speed at which the American locomotive can pull the world's economic train is getting slower and slower as the train's weight grows in relation to the size of the American engine. In the 1960s, the world's economy grew at 4.9% per year after correcting for inflation. In the 1970s, growth fell to 3.8% per year. With a reversal of the oil-price shocks, growth was expected to accelerate, but it further declined to 2.7% per year in the 1980s. In the first three years of the 1990s, yet another decline occurred, to an average of less than 1% per year.

Take any product, add up the world's capacity to produce that product, estimate how much the world will buy of that product, and there will be at least 30% excess production capacity. While no one has yet reached the levels of unemployment recorded in the United States in the 1930s (27%), a number of countries (Spain, Ireland), aren't far away.

In normal recessions, there are some booming industries that can serve as engines of growth. In 1981 and 1982, computers and consumer electronics boomed right through the recession. No new, large, rapidly growing industries have emerged to take their place.

**'Trade surpluses on the Pacific Rim . . . threaten to extinguish any recovery.'**

Quickly rising trade surpluses on the Pacific Rim, especially in Japan, threaten to extinguish any recovery elsewhere in the world. Japan's trade surplus reached $110 billion in 1992 and is headed for at least $150 billion in 1993. At American productivity levels, every $45 billion represents a million jobs lost elsewhere in the world. How does one restart a world economy if the world's second-largest economy is siphoning 3 million jobs away from the rest of the world?

The answer to kick-starting the world economy can only be found in coordinated fiscal policies where governments stimulate their economies with social investments—infrastructure, research and development, work skills and education. Cutting business taxes won't work because of all that excess production capacity. Cutting personal taxes shouldn't be done since, once cut, they are impossible to raise.

The United States cannot be the world's economic locomotive all by itself. But if fiscal stimuli were coordinated among the big three—Germany, Japan and America—and interest rates were cut on the certainty of tax increases or expenditure cuts when growth is restored, there is no reason why rapid growth could not be restored. If something isn't done to contain Pacific Rim trade surpluses, however, the world faces a decade of 1% to 2% growth.

I would predict that Clinton will work very hard for six to 12 months to get Germany and Japan to cooperate in coordinating fiscal and monetary policies and controlling trade surpluses to generate a 4% growth rate for America and the world. If they refuse to cooperate, Clinton will have to go it alone if he wishes to improve prospects for the average American family.

To go it alone, he will be forced to "decouple" the American locomotive from the world train. That does not mean no trade. It simply means keeping the U.S. trade deficit from getting so large that it prevents the economy from 4% growth. The only countries that need be affected by "decoupling" are those attempting to cure slow growth by generating large trade surpluses in the American market.

At the moment, the world is like the Beckett play "Waiting for Godot." It is waiting for the American locomotive. But just as Godot never arrives in the play, so the American locomotive is never going to arrive. The world will build a cooperative locomotive or it won't have a locomotive.

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ALLEN SINAI

# *What's Wrong With the Economy?*

*The combination of cyclical recession with a slowdown in long-term potential growth has led to economic gridlock unprecedented in the period since World War II. First we must deal with growth. Then we can tackle the deficit.*

The economies of the United States and the world are in trouble: that is not debatable. In the United States, real economic growth has been only 0.7 percent per annum since the first quarter of 1989. The unemployment rate is far above a low 5 percent in March 1989. Job creation has been woefully inadequate, with a net increase of 563,000 persons since the first quarter of 1989. Job losses of 1.7 million have occurred since the peak of the business expansion in July 1990. The federal budget deficit remains extremely high, at levels near $300 billion, due to a large extent to the weak economy itself. No single sector of the United States economy, except health care, has recovered in the traditional sense. Expenditures on health care, however, reduce the income or cash flow available for discretionary spending and place a burden on the government. And despite repeated actions by the Federal Reserve to ease monetary policy—some twenty-four instances between June 1989 and September 1992—the economy has failed to show meaningful revival.

In fifteen quarters since early 1989, only three have shown a bona fide recovery, real economic growth in excess of the growth in potential output of 2 percent to 2.5 percent. Three quarters—the third quarter of 1990 to the first quarter of 1991—were characterized by a full-fledged recession. The other nine quarters have exhibited growth in between, ranging from zero percent to only 1.7 percent.

Indeed, the current business cycle episode is the most unusual in the era since World War II, aberrant and perhaps different from all others in U.S. economic history. Most unusual is the jobs pattern, still showing net declines in most sectors as businesses try to cope with the prolonged stagnation by holding down headcount, squeezing wages, reducing fringe benefits, pushing health care payments back onto labor, and getting tough on suppliers.

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## *Economic gridlock*

As both a cause and effect of the unusual business situation, a new business strategy has emerged, a kind of new wave management. The only way to increase profits in a weak economy with only single-digit revenue growth is to control costs. The biggest source of costs is labor. As a consequence, few new jobs are generated and keeping headcount down is the religion. In a slack labor market with intense competition for existing jobs, wage compensation is pressed lower. Little growth in wage and salary income occurs, hurting spending, and consumers are gloomy because of job insecurity.

The weak economy produces lower inflation and low interest rates. Those low interest rates in turn also depress the incomes of an aging population increasingly dependent upon interest earnings. Businesses spend weakly, keep a tight rein on production, attempt to keep inventories lean relative to sales, and stay cautious on employment. This again results in less income and thus less spending.

This "positive feedback loop" has been in place now for several years as a kind of gridlock and internal mechanism of the economy. With other economies also weak or in recession and little external stimulus from any source, policy or elsewhere, the economy simply cannot lift off.

The gridlock in the economy has produced a prolonged period of stagnation, with no self-regulating mechanism to break the interactions that limit economic activity. In fact, the United States economy has never "self-combusted" out of a downturn or period of stagnation. External stimulus or impulses of some sort have always been necessary to lift the economy. Only then has the internal mechanism of self-sustaining growth taken over.

No wonder Americans have felt so bad about the economy. Few have seen such prolonged weakness and so tough a jobs climate for so long. For business, a similar situation exists, and the climate has changed management practices in a permanent way.

## *Global recession*

Elsewhere around the world, all is not well either. The industrialized countries have exhibited an extended period of weak growth and some are suffering full-fledged recession. The United Kingdom is in its fourth year of recession or no recovery. Switzerland has been in recession. France and Italy are growing, although slowly. Real economic growth in the OECD countries was only 0.9 percent in 1991 and about 1.5 percent in 1992. Lately, the German economy has shown a decline in Gross Domestic Product (GDP). And now, Japan is showing only anemic growth, just one to two percent. By historical Japanese standards, that is a recession.

At the heart of the matter for Europe is the "German Problem"—recession associated with a sliding German economy and high inflation engendered by the shock of unification. Heavy government spending, high federal deficits, high costs of integration, and cost-push inflation are all consequences of the political and economic unification of Western and Eastern Germany. Inflation, at 3.5 to 4 percent, has resulted far in excess of the 2 percent German target.

In order to restrain inflation, the Bundesbank has followed a policy of keeping interest rates very high. Since the defense of currencies in the Exchange Rate Mechanism (ERM) has linked the currencies of Europe and until recently the United Kingdom and Italy, the high German rates have forced higher rates than domestically necessary in France, the United Kingdom, the Netherlands, Spain, and elsewhere, dragging down these economies. As the spending boom from German reunification has receded, the reduced pace of outlays has been felt throughout Europe. The German stagflation shows no signs of ending soon, although a reduction of inflation to near 3.5 percent and widespread economic weakness have brought some interest rate reductions in Germany and in other countries as well.

Unfortunately, the negative economic effects of German unification, a one-time but permanent shock, have been exported to other countries, prolonging European and United Kingdom economic weakness, limiting U.S. exports, raising U.S. interest rates and, in turn, maintaining worldwide stagnation.

## *Japan's boom unravels*

Yet another reason for world economic weakness is the "Japanese Thing"—the unraveling of a boom or bubble economy in Japan and the emergence of a Western-style recession-like pattern. Japan's financial economy is fragile—a term previously applied only to the United States—suggesting a situation of overleveraged and overextended financial institutions, a weak real economy, and policy actions too little or too late to reverse the momentum of the financial and economic problems. Japanese financial institutions are exposed to heavy

loan losses, regulatory requirements on capital adequacy, and the depressed Nikkei Stock Market.

The collapse of real estate and stock prices, the deceleration of the real economy, and the liquidity squeeze on financial institutions are new to Japan. The recognition lag by Japanese policymakers has been long because they are unfamiliar with these economic and financial problems. Their reactions have been too slow to offset the slide in real and financial activities. Fears of reviving a bubble economy, of reigniting inflation, or worsening a politically troublesome trade surplus with the West have helped to prevent action. The result is an economic slowdown fraught with risks of a full downturn and potential international credit crunch as Japan cuts back on spending, lending, investment, production, and employment.

With the three major economies of the world—the United States, Germany and Japan—all having economic difficulties, the United States and world economies cannot easily mount a solid recovery. The problems of the major industrial countries appear unique to each and are interactive. Thus no easy common solution exists. The risk of continuing recession or stagnation is significant, with the current episode in many ways more like the 1930s than typical post-World War II behavior. With so much economic weakness in so many parts of the world and little public sector stimulus, the risk of continuing stagnation and even full-fledged world recession is high.

## *Source of U.S. expansion*

For 1993 the best that can be expected is weak, positive, and minimal growth in the United States and major industrialized countries, with subdued inflation and high unemployment, sticky in moving down.

What will be the source of economic expansion? For the United States, the main source is trend growth in consumption and other categories of spending. Over the postwar period, consumers have almost always increased spending; in real terms, at 1 percent per annum. It is rare for consumer spending to decline. So long as no other sector of the economy is caving in, consumer spending alone, which is two-thirds of aggregate outlays, should carry the economy up.

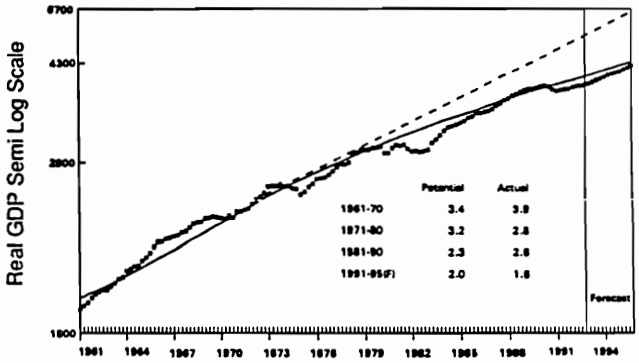
Spending on necessities such as services, food, clothing, and shelter should produce some lift, since population is generally rising. Residential construction should continue to move ahead. Some inventory building will be necessary. And, should the economy falter or keep underperforming, monetary and fiscal policy probably will be used to help raise growth.

Meanwhile, by-products of economic weakness are sustained low inflation and a low profile of interest rates, distinct pluses for the long run. Continuing chronically high budget deficits are also likely, due in part to the poorly performing economy. Nevertheless, profits can still rise, mainly because of much lower break-even points achieved by American business.

## *An unusual period of weakness*

The United States has gone through other downturns since World War II, but in these episodes the principal problem has been cyclical. The current period of weakness has been unusually long because of the combination of a secular or long-run slowing of potential growth and a cyclical recession (see Chart 1).

**Chart 1 Potential and Actual Real Economic Growth: Trend and Cycle (1962 to 1995, Billions of 1987 $'s)**




-- Potential GDP derived from 1961–73 potential growth rate
— Potential GDP at decade average growth rate
••• Actual GDP

*Source:* Bureau of Economic Analysis and The Boston Company Economic Advisors.

The Chart shows how the current situation differs from prior episodes. This time, a slowdown in the trend rate of growth *and* cyclical downturn together produced the current stagnation.

The trend of potential growth can be seen to have fallen over the postwar era, the result of secular or long-run changes in the economy. There is also a cyclical component, with actual growth fluctuating about a trend that has moved down. The trend and cyclical factors do interact, with cyclical changes in the economy affecting the potential rate of growth through

effects on labor and capital formation, R&D, entrepreneurship, and productivity growth. A lower rate of growth in potential output, or in the supply side of the economy, can limit actual growth through higher inflation and higher interest rates than otherwise would have occurred. This, in turn, can limit potential economic growth itself. Both the trend and cyclical fluctuations have been tending, on average, to produce lower growth for some time.

The up-cycle of the 1980s did not, as usually occurs, produce a pickup in potential output growth. Much of the expansion in the 1980s was consumption-oriented or involved debt-financed transactions in the business sector, with little saving or provision for an increase in the quality of labor, capital, and productivity. The shift of the U.S. economy from goods-producing to lower-productivity, services-producing activities may have been one reason for the declining growth in potential. Growing debt and debt service burdens made the problem worse, limiting funds available for productive capital outlays, R&D, education, and new business. A lack of infrastructure spending may have been another adverse factor. Slowing labor force growth could be yet another. Economists have not yet fully explained the decline in potential growth that began around 1973.

A true economic revival depends both on achieving a cyclical upturn and also on raising the long-run potential rate of growth.

Measures that are designed to raise cyclical growth will not fully deal with the U.S. stagnation. Measures that do "double duty," that is, affect both the short-run cyclical behavior of the economy *and* the long-run potential, are needed. The efficiency of macro policies, in this sense, is a new consideration. Moreover, because of high budget deficits, the "bang-for-a-buck" of any policy instrument must be calibrated. High productivity policy measures are necessary. If economic weakness is due to structural causes, policies designed to have a largely cyclical effect would be inappropriate and vice-versa.

The structural impediments in place are numerous, with some cyclical difficulties still remaining. Apparently, the negatives have more than offset the lift to the economy from the many positives that are slowly emerging.

## *What delayed recovery?*

Both structural and cyclical factors have depressed the economy and delayed a meaningful recovery. An understanding of the specific causes can help determine the appropriate policy responses.

1) *The shift from a "wartime" to a "peacetime" footing is a structural change; the resulting fiscal restraint has depressed the economy cyclically.*

The end of the Cold War and the shift from a wartime to a peacetime footing constitute a sea change in the structure of the economy. For the entire era following World War II, the economy essentially has been on a wartime footing, receiving support from increases in defense spending, more or less depending on United States military involvement—in Korea, Vietnam, and Iraq, for example.

Chart 2 **Employment in Defense-Related Industries (Seasonally Adjusted in Millions, 1985–92)**

*Source:* Bureau of Labor Statistics and The Boston Company Economic Advisors.

Large reductions in United States military spending now underway are causing related large cutbacks in employment (see Chart 2). Between 1976 and 1990, defense spending, in real terms, rose 3.3 percent a year. Currently, a 5 percent reduction has been programmed for each year and is being achieved. And there may be further reductions in a new Clinton Administration. The swing in federal government purchases from previous levels amounts to approximately $20 billion to $30 billion a year, a sizable dose of fiscal restraint at a time of economic stagnation. The Budget Enforcement Act of 1990 also limited the growth of federal expenditures. No new stimulus is permitted without offsetting reductions in spending or higher taxes elsewhere. State and local government spending is being held down because of state balanced budget laws. Tax increases occurred at the federal level in 1990–91 as a consequence of the



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Table 1 **Financial Instability in the U.S. Economy: Some Key Measures (Percent or Percent Change)**

| Sector | Latest | 91:4 | 90:4 | 1989 | 1988 | 1987 | 1980 | 1970 | 1960 |
|---|---|---|---|---|---|---|---|---|---|
| Household | | | | | | | | | |
| Mtg. & Auto Loan Repayments (% of Disp. Income) | 31.8 | 32.3 | 34.3 | 37.3 | 35.3 | 34.8 | 38.6 | — | — |
| Interest Payments on Mtg. & Auto Loans (% of Disp. Income) | 8.3 | 8.5 | 8.6 | 8.7 | 8.6 | 8.8 | 7.3 | 5.2 | — |
| Real Net Worth (% Chg.) | –1.6 | –1.3 | 0.2 | 4.6 | 4.7 | –46.6 | 3.3 | 3.2 | — |
| Nonfinancial Corporate | | | | | | | | | |
| Short- to Long-Term Debt (%) | 30.0 | 30.2 | 34.4 | 34.8 | 46.1 | 46.5 | 40.5 | 32.0 | 23.3 |
| Debt Service as Percent of Internal Funds | 64.2 | 70.2 | 73.6 | 65.2 | 62.5 | 61.2 | 59.8 | 47.2 | 21.8 |
| Debt to Net Worth (%) | 50.5 | 51.9 | 49.3 | 46.1 | 45.8 | 47.8 | 30.5 | 45.9 | 35.2 |

*Sources:* Federal Reserve Flow-of-Funds; The Boston Company Economic Advisors.

Budget Enforcement Act and at the state and local government level in 1991–92. *Never before has government spending dropped as the economy emerged from recession. The last time taxes were raised in a recession or in a fledgling upturn was during the Great Depression years.*

2) *Debt and debt service burdens (structural and cyclical).*

As the economy entered the 1990–91 recession, debt and debt service as proportions of income, cash flow or—in the case of government—revenues, were at unprecedented levels. The U.S. economy was extremely leveraged, after experiencing a decade of rising asset prices and borrowing secured by inflated asset values.

The overhang of debt and debt service from the inflationary and expansionary decades of the 1970s and 1980s is without parallel in American economic history. More important for the economy than outstanding debt, which can be secured by the asset value of collateral, are the interest charges on debt that constitute prior claims on cash flows or incomes. These have turned out to be a major impediment to spending by households, business, and the government sector. Considerable improvement has occurred over the past year-and-a- half, but debt and debt service burdens remain well above historical trends and higher than typical in other periods when inflation was low.

The "good news" is that these burdens have not produced a great depression. The "bad news" is that it is not possible to determine how long the debt overhang will continue to restrain spending and the economy. For the long run, deficits, debt, and debt service burdens have to be worked down, a process that limits both near-term growth and long-run potential output until much later.

3) *Financial instability and balance sheet shock (structural and cyclical).*

The overextended financial positions of households, business, and financial institutions and the slowdown in the economy have combined to produce substantial financial risk and balance sheet instability in the U.S. economy. This is a typical cyclical characteristic, but it is more pronounced now because of structural changes in the prices of real assets, inflation, and the tax system.

Asset price deflation, particularly in real estate, has resulted in insufficient asset value collateral in the household, business, and financial sectors, leading to bankruptcies, failures, lower levels of economic activity, and for a time a credit crunch in banking.

The financial ratios of the private sector deteriorated greatly over the decade of the 1980s, reflecting aggressive spending and borrowing, and rising debt and debt service. So long as the assets were secured by the market values of asset collateral, no problem existed and active spending could occur. But once real estate and stock prices fell, loan losses to the banking system mounted and the economy weakened, balance sheets deteriorated further, and the resulting balance sheet shock limited spending.

Financial instability limits the funds allocated to capital formation and diminishes the potential rate of growth in the economy. In the extreme, during a credit crunch, productivity-enhancing expenditures may be completely rationed out.

The restructuring of balance sheets, or reliquefication, is a characteristic of the U.S. business cycle and is yet another factor preventing the economy from growing more rapidly. The process of repairing financial positions appears to have begun in 1989, as is shown in Table 1, but will continue well into and perhaps through 1993.

Table 2 **The Diminution of First-Time Homebuyers and Aging of the Population**

| | Households by Age-of-Head (Mils. of Units) | | | | | | Distribution of Households by Age-of-Head (In percent) | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1970 | 1975 | 1980 | 1985 | 1990 | 1995p | 1970 | 1975 | 1980 | 1985 | 1990 | 1995p |
| All | 63.4 | 71.1 | 80.9 | 86.8 | 93.3 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| 15–24 | 4.4 | 5.8 | 6.6 | 5.4 | 5.1 | 4.9 | 6.9 | 8.2 | 8.2 | 6.2 | 5.6 | 4.9 |
| 25–29 | 6.1 | 7.8 | 9.3 | 9.6 | 9.4 | 8.4 | 9.6 | 11.0 | 11.5 | 11.1 | 10.1 | 8.4 |
| 30–34 | 5.6 | 7.1 | 9.3 | 10.4 | 11.0 | 11.1 | 8.8 | 10.0 | 11.5 | 12.0 | 11.8 | 11.1 |
| 35–44 | 11.8 | 11.9 | 14.0 | 17.5 | 20.6 | 23.2 | 18.6 | 16.7 | 17.3 | 20.2 | 22.0 | 23.2 |
| 45–54 | 12.2 | 12.9 | 12.7 | 12.6 | 14.5 | 18.0 | 19.2 | 18.1 | 15.7 | 14.5 | 15.5 | 18.0 |
| 55–64 | 10.8 | 11.3 | 12.5 | 13.1 | 12.5 | 12.6 | 17.0 | 15.9 | 15.5 | 15.1 | 13.4 | 12.6 |
| 65–74 | 7.7 | 8.9 | 10.1 | 10.9 | 11.7 | 12.3 | 12.1 | 12.5 | 12.5 | 12.6 | 12.6 | 12.3 |
| 75+ | 4.8 | 5.4 | 6.4 | 7.3 | 8.4 | 9.5 | 7.6 | 7.6 | 7.9 | 8.4 | 9.0 | 9.5 |

p-projected
*Source:* Bureau of the Census

4) *Demographics and big-ticket item purchases, especially housing (structural).*

Significant demographic changes are now working to limit household purchases of big-ticket items, especially homes. The proportion of families in the prime first-time homebuying age of 25–to–34 years is falling and will continue to do so throughout the 1990s. Table 2 shows the changing demographic composition of the population for the last twenty-five years, indicating a diminishing rate of increase for the 25–to–34 year age group and a smaller proportion of families in this category than at any time in the last twenty-five years. The diminished number limits the pent-up demand for new and existing homes that usually occurs with easier money and lower interest rates. Many of the potential first-time homebuyers are liquidity- or jobs-constrained, with considerable concern about the future. The result is a softer upturn in housing and residential construction than typically occurs in the aftermath of a recession.

The same story holds for automobile sales, another big-ticket item. The aging of the baby boomers that is principally responsible for the change in demographics represents a significant structural change in the economy.

5) *Global competition (structural).*

Compared with ten years ago, competition in the global economy is greater and more intense now. Over the past decade, companies based overseas—Japanese, German, other European, and particularly those of the newly industrialized countries (NICs) such as Taiwan and Korea—have become prominent in markets around the world. This makes it more difficult for U.S.-based firms to capture share in world markets and has made it harder for the economy to revive. The global environment is immensely different today from any previous time in the postwar era. American businesses are just beginning to figure out how to compete better in the new environment.

6) *Commercial real estate depression (structural and cyclical).*

This factor is both structural and cyclical, with the Tax Reform Act of 1986 playing a significant role in depressing the demand for, and funding of, commercial real estate. Commercial real estate is depressed in almost every major urban center of the world, ranging from California to New York to Chicago, London, and Tokyo. The glut of space will take a long time to be sopped up, especially in slow-growing economies; this feeds into the cyclical side of the real estate difficulties.

7) *New wave business strategies (structural).*

The new strategies of business—cost-cutting, productivity enhancement, quality improvement, and better service—clearly are a plus for the economy in the longer run. However, near-term, the cost-cutting wave means fewer jobs, downward pressure on wages, and less growth in incomes and benefits for individual workers. As profits improve, business will increase spending and create more permanent jobs. But the propensity of business to spend out of profits is lower and has longer lags than the propensity of consumers to spend out of incomes generated by new jobs. The lack of job creation will probably continue to plague the economy for some time. Jobs that have been lost will be slow to return, if indeed they ever do, with workers having to be reabsorbed in new activities.

8) *Consumer behavior (structural and cyclical) and sentiment (cyclical).*

Consumer behavior now is radically different from that in the 1980s, when spending and borrowing were

the rage and saving and paying off debt were eschewed. Just the opposite is the case for the 1990s: spending and borrowing are out, and saving and paying off debt are in. Consumers are bargain-hunting, downsizing and downscaling, being cautious, and refusing to buy. With jobs hard to get, slow growth in real income, insecurity over the future in terms of health care, pensions and the like, the retrenchment in the pace of consumer spending that started in 1989 is likely to continue.

Part of the gloomy and pessimistic consumer sentiment is due to the lack of new jobs and meaningful economic recovery. A new factor in consumer pessimism has been the perceived inability of government to diagnose and deal with current U.S. economic problems.

9) *Financial system disarray (structural and cyclical).*

For some time, the collapse of the thrifts and implosion of the commercial banking system crunched the economy and helped to prevent economic revival. More recently, because yield curves are sloping upward and financial institutions have worked out much loss and risk exposure, the U.S. financial system is in better shape. Weakness in credit outstanding is more a consequence of lack of demand than of an inability of banks to lend.

The financial intermediaries do remain reluctant to lend except for well-structured projects with high and competitive returns. But there is neither the lack of funds nor the nonprice rationing that existed before.

The structural change that remains is how financial intermediaries do business. They are more inclined to do business that earns fees and involves less risk-taking. They are more efficient. They are keeping the number of employees down. Lending is more costly and risky than investing in U.S. Treasury securities; as a result, commercial banks are building up huge holdings of securities in their portfolios. The near-collapse of the depository intermediaries in recent years is a structural change that has impeded the credit channels of the economy from operating efficiently.

10) *Overseas economic problems and risks (structural and cyclical).*

Most troublesome to the U.S. economy at the current time is the continuing stagflation in Germany, stagnation on the Continent and in the United Kingdom, the recent slide in Japanese economic activity, and potential for an international credit crunch emanating from Japan.

Each of these areas has its own structural and cyclical impediments to economic revival, different in origin and across countries, but a bottom-line risk to the United States on exports. Europe, the United Kingdom and Japan account for 37.7 percent of total U.S. exports. The problems of Germany and the Continent will take some time to work out. The same is true of Japan. This means less U.S. economic growth. At worst, an international credit crunch and worldwide recession are possible.

11) *A "speed limit" for the economy because of slow growth in potential output (structural and cyclical).*

The downtrend in the rate of growth for potential output, in place since 1973, has not yet been reversed. It is not yet clear why and how productivity growth and potential output have diminished. But the actual performance of the economy is limited by potential growth at just 2 percent. Policy cannot revive the economy too rapidly nor push the economy to rates of growth typical of past expansions for very long without running into reinflation from demand pressing against supply.

## *Why has monetary policy not revived the economy?*

One of the puzzles of this episode has been the inability of the economy to revive after so many instances of monetary ease. Lags between the time of easier monetary policy and economic recovery had been thought to be from six to twelve months. The lags now have stretched to over three years, longer than for any other postwar situation.

Monetary policy stimulates the economy by reducing marginal borrowing costs, lowering debt service, reducing break-even costs for business, improving financial positions, liquefying banks and establishing a base for credit expansion, diminishing the cost of capital, and boosting the stock market and consumer confidence.

But with so many structural impediments in the economy, the stimulative effects of easier money have been overwhelmed. There have been massive declines in defense spending, overwhelming burdens of debt and debt service, a tax increase in 1990, financial institution fragility and a credit crunch, changes in demographics to limit big-ticket item buying, a glut in real estate, deflation in asset prices and deteriorating balance sheets, and economic weakness abroad.

Because of these factors, the demand for money and credit has been shifting down faster than the supply has been expanding, driving interest rates lower, but not enough to reverse the weakness in spending and in the demand for money. A similar situation may have oc-

curred in the 1930s: factors affecting the demand side of the economy, including sentiment, were so negative that even when the Federal Reserve pushed interest rates significantly lower, the economy did not revive. This has been reflected in extraordinarily weak money and credit aggregates which, in real terms, have actually declined. Thus, yet another factor holding the economy down has been the lack of money and credit.

The Federal Reserve has probably erred in pegging the federal funds rate, essentially "fixing" a market price. The Fed set short-term interest rates too high for equilibrium between a sinking demand for funds and the supply of funds. The slow and cautious reductions in the federal funds rate, and thus in other short-term interest rates, probably have kept interest rates higher than equilibrium, limiting the quantity of funds and credit demanded, and preventing the economy from rebounding faster. The by-products of a weak economy—deflation in many instances and higher unemployment—represent prima facie evidence that short-term interest rates are being set too high. The surplus of funds in the financial system has gone toward investments in U.S. Treasury securities. This in turn has brought less economic growth and reduced the demand for money and credit, impairing economic performance and slowing the growth of the monetary aggregates.

U.S. monetary policy must continue to sustain a low profile of interest rates, perhaps the key ingredient for lasting improvement in long-run potential output. Even more desirable would be a freeing up of interest rates to whatever levels the demand and supply of funds would bring. The U.S. central bank should target bank reserves to achieve monetary growth targets, letting the demand and supply of funds determine the federal funds rate and other short-term interest rates. If the demand for funds is weak, then the federal funds rate would quickly drop to lower levels. Significantly lower short-term interest rates would then act more quickly to revive economic growth and the demand for funds.

Simulations with the Sinai-Boston Macroeconometric Model of the U.S. economy have long indicated that a quick reduction in the federal funds rate to around 2 percent would be required to achieve 2.5 percent real economic growth, given the structural impediments that exist. A reignition of inflation would not occur even if the federal funds and discount rates were lowered by another percentage point. Plenty of slack exists in an economy with a high unemployment rate and low inflation. Such a policy would resemble that of the central bank in 1979–82 under Chairman Volcker, where interest rates were freed to seek higher levels to restrain growth and inflation. Just the opposite problem exists now. Such a change in the operation of Federal Reserve policy, given the unique set of impediments at this time, could help reverse the economic stagnation.

## *What role for fiscal policy?*

The failure of the United States and world economies to perform as expected indicates that policies should be altered to bring about improvement. Varying doses of fiscal and monetary stimulus are needed in the United States, Germany, and Japan. The United States can relax its deficit modestly with up to $50 billion of net fiscal stimulus without fear of reigniting an unwanted inflation. Further deficit reduction can come after growth is revived or a trigger growth rate can be established legislatively for fiscal restraint in advance. Germany need not run such high interest rates, when its rate of inflation runs at about 3.7 percent and its economy is declining. All countries can reduce interest rates, given relatively low inflation in each. Japan has room for even more fiscal stimulus *and* some more monetary easing, given its budget and trade surpluses.

Fiscal policy can help simultaneously to engineer a faster cyclical expansion and raise the potential growth of the economy. With high structural budget deficits and the Budget Enforcement Act of 1990, any relaxation of the deficit with fiscal stimulus is difficult, however. Higher deficits add to debt and debt service burdens, one of the major structural problems of the economy. Interest rates can rise, limiting the positive effects of the stimulus. But it is clear that the combination of monetary ease and fiscal restraint that has been in place, along with the other negative factors, has not produced the desired results for the economy. Therefore, a temporary relaxation of the deficit restraint set by the Budget Enforcement Act is now necessary.

*A moderate dose of net fiscal stimulus on the order of $30 billion to $50 billion is necessary, set at the higher end of the range in the near term and lower in the second year, so long as the measures involved do "double duty"—serving simultaneously to lift near-term economic growth and to enhance long-run productivity and the potential output of the economy.* A fiscal stimulus of this size would be minimal in a near $6 trillion economy, far less than any employed in the past. The new Congress and administration would be well-advised to pass some "double-duty" fiscal mea-

sures that would enhance growth and long-run productivity: (a) investment tax credits targeted on "productive" investment; (b) nondefense infrastructure spending and repair; (c) capital gains tax reduction, at least indexing to inflation; (d) well-thought-out expenditures to improve education, especially K–12; and (e) education and retraining programs. Legislators and policymakers should avoid any measures that do not do "double duty," for example, reducing personal income taxes, spending on public works of the 1930s variety, and government outlays that are not targeted or tracked in accountability. Calibration of the results obtained in terms of output, the unemployment rate, and inflation per dollar of lost revenue or extra spending is another way to judge the relative efficiency of any fiscal measure.

## *Conflict and choice*

In 1992–93, the United States economy is confronted with several economic problems—growth and jobs, large budget deficits, and stagnant overseas economies. In 1988–89, the only major problem was the deficit. Unfortunately, the problems of growth and deficits cannot generally be solved at the same time. Reducing federal budget deficits through fiscal policy is incompatible with increasing economic activity and creating jobs. Increasing economic activity with fiscal policy can be incompatible with cutting the deficit.

If budget deficits fell of their own accord, then the resulting lower interest rates could increase economic activity in interest-sensitive spending, raising growth and lowering deficits together. But this generally can happen only through reductions of interest rates by the Federal Reserve. Changes in budget deficits often come from changes in government spending or taxation.

Reducing deficits by cutting government spending and/or raising taxes would only lower economic activity and decrease jobs. Those steps do not produce as much deficit relief as planned because of lost tax receipts from lower economic activity. Interest rates do decline in such a situation, somewhat softening the effects on the economy. But mainstream thinking in macroeconomics and virtually all econometric models indicate that the gains to the economy and jobs from lower interest rates are more than offset by the losses from reductions in government spending and higher taxes.

The time to reduce spending and/or impose higher taxes in order to bring down the deficit is when the economy is at or near full employment, with rising inflation. Such is not the case now, after three-and-a-half years of prolonged weakness, growth below trend, the lowest inflation rates in thirty years, an unemployment rate near 7.5 percent, and stagnation in much of the industrialized world.

Enough relaxation of the budget deficit to permit a modest dose of fiscal stimulus would tend to raise economic activity without noticeable costs of higher inflation and interest rates. In any case, some dose of fiscal stimulus has always been used to lift the economy out of slack, whether before or after World War II. Fiscal stimulus can generate jobs and new economic activity, perhaps jump-starting a chronically stagnant economy.

While such a policy shift would permit the deficit to rise in the short run, the government should hold to the goal of eliminating the deficit in the long run. The deficit to be balanced, it should be noted, is the *structural* or *full-employment* budget deficit, not the overall federal budget deficit which has ballooned because of economic weakness.

At the same time that an increase in the budget deficit is established, measures to reduce the deficit in later years can be chosen and legislated. Once the target rate of economic growth is achieved and the internal mechanisms of the economy are driving growth, eliminating the structural budget deficit can take top priority. For example, real growth of GDP at 3.5 percent per year might then trigger measures such as higher gasoline taxes, caps on the growth of some entitlements, higher taxes on social security benefits to the affluent, or an even greater acceleration of defense spending reductions, if warranted by international conditions.

Modest and gradual doses of fiscal restraint would not severely curtail economic activity. If chosen carefully to preserve those fiscal policies aimed at raising productivity and potential output, such restraints could sustain the gains achieved in raising the trend growth rate of the economy. Later on, the fiscal instruments chosen should be cyclical in impact and least subject to interaction of near-term growth with long-run potential output.

The lifting of growth should be from below and cautious, using a small to modest dose of fiscal stimulus, unlike the typical applications of fiscal stimulus in the past. In this way, especially with large budget deficits, the effects on financial markets would be limited, and if the stimulus was not enough, more could be applied later. Also, the economy does tend to relieve

excesses over time, setting up for expansion later. Too much stimulus might end up superimposed on an economy that was already doing better, leading to overshoot or too much growth relative to potential supply and a potential reignition of inflation.

In order to both raise growth and lower deficits, other factors should be in place as well: easier monetary policy, increased bank lending, improved economic activity abroad, greater efficiency and productivity in the private and public sectors, lower-cost provision of health care, and yet-to-be-determined new sources of growth or cost-savings.

## *Standard policies are not enough*

What's wrong with the economy? The problem is largely structural and somewhat cyclical. Potential or trend economic growth is down considerably, to 2 percent a year instead of the 3 percent plus of earlier post-World War II years. The lower track of long-run potential is being superimposed on cyclically depressed growth.

The structural weakness stems from factors such as heavy debt loads and large debt service burdens that over many years have limited the productive input of labor and capital, reduced R&D and technological innovations, allowed infrastructure and education to run down, hampered the operation of the financial system, limited business entrepreneurship, and led to a new wave business management that destroys jobs rather than creates them.

In such a situation, the most unusual in modern U.S. history, the standard macroeconomic policy prescriptions are not sufficient to achieve sustained noninflationary growth high enough to raise the standard of living to previous levels.

The nation needs measures that help somewhat to lift the economy near-term but, more importantly, raise the potential for growth long-term. For the two major problems—growth and deficits—there is a sequencing choice. To solve the complicated macroeconomic problems now facing the United States, we must first raise growth, then balance the structural budget deficit. In doing so, we must repair and rebuild the foundations of productive potential which have suffered long-term decay. This means strengthening the basic building blocks of any nation: the education system, the productive capacity of the public and private sectors, and the incentives for business enterprise and innovations.

THE NEW YORK TIMES **OP-ED** WEDNESDAY, FEBRUARY 24, 1993

# Let's Work With Clinton's Plan

By Herbert Stein

WASHINGTON

Bill Clinton's economic program is probably the most far-reaching effort ever made by a President to control the Federal budget deficit. In light of the challenge and opportunity facing him and the country, it is disappointing.

Still, the plan is the only place we have to start, and it needs support. For those seriously concerned about the deficit, the responsibility now is not to defeat the plan but to try to strengthen and improve it. Here are some suggestions and observations.

• The deficit reduction proposed is much too small. Even by the Administration's own estimate the plan would leave a large deficit in 1997 and, more important, it would rise thereafter. The budget target for 1997 is arbitrary. It provides no basis on which to resist the inevitable temptations to try to scale back the deficit reductions.

The President's program would have been more defensible if its goal had been to reduce the deficit to zero, even if this had to be accomplished over a period of six or eight years.

• The program does not take advantage of reasonable options for substantially reducing the deficit. These include cutting the Federal subsidy for Medicare, limiting or eliminating the exclusion of fringe benefits from taxable income and cutting spending more sharply for the space station, supercollider and farm price supports.

The energy tax, chosen as the broad-based levy that most people would pay, could have been imposed at a higher rate without a severe burden on anyone.

• The proposed rate increase in the corporate profits tax, from 34 to 36 percent, only worsens the current "double taxation" inequity and would be an obstacle to the growth of investment that is one of the program's main goals. Profits are already taxed at the corporate level and at the individual level, in the form of dividends or capital gains.

• Applying a proposed tax to the use of energy by businesses would deter investment, because production that uses much capital also tends to use much energy. In addition, taxing energy used by business would drive energy-intensive production, like aluminum smelting, out of the country.

• The proposed investment credit for businesses would be highly discriminatory. It would reward businesses that invested little last year; that invest in physical capital rather than in research and training; that invest in short-lived assets, and that invest in equipment rather than structures. This is as likely to result in a loss of efficiency as it is in a gain.

• The Administration program is dotted with little give-aways, like tax breaks and soft loans for small business and supports for particular ventures such as high-speed trains. These give-aways, which would add up to tens of billions of dollars a year, would undermine a comprehensive effort to deal with the deficit.

Most of them could properly be described as investments — which is how the President describes them. But many are unlikely to be as productive as the private investment that would result if the same amount of money were devoted to deficit reduction, which helps the overall economy. In general, the Administration's strategy shows an unjustified preference for government, or government-directed, investment over market-determined private investment.

• The selling of the program to the public relies heavily on the argument that the more progressive the tax system is, the fairer it is. That is not only a simple-minded view of fairness. It is also a dead end for budget policy. It means that when the economic limits of taxing the rich are reached there is no possibility of getting more revenue from the middle class, because that would reduce progressivity.

Despite these criticisms, the Clinton plan is the only deficit-reduction plan with a chance of being adopted. Some people, including leading Republicans, will say that they have an alternative plan to cut spending much more sharply than Mr. Clinton proposes to do.

But their plan is always described in general terms — "across-the-board cuts," "a freeze on total spending" or some such formula — never specifying what exactly is to be cut. The proponents of such "plans" have no more stomach than Mr. Clinton does for attacking the large middle-class benefits that are the essence of the budget problem.

This judgment may be too pessimistic. Some Republican leadership in Congress may arise to push strongly for significant specific cuts. If that happens, the President, given political cover by Republican support, may accept and possibly even welcome the reductions. In that case we could get a better program than the one the President has proposed.

But there is no sign of such a development and therefore little chance of getting a better deficit reduction package than Mr. Clinton's. Moreover, the President's package has every chance of being defeated. Elements of the program that save the most money will be vulnerable to opposition, because they are the most painful to the most people.

Advocates for the elderly will resist higher taxation of Social Security benefits. All kinds of users and suppliers will resist the energy tax. Unless some forces in the country and Congress are sufficiently concerned about the deficit to support the President's proposals — however much they dislike other parts of the package — the whole deficit-reducing effort could collapse.

If this effort fails we will probably not see another one for some time. The lesson will be that the system rejects even a cautious attempt by the President to exercise fiscal responsibility and to make a few tough decisions. And the public will once again see that no one really cares and that all the talk about the national interest in reducing the deficit is only a cover for the struggle of everyone to get his.

If the present effort succeeds, however, there will have been a demonstration of the willingness of Congress and the public to accept some sacrifice. Some budget untouchables will be seen to have been not so untouchable.

Discussion of the steps needed to reduce the deficit further can resume, one may hope, in a less demagogic and emotionally charged atmosphere than today. In that case we may yet say that 1993 was a turning point away from the disintegration of budget policy that has been going on for the past 25 years. □

*Herbert Stein, senior fellow at the American Enterprise Institute, was chairman of the President's Council of Economic Advisers under Richard Nixon and Gerald R. Ford. This is excerpted from an article to appear in the March-April 1993 issue of The American Enterprise.*

**It has flaws. But rejecting it will dash efforts to cut the deficit.**

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# New Clinton. New Era.

By Paul E. Tsongas

BOSTON

The Bill Clinton you saw on TV was not the Bill Clinton I ran against. I am pleased the evolution has taken place. Finally, a President who talks about the deficit, competitiveness, long-term growth and generational responsibility. A new era. A hard look at hard choices.

Does the economic package go as far as I, Warren Rudman and my Concord Coalition colleagues would go? Not really. We're more focused on deficit reduction. Are the savings as real as claimed, and will they survive the Congressional journey? I don't know.

We're on a new path, led by a very intelligent President who can absorb data and the realities they represent in a way his immediate predecessors could not or would not.

What are the true options? I believe there are four. First, steady as she goes, status quo. If Bill Clinton did nothing else, he awakened America to the stark consequences of doing nothing. Doing nothing means catastrophe. Status quo is not an option. Second, follow the Congressional alternative. Ha! What alternative? You will hear the cries of outraged Republicans. No new taxes! We need a strong defense! These positions and deficit reduction are incompatible! Listen to the Democratic committee chairmen and caucus activists. You will hear pleas for expanded entitlements and increased domestic appropriations. You will never see a specific Congressional alternative. And certainly not one that comes close to the President's deficit reduction package. Remember, these are the same people who lay dormant as Ronald Reagan and George Bush racked up $3 trillion of debt. They are incapable of a true balanced budget proposal.

## Delay health reform. It would be disruptive.

Third, the Clinton plan. To use very rough numbers, the package breaks down as follows: a little over $202 billion in savings (from the 1994 to 1997 fiscal years) and $267 billion in new taxes in that same period; that's $469 billion in possible deficit reduction. From that total, subtract $109 billion in stimulus and people-first investments and $60 billion in investment tax incentives. This results in about $300 billion in deficit reduction plus $24 billion in interest payments that will not have to be paid — $324 billion less debt. Not bad.

The danger is that a package will pass without some of the tougher measures and deficit reduction will fade to a low-impact number. Instead of the fiscal 1997 deficit going from $346 billion to $206 billion, it could end up at $260 billion. After all the agony and tax increases, the public will feel deceived.

As for the fourth option, a growing consensus says that the deficit reduction bottom line has to be raised. The original hope expressed by Leon Panetta, director of the Office of Management and Budget, of a 2 to 1 ratio of spending cuts to new taxes is now seen as less than 1 to 1. Congress could add new cuts here and there and reduce the level of investment and stimulus spending just enough to cause the fiscal 1997 deficit to drop below $200 billion — to, say, $180 billion. Thus, the mystical goal of reducing the deficit in half in four years would be realized (close enough), and we would enjoy business confidence. The public would feel it is on the path to fiscal solvency and Bill Clinton would sweep to re-election.

A caveat. If a $30 billion to $90 billion health care proposal is dropped on the table in the middle of all this, it will disrupt everything. Fast-tracking a health care proposal that requires extensive deliberations and vast new revenue sources is to undertake an initiative that will compete with the economic package in a way that will harm both. We need a health care package, but it must delay its debut until after the economic plan has been passed, taken root and begun to bear fruit. □

*Paul E. Tsongas, former Senator from Massachusetts, sought the Democratic Presidential*

# Taxes vs. Growth

By Jack Kemp

WASHINGTON

The Clinton campaign that promised a plan for economic growth has suddenly turned into an Administration demanding across-the-board sacrifice from the American people. Indeed, the myth that Americans are undertaxed has become the defining principle behind President Clinton's economic policy. The truth is that Americans are overtaxed, not undertaxed.

Sacrifice is not an economic policy and it's certainly not a goal for which the nation should be striving. Besides, it's not the people who need to sacrifice, it's the bloated Government.

More important, raising tax rates will not reduce the deficit but weaken our fragile economy. The faulty premise behind the 1990 budget agreement was that higher taxes would lead to more revenue, lower deficits and growth. Instead, the deficit increased from 3.1 percent of G.N.P. in 1990 to 5 percent by 1992 because the anticipated tax revenue failed to materialize, as it always does when taxes rise.

According to some estimates, the slowdown in growth after the budget agreement cost the Treasury $183 billion, six times the amount of Mr. Clinton's $31 billion "stimulus" package. Expanding growth and opportunity for everyone, not redistribution of wealth, must be the highest goal of economic policy. In fact, we should set a goal of doubling the size of our economy, to $10 trillion from the present $5 trillion, in no more than 12 years.

Achieving the needed 4 to 6 percent growth rates requires a radically different path than the Clinton plan of higher income taxes, surtaxes, new energy taxes and taxes on Social Security recipients. Instead, we must build a strong foundation of incentives for entrepreneurship and productivity.

- *Taxes.* In his campaign, Bill Clinton accepted the principle that cutting capital gains taxes spurs growth. Our unindexed gains tax is a huge barrier to capital formation and job creation. We should eliminate this tax or at least reduce and index it for inflation. We must also reverse the trend toward higher income taxes with a flatter, fairer and simpler tax code, one that rewards, not punishes, success.
- *Government spending.* Government at all levels spends too much, consuming nearly 40 percent of G.N.P., up from 26 percent in 1960. If the private sector is the engine of economic growth, then we must restore the balance between the public and private sectors. One proposal would be freeze spending and limit the growth rate of entitlements, except Social Security, to inflation plus population growth. This would still allow a 5 to 6 percent annual increase, permitting us to meet social obligations while producing substantial savings.
- *Trade.* Restricted trade forces companies to compete for special treatment from government instead of competing to develop better products. Open trade forces governments to compete to lower taxes and reduce regulations to make their economies more competitive.

## 'Sacrifice' is not an economic plan.

Unfortunately, the Administration seems intent on a protectionist path of higher tariffs matched by retaliation by our trading partners. Tariffs averaging 27 percent on imported steel and restrictions on U.S. purchases of European communications equipment have already been proposed. While Mr. Clinton has endorsed the North American Free Trade Agreement, our goal should be nothing less than global trade liberalization.

Mr. Clinton has outlined some laudable goals: : creating new jobs, ending welfare as we know it, reducing the deficit, encouraging the private sector as the engine of growth. Unfortunately, his tax increases directly conflict with these goals. While at times he sounded like John Kennedy and Ronald Reagan, tragically his policies are closer to those of Herbert Hoover and Jimmy Carter.

*Jack Kemp was President Bush's Secretary of*

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# The Fed: Politician's Scapegoat

By GARY GALLES

Our politicians' most valuable assets are their index fingers: They vigorously point them at themselves when something good happens, but just as vigorously point them at someone else when something bad happens.

Nowhere has this finger-pointing approach been honed to as fine a point as with our elected officials' relationships to the Federal Reserve System, an independent agency of the government charged with control over monetary policy.

When the Fed accelerates money growth, our representatives point the finger of credit at themselves; they say, "Haven't we done a good job of stimulating the economy."

But later they point the finger of blame at the Fed for causing inflation, which is just the delayed effect of the same policy.

When the Fed slows a too-rapid rate of inflationary money growth, they blame the Fed for the resulting recession. But later they claim credit for bringing inflation under control — also the delayed effect of the same policy.

No matter what the Fed does, politicians claim credit for the good effects and blame the Fed for the bad ones, or fault the Fed for preventing their own wonderful plans from working. That makes an independent Fed a great scapegoat.

The only problem is that the same politicians would like to exercise more power over the Fed, particularly in the direction of more monetary stimulus to the economy (to claim credit for growth), while maintaining enough political distance to preserve the Fed's role as scapegoat for any unpleasant results.

The pressures for increasing political control over the Fed have been intensified by an incoming Democratic administration that will share credit with Congress (but little blame) for the results. They have taken form in a proposal by House Banking Committee Chairman Henry Gonzalez, D-Texas.

Rep. Gonzalez' proposal would end long-term practice, in which each of the Fed's 12 regional bank presidents is selected directly by its board of directors and then confirmed by the Fed's Board of Governors. That practice was established largely to inhibit political manipulation of monetary policy.

Instead, under Rep. Gonzalez' proposal, each regional board would give a list of potential nominees to the president, who would pick "no more than a simple majority from the administration's own party" to be nominated as heads of the banks, with those nominees then subject to Senate confirmation hearings. This would give both Congress and the incoming president more power over the Fed's membership, and thus its policies.

This seemingly minor change is important because five regional bank presidents sit on the Fed's 12-member Open Market Committee (on a rotating basis), which is responsible for day-to-day Federal Reserve policy — with its implications for monetary growth, interest rates, inflation, unemployment and output.

These regional bank presidents have emerged as a strong anti-inflation block on the Open Market Committee, limiting the Fed's willingness to use expansionary monetary policy to stimulate the economy if it would likely lead to future inflationary consequences.

Rep. Gonzalez' proposal (whose logic, for history buffs, reflects similar populist pressures for an inflationary "free silver" monetary policy near the turn of this century) would achieve its goal. Extensive hearings would allow the Fed to be set up to take the blame for any economic difficulties during this administration if it didn't go along with Democratic initiatives to "get the economy moving."

It would give Congress more power over monetary policy, adding its confirmation control over the regional Federal Reserve Bank presidents to the Fed's Board of Governors, which comprises the rest of the Open Market Committee. (And we all remember the fine job Senate Banking Committee members such as Alan Cranston have done with banking matters).

Combined with public ignorance of monetary policy, it would keep the Fed at enough of an arm's length that it still fulfills its scapegoat function. Its party restrictions would provide the Clinton administration with plenty of leeway in its appointments, given its current makeup, but it would constrain any future Republican administration.

Rep. Gonzalez' dangerous proposal would transfer more power over monetary policy to both Congress and the president but allow them to continue to dodge political blame. It would abandon long-established buffers between politics and monetary policy, designed to insure against the political temptation toward inflation, and hand control of monetary policy to those who have run fiscal policy into the ground and contributed greatly to the banking crisis.

The last thing we need is "politically correct" monetary policy.

*Gary Galles is a professor of economics at Pepperdine University in Malibu, Calif.*

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THE WALL STREET JOURNAL WEDNESDAY, FEBRUARY 3, 1993

# The Trouble Ahead

By ALAN REYNOLDS

After a brief spell of bond market nervousness around election time, long-term interest rates have remained surprisingly low despite two quarters of about 3.5% economic growth. This is obviously good news for the new administration, while it lasts. But it is unlikely to last very long if any of the proposed tax and spending policies are enacted.

The most fashionable explanation for the calm bond market is that good economic news reduced the need for "fiscal stimulus" (a meaningless euphemism for bigger budget deficits). A typical news story (in this paper, as it happens) thus reported that "bond investors became more convinced that new signs of economic strength in the fourth quarter mean that any spending package will be modest. . . . Such a spending package could enlarge the deficit and spark higher inflation, both of which would reduce the value of bonds."

That story never made much sense. Despite many valiant efforts, nobody has convincingly demonstrated any clear connection between interest rates and even huge changes in budget deficits, much less the minor alterations the Clinton administration may contemplate. In the late 1980s, Britain, Sweden and Australia all ran budget surpluses yet had much higher interest rates than the U.S. The U.S. has experienced large and rising budget deficits ever since the infamous budget "cure" of 1990, yet both inflation and interest rates fell.

### Blaming the Deficit

It is nonetheless not surprising that every wiggle in interest rates is attributed to changing hunches about the budget deficit, or even about how it is financed. After all, every problem, real and imaginary, has been blamed on the deficit in the past decade. The deficit was supposed to "absorb savings" and abort the recovery in 1983. Then the deficit was said to be the cause of "overheating" in 1984. In subsequent years, the deficit was said to be the cause of both the rising dollar and the falling dollar, thus being both deflationary and inflationary.

The truth is that economists are not at all sure how to properly measure deficits, much less what their effects are. Indeed, the repeated failure of forecasts based on the budget is one thing that led to renewed study of the more complicated microeconomic details of public finance, under the banner of supply-side economics. And it is in these details where the Clinton economic plans, whatever their other merits, look troublesome for interest rates.

President Clinton has proposed an increase in marginal tax rates on higher incomes, and a tax credit for purchases of business equipment. Such policies have a direct impact on interest rates, regardless of their effects on the deficit. The explanation has to do with what economists call "intertemporal substitution"—which simply means people are clever enough to adjust the timing of their activities to minimize taxes and maximize deductions and tax credits.

In the very short run, the "intertemporal" effects of expected tax changes have helped to keep interest rates down. Unfortunately, the same incentives must have the opposite effect in the near future.

First, every accounting firm and financial publication told affluent couples to get their bonus checks, commissions and stock options paid in December 1992, to avoid possibly higher tax rates in 1993. Most of these lump-sum payments were parked in banks and mutual funds, holding interest rates down. If and when it becomes clear that tax rates are really going up, though, there will be an irresistible incentive to move funds into tax-free municipal bonds. Taxable securities, including mortgages, will then have to offer higher yields to remain competitive. If tax rates on interest income go from 31% to 36%, for example, a 7.4% bond has to rise to 8% to yield the same after-tax return.

*If the White House leans on the Fed to paper over the effects of its policies, the last two years of Clinton could look like the last two years of Carter.*

Second, the expectation of an investment tax credit (ITC) in 1993 provided an incentive to postpone purchases of business equipment until the new tax rules become clear, to ensure that such purchases will be eligible for the tax break. Treasury Secretary Lloyd Bentsen's recent comments about raising energy taxes and eliminating corporate deductions should likewise put capital spending plans on hold, temporarily depressing interest rates. As strong as December capital goods orders were, they will be even stronger if the ITC becomes a sure thing. Moreover, payment for such orders comes later, and that is when the scramble for credit will occur.

If enacted, though, the ITC will cause investments that would have been made in later years to be brought forward into 1993, because this subsidy has always been temporary. Such bunching of equipment spending into 1993 must increase corporate demand for credit and reduce its sensitivity to interest rates. Interest rates can therefore go up without curbing business borrowing, though not without causing damage to interest-sensitive construction, inventories and consumer durable goods.

Prices of tax-favored equipment will also rise with the added demand, further diluting the intended effect. If Congress instead reduced or indexed the capital gains tax, the effects would be quite different. Unlike the ITC, a lower tax rate on capital gains would help keep bond yields low, because part of the incentive for holding bonds or stocks is the hope of capital gain.

What about President Clinton's proposed $50 billion annual increase in public works spending? As Harvard economist Robert Barro notes in his macroeconomics text, there is no credible evidence that budget deficits per se raise interest rates, but some studies do find that increased government *purchases* (as opposed to transfer payments) raise interest rates. Capital, which is not unlimited, would thus be diverted from uses determined by markets to uses determined by politics. One rationing mechanism by which this dubious reallocation of capital is accomplished is higher interest rates.

A more subtle risk of higher interest rates could arise from hidden taxes in the Clinton agenda, such as mandating that businesses devote a percentage of payroll to health benefits and training. Mandated increases in labor costs have the same effect as an increase in payroll taxes—real wages or employment, or both, have to be lower, limiting economic growth.

The investment tax credit would further weaken employment growth, since it (1) provides an incentive to substitute machines for workers and (2) diverts capital from new enterprises (which can't use the credit because they are not immediately profitable) and labor-intensive industries (there is no tax credit for real estate, or for retail inventories). Since the resulting weak growth of jobs and wages will contradict President Clinton's campaign promise, the administration may soon become impatient with the absence of progress in labor markets.

This is where the risk of inflation comes in, since it could become tempting to try a monetary quick fix — talking the dollar down, or appointing inflationists to the Federal Reserve Board. Some members of the Clinton team lean toward inflationary, banana-republic monetary policies anyway. Laura Tyson, the new head of the Council of Economic Advisers, has written that "at the first sign the credit crunch is worsening, the Fed should purchase government bonds . . . to keep interest rates low."

President Clinton has stated that he would not like to see the Fed raise interest rates unless there was "clear evidence" of accelerating inflation. But politicians are the last to see such evidence, while bond and commodity traders are the first. The inflation risk is not imminent, any more than it was when President Carter took office in 1977, because the recession in Japan and Europe is helping to hold down world inflation and interest rates.

But this is a temporary reprieve. Foreign recessions will not last forever. If the White House leans on the Fed to paper over two quite predictable effects of its own policies — higher interest rates and slower job growth — the last two years of the Clinton administration could end up looking a lot like the last two years of the Carter administration. The Keynesian "policy mix" of rising tax and labor costs plus an "easy money" policy always adds up to stagflation.

### Curtailing the Robin Hood Impulse

If recent good news on the economy were to result in diluting or scrapping the public works schemes or the investment tax credit, that would be directly beneficial to bonds, because it would constrain the competing claims of business and government on real resources. Bad news on the deficit is already providing a handy excuse for backing away from the nebulous promise of middle-class tax relief. This could curtail the political impulse to play Robin Hood with the tax code. Without the facade of a middle-class tax cut, soak-the-rich policies lose their constituency. All that remains is a purely punitive "envy tax" on extraordinary effort and success.

If a coalition of enlightened Democratic and Republican congressmen can block the unwise increase in marginal tax rates, that would not only preserve incentives for highly productive people, but also help keep interest rates down.

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PERSPECTIVE ON CLINTON'S MESSAGE

# Barking Up the Wrong Tax Tree

**Tax incentives add up to new tax breaks; the real savings lie in cutting old tax breaks, such as full interest on home loans.**

By ROBERT J. SAMUELSON

Every so often, the President and Congress do the right thing. They did just that when they passed the 1986 tax reform. It lowered the top income tax rate for individuals from 50% to 28% and broadened the tax base by reducing the number of deductions and credits. The idea was that government should stop dispensing tax breaks as political favors and economic "incentives." President Clinton is about to gut the reform.

His major income tax proposals, to be outlined in tonight's address to Congress, repudiate the 1986 law. By all reports, Clinton would raise the top tax rate from 31% to 36% for individuals (it was increased from 28% in 1990) and from 34% to 36% for corporations. At the same time, Clinton wants Congress to pass new tax incentives: a tax credit for business investment; a cut in the tax on "capital gains" (stock profits) on investments in small companies.

Rhetorically, Clinton's program sounds fine. It's one part populism (soak the rich) and one part economic engineering (reward those, mainly the rich, who do government's bidding). But the second part of this formula is precisely the expansive tax philosophy that was rejected—correctly—in 1986, because it is presumptuous in theory and corrupt in practice.

Presidents and governments don't know enough (nor does anyone) to orchestrate economic growth through customized tax breaks. Every incentive invokes a worthy cause, but almost all have unintended consequences—often undesirable. The business investment incentives of the 1981 tax law helped create a glut of office buildings. Clinton's capital gains break, modeled on a proposal by Sen. Dale Bumpers (D-Ark.), aims to steer money to small companies in industries such as electronics and biotechnology. But these industries aren't uniquely deserving, and even if they were, they are doing OK without special help.

It is naive to think Clinton's proposals constitute only a limited unraveling of the 1986 reform. By embracing high rates and selective preferences, he sanctions a new quest for tax breaks. The process is corrupt, because one person's justifiable incentive is another person's ugly loophole. The more some groups get breaks, the more all groups want them. Tax breaks spread, creating pressure to raise top tax rates. All this feeds cynicism and unproductive work: tax avoidance and lobbying for new breaks. It's a boon for lawyers, accountants and lobbyists.

What's at issue is how government taxes—not the need for new taxes or Clinton's commitment to tax the rich. Budget deficits can't be cut without higher taxes. The wealthy can afford to pay (in the campaign, Clinton said the higher tax rates would apply to couples with incomes over $200,000), and politics demand that they be seen to pay. Otherwise, the "sacrifice" demanded of others (higher taxes, lower benefits) will seem "unfair."

The practical question is whether these ends could be met without raising tax rates. They could. Consider some proposals on the Congressional Budget Office's 1993 list of policies that would reduce the deficits:

- Tax capital gains at death. Profits on stocks or other investments escape taxes when an investor dies. Heirs get investments at current market value, not original purchase price. Taxing profits when the investor dies would raise about $7 billion annually. The impact would fall mainly on the wealthy. The richest 0.5% of Americans own roughly half of all individually held stock.
- Curb the mortgage interest-rate deduction. Limiting this deduction to $12,000 for a single taxpayer and $20,000 for a couple would raise about $4 billion annually. Again, the burden would fall on upper-income taxpayers. A $20,000 deduction at today's interest rates would finance a $310,000 home, assuming a 20% down payment.
- Limit tax-exempt state and local bonds. These bonds are intended to finance public projects, such as schools and roads. But the bonds are also used to finance everything from local industrial development to ports. Wealthy investors cut taxes by buying the bonds. Limiting the tax exemption to bonds used for true government projects would raise about $1 billion annually.

Clinton reportedly will endorse some proposals like these. But he obviously hasn't adopted enough of them to avoid higher rates. There was also another way to prevent a big rate increase. He could have proposed broadening the tax base for everyone—for example, by limiting the value of all itemized deductions—and then lowering tax rates for all but the richest. This, too, would have concentrated the tax increase on the wealthy.

It's easy to see why Clinton isn't defending the 1986 law. It was never popular among congressional Democrats, even though a few (notably Sen. Bill Bradley of New Jersey) were among its main architects. The symbolism of raising top tax rates—an oft-made campaign pledge—is more compelling than ending many obscure tax breaks. Moreover, each of these tax breaks has powerful protective lobbies. Clinton's plan to cut the deficit will arouse much opposition. Why pick more fights? The answer is simple: because it's good government.

After the 1986 law, taxpayer compliance rose. When tax rates drop, the rewards of cheating or of sheltering income drop. Fewer deductions mean fewer opportunities to overstate deductions. Between 1984 and 1988, the compliance rate for individuals (the share of taxes owed paid voluntarily) rose from 80% to 82.5%, says the Internal Revenue Service. That's more than $10 billion.

Clinton complains that the wealthy see "the tax code as a table game to be won." Actually, this game was slowing down. Now, he's speeding it up. The big winners are the accountants, lawyers and lobbyists.

*Robert J. Samuelson writes about economic issues from Washington.*

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# Inequality and Its Charms

By Robert J. Barro

During the presidential campaign a number of writers argued that the share of the rich in total income had grown rapidly, while that of the poor had declined. These outcomes were assumed to be bad and were usually blamed, at least implicitly, on the policies of the Reagan and Bush administrations.

Recent research has brought out two important developments that underlie the changes in income distribution. The first, which began well before a Reagan administration even looked probable in the early 1970s, is an increase in the spread between the wages of skilled and unskilled workers. In the 1980s, for example, the wages of highly educated workers rose sharply relative to those of less educated workers. This changing wage pattern reflects technological advances, including the proliferation of computers, that make worker skill more important in the production process.

In other words, economic forces are at work that governments cannot and should not seek to control. A useful governmental role in this area might involve improved access to education and training, not efforts to redistribute income or policies like trade protection that would retard the spread of new technologies.

The second development is a sharp increase in the share of income received by the richest individuals. Recent research indicates that changes at the top of the income distribution are justifiably tied to the Reagan period, specifically to the tax reforms of 1981 and 1986, but that the outcomes should be viewed as desirable.

For the richest taxpayers, what matters is the marginal tax rate at the top. This rate was lowered on unearned income by the 1981 law and on earned and unearned income (other than capital gains) by the 1986 law. The response was a dramatic increase in non-wage income reported by the rich after the 1981 law and in wage and non-wage income reported by them after the 1986 law.

## Supply-Sider Dreams

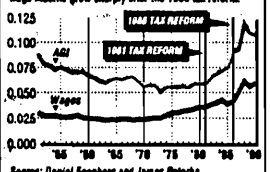
These reactions, which have been strong enough to raise the number of tax dollars paid by the very rich, are the stuff of supply-sider dreams. But the results have somehow been twisted into the view that supply-side economics did not work—because, as a matter of arithmetic, the dramatic rise in the income *reported* by the rich had to show up as an increase in the share of income *received* by the rich.

Most researchers have relied on information about income distribution from the Congressional Budget Office (CBO), but some shortcomings in their procedures have confused matters. The CBO adjusts the underlying income data in ways that remain mysterious to outside observers, and their corrections for changes in family-size composition are indefensible. (The calculations imply that a family with a given total income is worse off if it chooses to have another child. This is like saying that a family is worse off if it buys a TV set because family income net of expenditures on TV sets is thereby reduced. Similarly, the computations assume that two single adults — who have chosen to live separately — would be better off if the government forced them to cohabitate.) We can also learn more about changes in living standards from the distribution of consumer expenditure, which reflects long-run levels of income, than from the distribution of income in a single year.

David Cutler and Lawrence Katz — two Harvard economists who have unfortunately accepted government employment — have calculated the changing distribution of consumer spending for six family types (one or two adults and zero, one, or two children). They compute for each type how much of the total pie of spending is accounted for by the 20% with the least spending, the next 20%, and so on.

**Larger Share of the Wealth**

The share of the richest 1/2% of taxpayers in the aggregate gross income (wages plus other income) grew sharply after the 1981 and 1986 tax reforms. The share of the richest 1/2% of taxpayers in the nation's wage income grew sharply after the 1986 tax reform.




Source: Daniel Feenberg and James Poterba, Nat'l Bureau of Economic Research

For averages over the family types, the share of the lowest 20% in total spending fell from 8.3% in 1972-73 to 7.9% in 1980 and 7.0% in 1988, while that of the highest 20% rose from 36.9% to 39.2% and 41.1%. Thus, in the 1980s, the share of the richest one-fifth grew by about two percentage points.

By contrast, if one looks at income, then the poorest one-fifth appears much worse off, with only 4.6% of total income in 1989. In addition, the increase in the share of the highest quintile in the 1980s becomes greater, about three percentage points, compared with the even larger value of 4½ percentage points reported by the CBO. Thus, in relation to the more reasonable values computed by Messrs. Cutler and Katz, the CBO procedure more than doubled the estimate of the gain by the top quintile in the 1980s. Moreover, all the estimates agree that, at the broad level of quintiles, the movement toward a less equal distribution began in the early 1970s.

Much of the media excitement has centered on the notion that more and more of the income pie is being cornered by the very rich. The facts have been clarified by Daniel Feenberg and James Poterba ("Income Inequality and the Incomes of Very High Income Taxpayers: Evidence from Tax Returns," National Bureau of Economic Research working paper no. 4229, December 1992), who studied the behavior of the 0.5% of taxpayers with the highest adjusted gross incomes. In 1990, this group consisted of the 564,000 tax returns with incomes in excess of $258,000.

The chart shows the share of this rich group from 1951 to 1990 in the nation's totals of wage income and of a broader income measure, the aggregate of adjusted gross incomes from the tax returns. For wages, the share rose from its low point of 2.5% in 1970 to 4.3% in 1986, jumped to 6.2% in 1988, and then changed little through 1990. For gross income, the share grew from a trough of 5.3% in 1973 to 6.0% in 1981, 7.8% in 1985, 9.2% in 1986, and 12.0% in 1988, before falling to 10.9% in 1990.

One conclusion is that the recent increase in the share of the very rich shows up in wage income, as well as in other forms of income, such as interest, dividends and capital gains. The key finding, however, is the response to changes in tax policy.

The dramatic increase in the rich group's share of wages from 1986 to 1988 appears to be a response to the 1986 tax law, which sharply lowered the top marginal tax rate on earned income. The rich reported a lot more income in the form of taxable wages, although it is not yet clear how the extra amount divided up between reduced tax avoidance and more work. Either way, the response has to be viewed as desirable.

## Successful Tax Cuts

The share of the rich in other forms of taxable income also grew from 1985 to 1988. (The timing is complicated by the shifts of capital-gain realizations from 1986 to 1985 due to the rise in the capital-gains tax rate in 1986.) Similarly, the increase in the share of gross income from 1981 to 1985 reflects the cut in the top tax rate on unearned income in the 1981 law.

The strong responses of incomes reported by the rich to tax-rate changes accord with supply-side predictions and indicate that the cuts in the top marginal tax rates were a success. The evidence also implies that the restoration of higher tax rates at the top, as urged by President Clinton, would be a mistake. The higher tax rates would induce the rich to report enough less income so that the taxes paid by this group would fall. Although measured inequality would decline, this soaking of the rich would not benefit the poor — unless the poor would feel better simply because the rich were worse off. I presume, however, that one group's enjoyment of another group's misery is not what underlies Mr. Clinton's vision of shared sacrifices.

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*Mr. Barro, a Wall Street Journal contributing editor, is an economics professor at Harvard.*

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THE JOURNAL OF COMMERCE, Friday, January 29, 1993

# Why We Need Oil Import Fees

By EUGENE L. AMES Jr.

Oil is grabbing headlines again this week.

The new secretary of the treasury, Lloyd Bentsen, used his first post-inaugural appearance on national television to discuss an energy tax, one that would encourage Americans to "cut back on consumption and encourage investment for the creation of jobs."

Iraq continues testing allied resolve in the petroleum-rich Persian Gulf. As the European Community discusses ways to prevent a repeat of the Shetland Island oil spill disaster, another leaking tanker is spreading a huge slick over the waters near Sumatra. And our balance of trade deficit — new figures will be out soon — means America continues to be the world's largest debtor nation.

Each of these problems stems directly or indirectly from this country's dependence on imported oil.

In 1993, the United States will import 8 million barrels of oil a day, more than 50% of the nation's daily thirst for petroleum. (In 1982, it was 28%.)

The Annual Energy Outlook published by the Energy Information Agency projects that U.S. dependence on imported oil could more than double by the time today's two-year-olds start college in 2010.

Dependence on imported oil creates a direct environmental threat. Importing 8 million barrels of oil means more than 5,000 tankers will call at U.S. ports this year. More imported oil on more tankers means a greater chance of oil spills in American waterways and on American beaches.

Imported oil also means an economic threat. As Mr. Bentsen said, "At the present time, we're importing almost a billion dollars a week of oil, and that certainly adds to our trade deficit, and (it's) often being collected from unstable political areas."

Americans can only import oil if they export dollars to pay for it. Last year, paying for those imports accounted for more than 60% of our balance of trade deficit, or about $55 billion. (The much smaller trade deficit with Japan receives more attention from the press and public than this enormous deficit with the oil-producing countries.)

Those dollars could and should stay at home to help revitalize the economy.

In his search for policies to reduce the nation's budget deficit, President Clinton will find that an oil import fee is the only way to also begin weaning America from its oil dependence.

An oil import fee would discourage imports while encouraging a shift to energy sources free of the environmental peril inherent in shipping oil by tanker. Natural gas, for example, is environmentally friendly because it burns more cleanly than oil. And we have an enormous domestic supply that moves from wells to homes to automobile service stations by pipeline.

An oil import fee would also encourage conservation. Too much of America's energy continues to be wasted. An oil import fee will help Americans wake up to the cost of energy inefficient homes, offices and factories.

The economic arguments for an oil import levy are equally persuasive, since such a fee will have both short- and long-term economic benefits.

For starters, an oil import fee would help the Clinton administration reduce the federal deficit. A $10 a barrel oil import fee, for example, could generate $20 billion in new revenue each year, and it is equitable deficit reduction. It would push up prices at the pump much less than an increase in the federal gasoline tax and it would reach non-transport uses such as manufacturing, home heating and electric utilities.

An oil import fee can be imposed without a wrenching "oil shock," and without drilling in environmentally sensitive areas.

There are petroleum reserves and vast natural gas deposits in the lower 48 states, outside environmentally threatened areas, waiting to be developed. In fact, thousands of wells that could supply our domestic needs are in danger of being capped forever. They are being closed because domestic producers simply cannot meet the artificially low prices the oil importers set to create the illusion of "cheap" imported oil.

At a time when the country needs a domestic petroleum industry and the energy it can supply, it is nearing a state of collapse. More than 400,000 jobs have been lost in the domestic petroleum industry in the past 10 years, more than the total jobs lost in the textile and automobile industries combined. Production from existing fields has shrunk to the lowest level in 30 years. In the South and Southwest, production is at its lowest level in more than 50 years.

The United States is losing the ability to produce the energy that fuels the economy. As that happens, this nation puts its economy and its future in the hands of others.

President Clinton and Congress should support an oil import fee to encourage domestic production and discourage foreign imports. This country needs public policies that say the price of imported oil — environmental disasters, the lives of service men and women at risk in international conflicts, scarce dollars expended on what could be produced at home — is too high. The United States needs policies that recognize that securing our energy future must begin at home.

*Eugene L. Ames Jr. is president of the Independent Petroleum Association of America.*

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The Washington Post

March 25, 1993

*Robert J. Samuelson*

# Energy Tax: A Good Idea? Probably.

I have advocated some type of energy tax for 15 years. President Clinton's proposal strikes me as desirable for all the reasons the White House cites. It would trim the budget deficit—by 1997, the tax would raise about $22 billion of revenues. It would also prod Americans to use energy more efficiently. This would reduce our dependence on imported oil and cut pollution. And yet, there is something disturbing about the debate over the energy tax: It hasn't happened.

Adopting an energy tax would be a major change in our tax system. We shouldn't do it casually. By itself, the Clinton tax is modest. Overall energy prices would rise about 3 percent to 8 percent after a three-year phase-in. But once enacted, this tax would probably go in only one direction: up. It would have to be at least doubled or tripled to have a big impact on energy use. And pressures for higher taxes to cut the budget deficits would be unrelenting. Do we really want an energy tax as our next big tax?

As I said, my view is yes. Energy use imposes social costs, like greenhouse gases, not reflected in market prices. I also think that investments in energy efficiency would ultimately save businesses and consumers money. But there's a legitimate debate here. An alternative to an energy tax is a "value-added tax," or VAT, which resembles a national sales tax. Companies would pay a tax as a share of the value of their own production. Most of the tax would be passed along to consumers in higher prices. Many economists argue that a VAT would encourage more consumer saving (people wouldn't pay any VAT on money they saved).

Congress should critically examine these rival proposals. The Clinton tax is imposed on British Thermal Units: a BTU is the amount of energy needed to raise one pound of water one degree. After the phase-in, the BTU tax would increase the price of oil by $3.50 a barrel, or about 18 percent of today's price. A ton of coal would increase $5.60, a 26 percent jump. A thousand cubic feet of natural gas would rise about 13 percent. But the price increases to consumers would be smaller, because fuel costs account for only a part of final energy prices. The administration figures the final increases as follows: 5 percent for gasoline (7.5 cents a gallon), 3 percent for electricity, 4 percent for residential natural gas and 8 percent for home heating oil.

Because the tax increase is so mild, both the claims for it and objections to it are exaggerated. Yes, it would depress oil imports—but not by much. In 1991 imports totaled 6.6 million barrels a day, or 40 percent of our oil use. By the year 2000, the Department of Energy estimates imports to rise to 10.8 million barrels daily, or 56 percent of consumption. Against that, the administration says the tax might cut imports by 3 percent (350,000 barrels daily). The Congressional Budget Office puts savings at half that. Indeed, no tax could end our dependence on imports. We simply don't produce enough oil to meet our needs. Likewise, the tax wouldn't reduce pollution or greenhouse gases because it doesn't cut overall energy use. Economic and population growth will raise energy consumption an estimated 15 percent in the 1990s; the tax might shave the total by 2 percent, says the administration.

If the energy tax isn't stiff enough to do much good, neither can it do much harm. The wails of manufacturers that it may make them uncompetitive are overblown. On average, energy accounts for about 4 percent to 6 percent of manufacturing costs. At most, the Clinton plan might raise that by 0.5 percentage points. Such tiny changes are overwhelmed by slight shifts in exchange rates (which make U.S. products more or less expensive on world markets). But the same might not be true of a much higher tax. The CBO has estimated how big a tax would be required to stabilize emissions of carbon dioxide, the main greenhouse gas and a byproduct of fossil fuels. Compared with the Clinton proposal, the overall tax would have to be twice as high and the tax on coal three times as high. Other estimates indicate even higher taxes would be needed.

At that point, a VAT might be appealing. A 5 percent VAT might raise about $125 billion annually. A VAT could be used both to increase revenue and to reduce the income tax. Income-tax rates could be cut, and some of the system's complexity could be eliminated. Former Treasury secretary Nicholas Brady proposed such a plan; the harsh impact of a VAT on low-income families would be offset by exempting more of them from the income tax. Finally, a VAT would not penalize energy-intensive sectors like manufacturing. A stiff energy tax could cause industries that use huge amounts of energy (paper, aluminum, oil refining) to locate new plants elsewhere.

My reservations about a VAT are many. In practice, it could be riddled with exceptions. Congress might try to distinguish between luxuries and necessities. A hopelessly complex tax could become a honeypot for lobbyists, lawyers and accountants. The CBO estimates that a VAT similar to those in Europe would involve compliance costs of $5 billion to $8 billion annually. But the VAT's biggest defect would be its invisibility. Because the tax would be absorbed in everyday prices, it would fade into the background. Big taxes should not be unobtrusive. People should feel the taxes they pay. Otherwise, taxes don't discipline government spending. I also doubt that a VAT would much increase saving; economists routinely exaggerate the power of taxes to change behavior.

Perhaps Clinton ultimately wants both a VAT and an energy tax. But for now, he's simply trying to stampede his program through Congress. He envisions a one-time spasm of deficit reduction. By fall, all the political dirty work would be done. This means that Congress won't consider the full implications of an energy tax or compare it with a VAT. It also means accepting a Clinton package that has too many taxes and too few spending cuts.

These problems have a solution. Congress should separate the energy tax from the Clinton package and deliver a firm message: We won't pass this tax—or its equivalent—until you propose more spending cuts. This would give Congress more time to evaluate the energy tax and put more pressure on the White House to cut spending. Unfortunately, Congress shows no interest in asserting itself. It prefers to be stampeded.

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THE WALL STREET JOURNAL WEDNESDAY, MARCH 3, 1993

# Clinton Energy Tax—Worse Than It Seems

By TERENCE L. BARNICH

President Clinton's energy tax proposal is fundamentally discriminatory and grants a massive artificial advantage for natural gas.

Mr. Clinton has proposed a BTU-based tax of nearly 60 cents for every million BTUs of energy content contained in oil and about 26 cents for the comparable energy content in other raw fuels. Putting aside the more than double BTU tax rate for oil, the tax imposes gross disproportionality in the tax burden on different energy sources used for electric generation. Because different fuels contain quite different energy content relative to their prices, the BTU tax amounts to about a 10% sales tax on natural gas, a 24% sales tax on coal and a 50% sales tax on uranium for nuclear power plants—thereby anointing natural gas as the government's fuel of choice. The president has even decided to impose the tax, on an imputed BTU basis, on water used for production of hydroelectric power, even though the cost of river water flowing through electric turbines is zero.

Mr. Clinton's BTU-based tax must have been consciously designed to push the market toward gas and away from coal, hydro and uranium. After all, his stated reasons for advancing the energy tax are so transparent and false.

The president first claims that energy in America is undertaxed relative to tax levels in other developed countries. But that simply is not true. While gasoline is more heavily taxed in Europe and Japan, the Europeans continue to provide massive tax subsidies for energy and utility fuels. The European industrial nations take full advantage of the European Community's rules permitting them to subsidize their energy sector by up to 20% of cost. In Britain, for instance, coal is the annual beneficiary of nearly $2 billion in explicit price supports, and the government applies its EC subsidy allocation to prop up the British nuclear industry. Most EC countries mandate coal purchases by utilities, an indirect fuel subsidy.

By contrast, in the U.S. hardly anything is more heavily taxed than energy utility service. In Chicago, for example, about 25% of the total monthly residential electric and gas bill is accounted for by a variety of federal taxes, state taxes and local utility taxes and franchise fees.

The supporters of the energy tax have also dragged out that tired old dog of American political debate—the threat of imported oil. But the tax will be the same on both imported and domestic oil and, therefore, will not make domestic sources any more economically attractive. Nor is the energy independence argument buttressed in the least by the claim that the energy tax will result in conservation. BTU-tax-induced conservation will have little effect on imported oil, since (as of 1991) imported oil represents only 17.5% of total raw energy sources used in the U.S.

That leaves environmental protection as the Clinton-Gore trump card for justifying the tax. But if the greenhouse effect is the greatest challenge facing humanity, as Vice President Gore tells us in "Earth in the Balance," why is the heaviest proportional tax, relative to delivered fuel price, placed on the two fuels that produce no greenhouse gases—nuclear and hydro?

Perhaps there is a more street-wise, unstated, political explanation for the "tilt" toward gas. It is no secret natural gas is a favorite of the president. White House chief of staff Mack McClarty, of course, is only one month out of his job as CEO of one of the country's prominent natural gas pipeline and local utility companies.

So far, the Clinton administration has followed the old rule that the best way to make sure the hounds don't follow you is for another fox to cross your path. The Treasury Department has tried to focus the discussion solely on the direct effects of the tax, telling middle-class Americans that the BTU tax will cost roughly $2.25 a month on a $65 monthly household utility bill and 7.5 cents per gallon of gasoline, leaving the average American family only worse off by $17 a month. The promise is that much more value will magically flow back to American consumers in the form of a reduced deficit or the satisfaction for having "contributed," if nothing else.

In addition to the misrepresentation of the BTU tax as fair and evenhanded, the numbers being dribbled out by Treasury, explaining the effect on consumers, focus only on the direct costs to energy end-users. But household direct energy costs are but a small fraction of the impact of the energy tax. A new tax that increases underlying natural gas costs by 10%, coal by 24%, nuclear fuel by 50%, and hydro by heaven knows what amount will dramatically echo throughout the economy. If this is the president's idea of the courage to change, then call me "chicken."

*Mr. Barnich is a public utility commissioner in Illinois.*

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The Wall Street Journal January 27, 1993

# Never Mind Energy, Tax Consumption

By Robert M. Giordano

It looks like the Clinton administration's first big effort at deficit reduction may be an energy tax. Unfortunately, an energy tax is unlikely to do the job, however desirable it might be on environmental or national security grounds. Its revenues will be insufficient. A quadrupling of the federal gas tax, for example, would raise less than $50 billion a year.

But the deficit still has to be addressed. The best way would be to cut spending, of course, but achieving a consensus on cutting entitlement spending – by far the biggest chunk of the budget – will take years, even in the case of health care. Given the tenacity of special interests, it may not be possible at all – in the absence of a real economic crisis. Thus, there is no getting around the need for increasing revenue.

A tax on consumption is the best way of meeting this need. It is the only tax that can raise enough revenue to make a serious dent in the deficit and do so with a minimum of economic distortion. Raising income taxes on the rich is not the answer: There are simply not enough rich folks around. Only about 5% of all tax returns, and 20% of tax liabilities, are accounted for by people with incomes greater than $200,000. Besides, taxing income undermines work effort and is most prone to result in a misallocation of resources.

By contrast, several key benefits of a consumption tax readily come to mind. First, such a tax would remove the fear of a further deficit explosion, and thus induce some further decline in interest rates. It would also help restrain, if not reverse, a rise in the dollar exchange rate. A stable or lower dollar, in turn, would help preserve the competitive advantage in export markets that is now so important to the economy.

Second, a consumption tax essentially guarantees a reliable source of large revenues down the road. In particular, it would broaden the tax base by ensnaring income earned in the underground economy but spent in the measured one. This would be real money, not some vague calculation of future revenue based on wished-for spending cuts or counterproductive income-tax hikes. Rough calculations suggest that a consumption tax of only 5% to 10% could raise approximately $100 billion to $150 billion per year, depending on the exact tax base selected. By comparison, consumption tax rates in European countries are commonly 15% to 20%.

Third, taxing consumption could bolster the economy's long-term growth. By exempting capital goods, it would encourage productive investment. The tax would encourage more saving, too, by raising the cost of consuming today vs. tomorrow. In addition, it would allow taxes on capital, and marginal income tax rates for low- and middle-income households, to be cut. Indeed, a consumption tax is the only practical way to fund income tax relief for people on the lower end of the income scale.

The two most forceful objections to the consumption tax have to do with its regressivity and the fear that a consumption tax would act like a Trojan horse for more reckless tax-and-spend policies. These objections are easily met.

Consumption levies do indeed impose a greater burden on citizens with lower incomes. But the tax can be structured to correct this bias and still raise revenues. Many staples, for example, could be exempted, or a negative income tax could be introduced for households with incomes below a certain level. This would help preserve the fundamentally progressive nature of the tax code.

Without a doubt, a consumption tax could be used as a blank check for more spending. Specific guidelines and constraints, however, could be written into the legislation that would limit future tax hikes. For example, a two-thirds majority vote of Congress could be required to change the rate. Or perhaps the size of any individual rate hike could be limited to a few points and allowed only at certain intervals.

All of this will take time, of course. But it is well worth doing. Up to now, the ballooning federal budget deficit has been more of a problem for economists than the economy. Output grew throughout the 1980s, inflation remained low, and interest rates declined – all contrary to expectations. The situation, however, is starting to change, and a more serious effort must be made to correct the budget's imbalances. If left alone, the deficit and public debt relative to gross domestic product will go notably higher in coming years, exposing the economy to real dangers. Most noticeably, it will impair the Clinton administration's ability to use fiscal policy as a stimulus weapon.

Now is the time to start planning for the eventuality of a broad-based tax on consumption, before the budget deficit becomes a desperate problem. A bipartisan study sponsored by Sens. Sam Nunn (D., Ga.) and Pete Domenici (R., N.M.) recently acknowledged as much when it recommended that the U.S. adopt such a levy as part of a reform of the tax system.

A consumption tax will certainly be no panacea for the nation's fiscal ills. It will do more, however, than any of the other deficit reduction plans now under consideration.

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*Mr. Giordano is director of economic research at Goldman, Sachs.*

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## ENVIRONMENT

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ENVIRONMENT BULLETIN

A NEWSLETTER OF THE WORLD BANK ENVIRONMENT COMMUNITY Vol. 5, No. 1 Winter 1992/93

# KEY ENVIRONMENTAL STRATEGIES SET FOR FOSTERING EAST-WEST COLLABORATION

Market reform associated especially with energy price increases, which tend to lead to economic growth while also improving the environment, is one of the most important measures that have the potential for improving environmental conditions. This is reported in a new background study being issued during preparations of the Environmental Action Programme for Central and Eastern Europe. The study is intended as an interim product to indicate the direction of the work underway.

Among other measures designed to help meet the key objective of the Programme's goal--of achieving tangible and immediate improvements in the most serious environmental problems in the region--are measures that include economic and industrial restructuring. This often involves a relative shift to less polluting economic activities, and capital stock turnover, which tends to be associated with environmentally more benign technologies, and/or improved industrial management.

The main report of the Action Programme will recommend measures to strengthen the policy framework and build institutional capacity which are consistent with the severe resource and institutional constraints in the CEE countries. These measures will build on the many environmental initiatives already underway as part of domestic, bilateral and multilateral programs and, at the same time, they are designed to achieve the greatest short-to-medium term environmental benefits at lowest economic cost.

**Approach**

The Action Programme has been proposed for submission to governments for the next ministerial conference "Environment for Europe" in April 1993. The conference will be attended not only by delegates from environment ministries but also from finance, planning, industry and economy ministries. At a recent meeting in Switzerland, the Swiss Government--as host of the Ministerial conference--briefed senior representatives of these non-environmental ministries from 12 CEE countries.

The discussion document on analytical approaches, entitled "Setting Environmental Priorities in Central and Eastern Europe," describes criteria for ranking environmental priorities and proposes a balanced set of measures to address (1) the most urgent problems, especially from a human health perspective, and (2) certain aspects of longer term problems in water and waste management as well as the conservation of natural ecosystems. The document is being discussed with all participants in the process, including NGOs.

**Air Pollution**

Most of the major environmental health problems are linked to various forms of air pollution. Among these, emissions of lead and other heavy metal dusts from non-ferrous metal smelters are linked to impaired neurophysiological development of children in several affected regions. There are also problems of excessive exposure to lead among children living close to major urban arteries as a result of the reliance upon leaded fuel for vehicles. Airborne dust--notably soot and particulates from burning coal in household grates, small boilers or even large boilers with inadequate dust filters--is a major contributor to acute and chronic respiratory diseases and, in some cases, to excess levels of cancer.

**Water Quality**

Issues of water quality revolve primarily around the availability and cost of safe drinking water. Most urban areas have adequate treatment facilities but the maintenance and effective operation of treatment plants is critically important. Excessive levels of nitrates in rural drinking water drawn from shallow wells is a problem throughout the region. The other main problems of water quality concern: (1) excessive salinity caused by mining discharges in Poland and Ukraine; and (2) deterioration of groundwater due to the intrusion of heavy metals, chemicals and nutrients. The careless disposal of nuclear, solid and hazardous wastes is a particular problem in protecting the quality of groundwater sources.

**Actions**

The analytical basis for the Action Programme will be provided by a series of important studies now underway. Many of these are being developed by teams of local consultants. The studies will permit the development of an action programme which should lead to significant environmental gains in a relatively short period.

Detailed work is being carried out to demonstrate that economic policies such as raising energy prices to world or European levels, restructuring industries to reflect a shift in domestic demand from heavy industry towards services and light industry, and privatization of enterprises to reinforce market incentives should reduce levels of air pollution by 50 percent or more by the end of the decade.

Initial findings are expected in early 1993.

*For more information, contact Richard Ackermann, EMTEN, H-9039, the World Bank, 1818 H Street, N.W., Washington, D.C. 20433.*

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# NEW STRATEGY SEEKS TO REDUCE INDUSTRIAL POLLUTION IN DEVELOPING COUNTRIES

Development presents unavoidable problems of pollution intensity as well as scale. This finding, one of two key observations highlighting the importance of early environmental regulation, even in very poor economies, is revealed by a research program being conducted by a four-member team in the Environment Department to help policymakers find the most cost-effective route to rapid reduction of industrial pollution in developing countries.

Pollution intensity grows rapidly in the first phase of development. This presents important implications for policy, according to David Wheeler, Mainul Huq, Paul Martin and Sari Soderstrom, whose program focuses on identifiying and addressing the underlying causes of environmental damage, where possible.

The second key finding shows that the sudden tightening of OECD environmental standards in the 1970s was followed by a marked shift toward a pollution-intensive product mix in developing countries with little or no environmental protection.

A third major finding highlights the importance of general economic policy. The evolving product mix has been much more pollution-intensive in countries with strongly protectionist trade policies. This complements the fact that poor countries most easily compete in labor-intensive product lines. To accelerate the growth of more capital- and technology intensive sectors, protection from import competition must be granted. Since pollution intensity is strongly correlated with capital- and technology-intensity, this protection is also pollution-enhancing.

This correlation suggests the potential for an alliance between environmentalists and free trade advocates, at least on the question of industrial pollution, recognize the researchers who note that industrial growth always produces environmental damage, but its severity differs greatly among societies at similar levels of income per capita.

**Empirical Approach**

"Our approach is empirical. We want to identify cost-effective policies for poor countries," the four researchers say in a current report. They do not question the simple prescription of environmental economics: "The decisions were inappropriate because incentives were wrong." They claim that this diagnosis is not very helpful unless it can also answer two questions: (1) Why were the incentives "wrong?" (How do we observe and grade the environmental destructiveness of different activities?); (2) Which incentives have been most influential, and what does this suggest about the most cost-effective strategies for changing environmentally-destructive decisions on products, processes, recycling, and waste treatment?

Attempting to address these questions and to provide relatively comprehensive answers during the next two or three years, the researchers observe that the Bank has begun to play a major role in promoting and funding the development of environmental action plans and national environmental protection agencies in many client countries.

**Measuring Industrial Waste Generation**

Recognizing that industrial pollution data are extremely poor in most of the Bank's client countries, the researchers are developing an information system which can use manufacturing survey data to estimate the severity of environmental damage from present and anticipated industrial activity. The knowledge base combines complete emissions audits, economic data, and pollutant risk factors for approximately 40,000 manufacturing facilities in the United States. Cosponsored by the Center for Economic Studies of the U.S. Census Bureau, this project is generating a unique resource for analyzing the economics of indutrial pollution and is being extented to include plant-level pollution and economic data from several other industrial and developing economies.

**Technology Choice**

Even in industries which are identified as "heavily polluting," such as pulp and steel, some available processes are seen as generating very little pollution. Analysis of clean technology adoption in the pulp industry for approximately 60 countries during 1969-1991 shows that very protectionist developing economies lagged behind their more open counterparts by about 10 years in first adoption of the new technology. Although countries with large pulp capacity adopted the new technology relatively quickly, the general level of economic development had apparently no independent effect. India, for example, had first adoption of clean pulping technology sooner than Belgium.

"This reality highlights the importance of going beyond general sectoral studies," the researchers state. "Industrial systems built on the same activities can pollute at very different rates because they use different technologies. We want to know how fast these newer, cleaner technologies are spreading in developing countries, and what policies could accelerate the process. Inherently clean technologies have one big advantage for governments--once installed, they present little additional need for regulation."

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*American Enterprise Institute for Public Policy Research*

# Environmentalists Against GATT

By Jagdish Bhagwati



Some of the flintiest opposition to free trade at the moment comes from environmentalists. They are pressing for a watchdog panel—armed with punitive powers—to protect the North American Free Trade Agreement from environmental "wrongdoing." They are also showing extraordinary hostility to the General Agreement on Tariffs and Trade, and threaten to derail its latest negotiations with excessive and foolish demands.

The environmentalists' disenchantment with GATT, and hence with the Uruguay Round that seeks to extend and strengthen it, dates from 1991, when the United States lost the dolphin-tuna case brought by Mexico before a GATT dispute settlement panel. The panel ruled that a GATT member's trading rights could not be suspended simply because one country objected to the process by which another produced its products. At the time, the United States was embargoing Mexico's tuna products because Mexico used purse-seine nets that caught dolphins as well. This embargo was disallowed.

The environmentalists' frustration with GATT turned swiftly to anger. It was denounced as GATTzilla, evocative of the Japanese monster Godzilla. A blitzkrieg of condemnatory ads and anti-GATT propaganda followed, threatening retribution.

And yet the anger is misplaced. The dolphin-tuna decision was entirely sensible. If a nation's trading rights can be suspended simply because it refuses to accept another nation's idiosyncratic values, everyone could insist on "morality-driven" trade restrictions and the whole international trading system would head down a slippery slope. Thus, if we have our dolphins, the Indians have their sacred cows. Animal rights activists might object to the "cruelty" that fish endure as they are caught—even in "approved" nets.

Environmentalists are hostile to GATT for another reason. GATT established procedures for examining whether environmental regulations are really protectionism in disguise.

Economists have long recognized the problem of getting at the true intention behind regulations. A current-day example is Ontario's 10 percent tax on beer cans but not bottles. The grounds for such a law are supposedly environmental, but U.S. authorities rightly note that it discriminates against foreign beer suppliers, who (unlike local rivals) predominantly use cans. Tellingly, the use of cans for soups and juices (where Ontario producers would have been affected) was not proscribed.

Among the most pernicious of the environmentalists' recent demands, now rapidly acquiring converts on Capitol Hill, is for duties against foreign nations for "social dumping." This supposed evil is said to happen when a foreign country has less rigorous environmental regulation in a particular industry than does the U.S. and yet exports products here. Environmentalists argue that this is tantamount to dumping exports at less than full cost, since the foreign industry's "true" costs should include (but do not) the same regulatory costs as those faced by U.S. industries.

Such objections, along with demands for social dumping legislation, are acts of folly. They appear to address legitimate environmental concerns but in fact are illegitimate demands that will harm trade. One suspects that a protectionist agenda lies behind the social dumping crusade, as GATT investigators might well discover.

It is now well documented that antidumping laws have been systematically misused by protectionists to harass foreign rivals and to force them into accepting "voluntary" export restraints as the lesser evil. Thus the opening up of yet another opportunity to charge foreign competitors with "less-than-cost" pricing is not exactly a cause for celebration.

Unlike normal antidumping cases, the charge of social dumping accuses others not with doing something but with *not* doing something. The so-called subsidy to a foreign competitor is not given but only implied. According to Senator David Boren (D., Okla.), who supported the failed 1991 International Pollution Deference Act, the subsidy would be calculated as "the cost which would have to be incurred by the manufacturer or producer of the foreign articles of merchandise to comply with environmental standards imposed on U.S. producers of the same class of merchandise." You have to be naive to think the Environmental Protection Agency, charged with calculating this cost, would do anything except come up with the answer it wants, pushed by political forces. In short, the estimating procedure would be arbitrary.

The same problem arose when the United States had to assess dumping by the former communist countries, which had no usable price and cost data. In that case, we simply invented some. The best example of the absurdity of the procedure, and its susceptibility to political outcomes, was the case of Poland's exporting golf carts to the United States. The Poles were charged with dumping although, since they did not even play golf, there were no domestic prices, good or bad, to compare with what they charged in our markets. The witticism was that the Poles had put the cart before the course. A search (guided by the 1974 Trade Act) had to be undertaken for "comparable" countries whose costs could be used to reconstruct Polish costs, with Spain chosen as the ideal candidate!

But the chief objection to the social dumping idea is simply that it flies in the face of economic logic. Given the same preference for a better environment relative to income, each country will make several environmental choices that reflect its own priorities. These, in turn, will reflect its own evaluation of the costs of different types of pollution control and their benefits.

Thus if a chemical plant in Brazil is discharging pollutants into a lake that no one drinks from, pollution abatement there is of a much lower priority than for, say, a paper mill whose discharge affects a lake that supplies drinking water. Thus, Brazil will properly have pollution-control in the paper instead of the chemical industry. But the effects of various kinds of pollution, and the efforts at its control, may be very different in the United States.

It is only in rare cases that environmental regulations within the same industry will harmonize across different countries. By assuming otherwise, the proponents of social dumping legislation insult our good sense while opening the floodgates yet wider to protectionism.

[from *The Wall Street Journal*, March 19, 1993]

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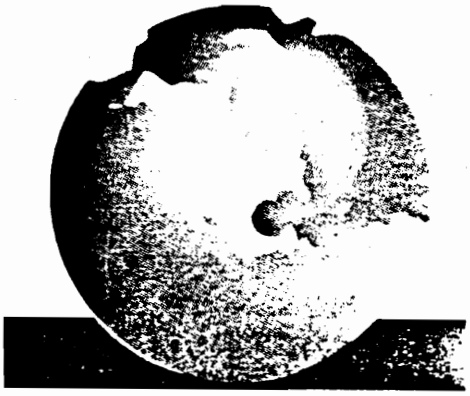
# Global Governance:



## The Politics of Protecting the Planet's Environment

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From the threat of global climate change to the unprecedented rate of species extinction, from the Chernobyl nuclear accident to the Valdez oil spill, and from the slashing and burning of tropical rainforests to the polluting and overfishing of the planet's oceans, it is increasingly obvious that environmental degradation pays no heed to national boundaries.

Indeed, with world population now standing at 5.5 billion and poised to reach between 8 and 19 billion within the next century, with less developed nations claiming their right to industrial advancement, and with the continued exploitation of nature by people the world over, the need for international cooperation in environmental protection could not be more clear.

Particularly in the latter part of this century, national leaders have made efforts to reach agreement on global environmental protection. Nonetheless, scientists now warn that the magnitude of global environmental degradation is greater than ever, and that dramatic action is needed now to restore a sustainable balance between population, resource use and waste generation.

That warning is prompting experts from a variety of fields to seriously consider the necessity and potential implementation of global environmental governance.

### From Stockholm to Rio

The United Nations Conference on the Human Environment, held in Stockholm 21 years ago, is considered by most to be the first attempt by scientists and leaders worldwide to acknowledge and address the widespread deterioration of the planet's environment.

Out of the Stockholm conference came a "Declaration of Principles" and an "Action Plan" aimed at protecting many facets of the global environment, as well as the creation of the United Nations Environment Program (UNEP). Many still consider UNEP's environmental assessment program, Earthwatch, its most effective means of prodding reticent governments into endorsing trans-boundary environmental protection agreements.

Of course, other multinational negotiations have addressed more specific environmental problems before and since the Stockholm conference. They include agreements on the protection of whales, international trade in endangered wildlife species and hazardous waste, long-range trans-boundary air pollution, ozone protection, marine pollution from ships, and the dumping of wastes and other materials at sea.

Most recently, the United Nations' 1992 Conference on Environment and Development (UNCED) called upon leaders worldwide to reach consensus on balancing global environmental protection and economic development. Among the documents approved by those attending the Earth Summit was "Agenda 21"—a comprehensive action plan on sustainable development to guide governmental policies into the next century. UNCED also provided the occasion for the signing of two international treaties, one on climate change and the other on biological diversity. (The U.S. delegation, however, refused to sign the latter.)

Unfortunately, the multinational environmental protection measures agreed to during this century have often been rendered less than effective by standards that reflect the lowest common denominator of agreement. And few, if any, include rules for monitoring and enforcement.

### Money, Money, Money...Money!

Many observers presume that only far-reaching institutional restructuring at the international level can meaningfully address the shortcomings of previous multinational agreements.

But what many consider to lie behind the shortcomings of previous global environmental protection efforts is precisely what they say is the major challenge to the future of global environmental governance: money.

Some countries in the highly industrialized world, particularly the United States, have refused to enter into agreements with specific greenhouse gas reduction targets and timetables, for example, on the grounds that to do so could translate into lost jobs and other painful adjustments in the midst of an economic recession.

Those in less developed nations, on the other hand, have often been reluctant to endorse trans-boundary, environmental protection measures precisely because they could threaten their immediate economic survival.

And even when rich and poor nations can agree in theory to global environmental protection measures, questions of who will finance them, and under what conditions, can be extremely contentious.

"Any calls for strengthened global governance will continue to be viewed warily so long as industrial countries do not offer the things developing countries most urgently need: financial and technological assistance to combat environmental degradation directly, and help with structural problems such as debt and deteriorating terms of trade that exacerbate Third World poverty and in turn only make the environmental problems worse," writes Hilary French in her Worldwatch report *After the Earth Summit: The Future of Environmental Governance*.

French notes that countries relatively rich in natural resources, but poor financially, will be unwilling to preserve the resources for the common good unless the world's economy is restructured in such a way that it becomes advantageous for them to do so.

### For the Common Good

Nonetheless, many are hopeful that the combination of widespread public concern generated by UNCED, rapidly shifting world political dynamics, and the U.S. election of an environmentally astute president and vice president may provide the momentum for both global economic restructuring and effective global environmental protection.

Most of those considering the future of global environmental protection agree, for example, that means to eradicate poverty and stop overpopulation are fundamental components of successful global environmental governance. But again, that would require a shifting of commitments, particularly from the one remaining superpower, the United States.

"Once we [the United States] begin to act in a way that convinces others that we aim at the interests of the planet rather than promoting an ideology, we will be able to engage in the new kind of politics that the situation demands," says Nathan Keyfitz, head of the Population Program of the International Institute for Applied Systems Analysis in Laxanburg, Austria. "We are only slowly learning to separate the newly required world environmental politics from our own short-term economic interests as well as from our own ideology."

But just what shape the new world environmental politics should take is wide open to debate.

Some, like Gareth Porter of the Environmental and Energy Study Institute and Janet Welsh Brown of the World Resources Institute, say it is crucial to make the "common heritage of mankind" and "intergenerational equity" legally guiding principles applicable to all global environmental issues. They believe such a "revolutionary development" in international law will have to be accompanied by the creation of a global environmental authority. That authority would have the power to monitor and impose sanctions against those nations who violate the protection of the Earth's shared resources and environment and/or those that threaten to compromise the environmental health of the planet for future generations.

Others, such as Vice President Al Gore, believe voluntary participation in international governance is the only feasible alternative for the immediate future. He suggests, however, that nothing less than a Global Marshall Plan is needed.

"The scope and complexity of this plan will far exceed those of the original" writes Gore in his book, *Earth in the Balance*. "What's required now is a plan that combines large-scale, long-term, carefully targeted financial aid to developing nations, massive efforts to design and then transfer to poor nations the new technologies needed for sustainable economic progress, a worldwide program to stabilize world population, and binding commitments by the industrial nations to accelerate their own transition to an environmentally responsible pattern of life."

Gore suggests putting in place, now, a "policy framework" that will be ready to accommodate increased political action as the magnitude of the global environmental threat, and public insistence that it be addressed, grow.

Perhaps the first step in that direction is the recent formation of the U.N. Sustainable Development Commission, upon which both industrialized and developed nations have agreed. The commission will hear evidence from governments and private groups to monitor how governments are living up to the agreements they made at the Earth Summit. Though the commission as currently structured lacks enforcement power, it will rely on publicity and international pressure to persuade governments to keep their promises.

"To some, the idea of global governance might seem hopelessly idealistic or quixotic," says Worldwatch Institute's Hilary French. "Yet few would judge it any less conceivable than the astonishing events of the past two years in Eastern Europe and the former Soviet Union. These events demonstrate how quickly even the most seemingly intransigent governments can be moved if their citizens feel passionate enough about their cause."

French is not alone in stressing that, as environmentalists from around the world work closely toward shared goals, the nongovernmental movement may become as adept at influencing international politics as it is at influencing the environmental politics of many single nations.

"This issue," finally, write Gareth Porter and Janet Welsh Brown in their book *Global Environmental Politics*, "is not whether nation-states will move toward progressively more effective cooperation on global environmental threats, but whether they will do so rapidly enough."

—*Jennifer Merrill*

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The Wall Street Journal April 2, 1993

# An Environmental Impact Statement for Immigration

The Clinton-Gore administration is viewed by both friends and foes as far more environmentally friendly than its predecessor. Among its goals is safeguarding and passing along an ecologically healthy and physically attractive environment. Yet to date (an admittedly early one) none of its members has linked this goal with its necessary precondition, an environmental impact statement for population growth.

Lacking such a reference map, the Clinton administration may unwittingly compromise America's demographic future by regarding population growth, especially that due to immigration, as simply a matter of dollars and cents. Earlier this year, when President Clinton told the

## Counterpoint

By B. Meredith Burke

California Economic Summit that the federal government should help states burdened by immigration, he clearly had financial aid in mind. But just as until December the Census Bureau discounted immigration's effects on fertility and population growth, so, too, elective and appointed officials have ignored both the localized and the qualitative effects of immigration.

Realistically, the U.S. as a whole does not receive immigrants. California, New York, Texas, Illinois, Florida and New Jersey do: 82% of the total. These states have long passed the point where additional population is desirable.

Lake Okeechobee, Florida's largest lake and the heart of South Florida's natural free-flowing drainage system, is now encircled by a dike, assaulted by more than 1,500 miles of canals and levees, and the daily recipient of 1.5 tons of phosphorus waste from cattle-raising, hastening its biological death. The Everglades is dying from both drainage and human construction. The National Agricultural Lands Study projects at the current rate of conversion of agricultural land to nonagricultural uses, Florida will lose all its prime agricultural land by the year 2000.

In the 1950s Los Angeles County led the nation in the value of agricultural production; its four neighboring counties were agriculturally based. Today this irreplaceable fertile land is asphalt-covered. While pollutants emitted per car have been cut in half, the doubling of the population in the past 30 years has wiped out nearly all the potential air quality gains. Its current residents look out upon a degraded natural setting unrecognizable as the beautiful combination of beach and mountains that enchanted the servicemen and factory workers of World War II.

In the past four decades the San Francisco Bay Area has lost one-third of the total pasture and crop acreage that once existed. The Greenbelt Alliance predicts there will be virtually no fertile cropland left in this area by the year 2000.

Texas lost more than 600,000 acres of prime farmland to permanent nonagricultural uses just between 1977 and 1982.

Yet foes of immigration control and the demographically ignorant erroneously attribute high levels of popular support for tighter immigration limits to xenophobia and short-term economic interests. They deem citizen concerns about the quality of life for themselves and their children self-indulgent.

Consider the keynote speaker at a recent World Affairs Council immigration conference in Palo Alto, Calif. An official in the State Department's Bureau of Refugee Affairs, he ignored the disproportionate effect of both refugee and immigrant admissions upon California and shrugged off audience concerns about the environment. I asked, "What size population would you consider too much for California?" (Its 1970 population of 20 million has grown to more than 30 million.)

"Oh, 100 million or so," he replied airily. "Look," he instructed me, "eventually it will get unpleasant enough that people will start to move out and the situation will resolve itself. That's the free market solution."

I deplore several assumptions embodied in his reply. One is the "slash and burn urbanization" tenet: It is OK to despoil one area and just move on. Staying put and fighting to preserve one's habitat are questionable behavior.

Another fallacious assumption is that

*The time has come for a demographically mature America to narrow if not close its gates.*

the resource problem is solved through dispersal of population. He fails to see that inhabitants of an industrialized country make demands upon resources and are responsible for pollution (for products they consume) at locales far from their homes. The activist group Population-Environment Balance defines "carrying capacity" as the number of people who can be sustainably supported in a given area without degrading the natural, social, cultural and economic environment for present and future generations. When migration becomes imperative, clearly the base population has exceeded this capacity.

His reply also places a much lower value on access to rural and wilderness areas than does the American public. Perhaps an artifact of a society that so recently enjoyed a "frontier," Americans cherish small towns and open space and stubbornly resist high-density housing. But undeveloped coastline and wilderness areas are crumbling under population pressures. Ironically, were it not for the post-1970 immigration input, population in California and other high-growth states would soon be leveling off.

We know from Immigration and Naturalization Service figures where immigrants of different origins settle. If Vice President Al Gore and Interior Secretary Bruce Babbitt are serious about protecting America's physical fabric, they should work for legislation requiring Congress to estimate the environmental and public goods burden of proposed immigration quotas. In no other manner can we impose demographic accountability on our national legislators, who so far have found it impossible to withstand the importunings of individual pressure groups. A legislator who can straightfacedly tell Californians, New Yorkers, Floridians and so forth that their carrying capacities can indefinitely absorb tens or even hundreds of thousands of new immigrants annually should be challenged.

Results from the 1990 Latino National Political Survey (which also surveyed non-Hispanic whites) were recently released. Three-quarters of both Anglo and Mexican-American citizens agreed there were too many immigrants, as did 73% of Cuban noncitizens and 84% of Mexican noncitizens. Only our popularly elected legislators resist the people's message that the time has come for a demographically mature America to narrow if not close its gates. If Messrs. Clinton and Gore can acknowledge this reality, they will both reassure the populace that "Washington listens" and take a giant step toward the environmental future to which Americans aspire.

*Ms. Burke, a Cupertino, Calif.-based demographer and economist, has frequently consulted on immigration issues.*

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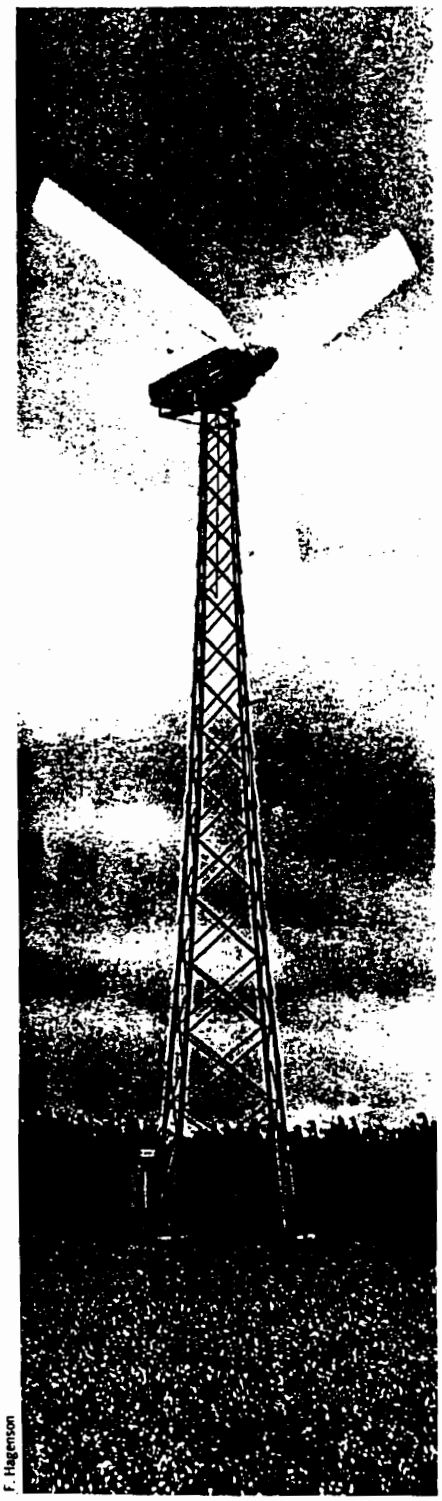
OUR PLANET

THE MAGAZINE OF THE UNITED NATIONS ENVIRONMENT PROGRAMME

# DENMARK'S WIND POWER LESSONS

by SHANE CAVE



F. Hagenson

Wind is free, clean and readily available. Denmark's wind power industry, subsidized into life by the government, now stands on its own and leads the world in its capacity to contribute to the electricity supply as a whole.

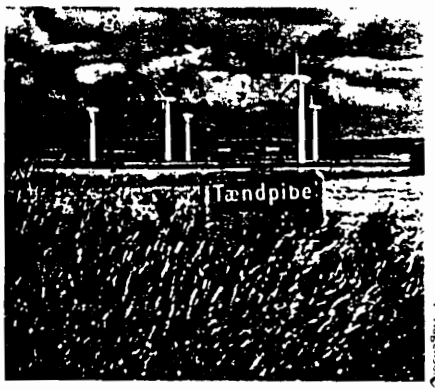
Faced with the two sharp oil-price rises of the 1970s, Denmark, with no significant oil or hydro-electric resources, embarked on the world's most ambitious wind power programme. As a result, the country now has a wind turbine generating capacity of 70 watts per person. The next highest in the world is the United States with 5 watts per person, most of which is concentrated in California. (At the beginning of 1991 Denmark had wind turbines with the capacity to produce 343 megawatts (MW) of electricity, whereas the US could produce 1630 MW. See *Our Planet* Volume 4, Number 3 for California's wind-power story.)

Wind now produces 2.5–3 percent of Denmark's electricity, and the Danes hope to get this up to 10 percent. This means not only a saving in oil and coal, but a cut in pollution emissions. In the Nordic countries this is an especially sensitive subject, because acid rain caused elsewhere in Europe by sulphur dioxide emissions from the burning of fossil fuels, especially coal, is causing enormous damage to Nordic forests and lakes.

Denmark's leap ahead of the rest of the world in wind energy capture started in the early 1980s, with government installation subsidies to individuals and private groups who banded together to erect wind turbines. This meant that 30 percent of the purchase and installation costs of a wind turbine would be met by the Danish government. About 300 turbines were installed every year during the 1980s, even though the subsidy was reduced several times. The subsidy was abolished in 1989, but the rate of installation has continued unaffected. Some incentive remains, however, as the government obliges electricity supply authorities to buy any excess power generated by wind turbines. The price paid to turbine owners for excess power is favourable compared to the price at which they buy back electricity when the wind is low or their private demand is low. A little more than 200 MW of generating capacity is owned by private groups and individuals, and slightly more than 100 MW of capacity is owned by utilities.

Individuals and groups are free to erect wind turbines in Denmark, but this cannot be more than 15 km from where they live, and an individual or family can only build or buy a share in a turbine equal to the amount of energy they will use. But, because of a dramatic jump in the generating capacity of wind turbines, turbines are now cost-effective to build for the energy they produce. This means that more people are now required to own wind turbines to comply with the ownership/capacity rule. With the latest turbines capable of generating 500 kW, up to 200 families join together to build a plant.

*Wind power is a cost-effective source of energy in Denmark, and private groups and individuals own some 200 MW of generating capacity.*

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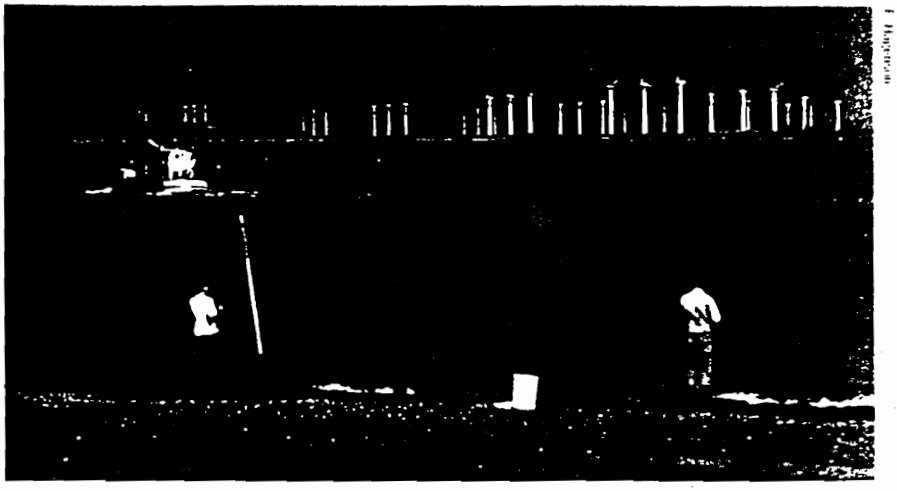
Aided by healthy returns from domestic sales and exports to California, Danish companies invested heavily in research and development. This saw the size of turbines rise from an average capacity 55 kW in 1980 to up to 500 kW in 1990. Improvements in efficiency, that is, the energy generated in relation to the diameter of the rotors, have also increased. This comes from improved rotor design, which allows better wind capture and also allows the rotors to start turning at lower wind speeds, so they generate electricity for more time. The combined effect of bigger and more efficient turbines has meant that while the number of turbines in Denmark increased by 580 percent between 1983 and 1990, the country's wind-generated electricity capacity increased by 1790 percent. (Wind turbines turn at a constant speed set according to the cycle speed of the circuit so that higher speeds do not mean more electricity).

Reliability has also increased. In 1980 there were serious accidents in about half the turbines every year. By 1990, there was one serious accident per 1000 turbines each year and a turbine's economic life expectancy stood at 50 percent. The main improvement has come with the fitting of aerodynamic brakes so that as the wind gusts and the rotor speeds up, brakes come on to slow the turbine so that it does not spin out of control. The failure of early air brakes was the most common cause of early turbines self-destructing. Bigger plants and improved efficiency and reliability have cut production costs dramatically. Without costing pollution savings, wind is now easily competitive with natural gas, and the costs are falling all the time. Using 1989 figures, wind electricity in Denmark costs just over five US cents per kilowatt hour.

Pressure for land, aesthetic considerations, problems with bird life and noise from the turbines has meant that wind farms are now being installed offshore. Although the costs are up to 100 percent higher, the wind conditions are also better, making the farms, on average, 50 percent more efficient. Denmark has also produced a wind atlas to allow for the most efficient siting of turbines on land and along the nearby coast.

Because the timing of the wind bears no relation to consumption patterns, and the energy cannot be stored on a large scale, wind power will only ever be a supplement to other sources for a large grid. However, for small isolated communities and islands, dual wind/diesel systems are being developed by Denmark's Risø National Laboratory. These systems will use wind whenever it is available, even charging batteries when there is excess wind. Only when there is insufficient wind will the diesel generator cut in.

Although wind power is consigned to a supplementary role, Denmark's national goal envisages that 10 percent of its total power consumption will come from wind-generated electricity by 2000.



*Wind farms are being installed offshore, as a result of pressures for land, aesthetic considerations, problems with bird life and noise pollution. Offshore farms are up to 50 percent more efficient than those on land.*

But, as Sten Frandsen of the Risø laboratory points out, if the same per capita wind generating capacity were applied to a developing country with far lower consumption, up to 25 percent of its electricity needs could be met by wind power.

### UNEP's Centre on Energy and Environment at Risø

To refine the understanding of the links between energy use and the environment, and to encourage more efficient and environmentally sustainable energy use, UNEP and the Danish International Development Agency (DANIDA) established the UNEP Collaborating Centre on Energy and Environment at the Risø National Laboratory at Roskilde in Denmark. The centre was established in 1990.

The centre's projects include the establishment of a methodology for calculating the costs of reducing greenhouse gas emissions, the funding of a forum to develop sustainable energy use in Africa, and the prediction of energy consumption/pollution scenarios, with the first case study being of New Delhi.

NATIONAL JOURNAL 2/13/93

# AN ENERGY TAX? OK, IF IT'S NOT ON US

BY VIVECA NOVAK

The turnout was impressive when the American Petroleum Institute (API) held an all-comers gathering on Feb. 4 for opponents of new energy taxes. "There was a strong message of 'Let's not fight each other,' " said Kenneth D. Simonson, the chief economist of the American Trucking Associations Inc. (ATA) and one of the participants in the meeting of about 70 people.

WASHINGTON INC.

Fat chance. Ever since late January, when Treasury Secretary Lloyd Bentsen said on national television that the Administration was considering broad-based new energy taxes to help raise revenue, hundreds of corporations and trade and consumer groups have been scrambling for position, holding press conferences and signing on to myriad, often overlapping coalitions. Their arguments center on tax regressiveness, environmental impact, global competitiveness—and, most of all, jobs.

Many, such as API, are sending the message that energy taxes shouldn't be raised, period. But for most groups, there's an urgent subtext: If taxes have to go up, gore the other guy's ox.

Take Michael Baly III, president of the American Gas Association (AGA). "Currently the AGA opposes across-the-board energy taxes," he said. "But we are taking a look at the gasoline tax, and we'll take a look at [oil] import fees and the carbon tax."

Or note the comments of Robert Hurley, a lobbyist who represents the National Coal Association. "If President Clinton wants to come out roaring with a strong economic program, a carbon tax will knock it flat on its back," said Hurley, who's with the Washington lobby firm of R. Duffy Wall and Associates. "From the coal producers' perspective, a gasoline tax would be best."

Denise A. Bode, head of the Independent Petroleum Association of America, has been offering interviews on how the gasoline tax most hurts low and middle-income people. Instead, she said, the United States should consider an oil import fee.

"Certain groups would die with a particular tax," said Gary Klein, a partner in the law firm of Verner, Liipfert, Bernhard, McPherson and Hand who heads the Energy Consumer Tax Coalition, a group of large petroleum users formed in 1979. "The airlines cannot live with any energy tax. The railroads can't live with a coal tax. The truckers can't live with a gasoline tax. Petrochemical [firms] can't live with an oil import fee." And so on.

The ATA published an open letter to Clinton in *The Washington Post* on Feb. 5 urging him not to propose a gasoline tax and reminding him of his promise in the final presidential debate that he wouldn't "raise taxes on the middle class to pay for my programs." Four days later—in the politics-makes-strange-bedfellows category—the ATA helped engineer an anti-gasoline tax press conference featuring such groups as the National-American Wholesale Grocers Association, Citizens for Tax Justice and the National Consumers League. The Consumers League is represented by Jack Blum, a former Senate investigator who's now with the Washington law firm of Lobel, Novins, Lamont and Flug. But automakers strongly support a gasoline tax hike, in part because they hope to head off tougher fuel-economy standards.

The tax threat has given new life to the Global Climate Coalition, a group of energy producers and heavy energy users, including API, the National Coal Association and the Edison Electric Institute. The coalition, which started in 1989 to fight calls for action on global warming, is dusting off several reports from last year showing that carbon taxes will lead to job loss and other dire economic fallout. Its public relations firm, E. Bruce Harrison Co., has been helping with the press blitz.

Many of the same arguments are being offered by the Alliance Against a Carbon Tax, whose members include Illinois Power Co.; the alliance is being assembled by Jeffrey P. White of the Washington law firm of Newman & Holtzinger and is contracting out studies, grass-roots organizing and lobbying work to other firms. *(See NJ, 1/30/93, p. 292.)*

On the flip side, a coalition of major environmental groups, including the Natural Resources Defense Council Inc. and the National Wildlife Federation, have written to Clinton urging him to impose both a carbon tax and a gasoline tax—and to make them both steep so they'll force a change in people's behavior. Environmentalists have long wanted a tax on fuels with high carbon content, saying that carbon dioxide is the main culprit in global warming.

Regional interest groups have been getting into the act, too. Northeasterners are concerned about oil import taxes, western and southern interests are worried about gasoline taxes and midwesterners fret over a carbon tax. The Northeast-Midwest Congressional Coalition is urging its members to contact the White House to oppose an oil import tax and has recently done two studies showing the impacts of such a levy.

Immediately after Bentsen's remarks about a broad energy tax, a group of Senators, including David L. Boren, D-Okla., John C. Danforth, R-Mo., Pete V. Domenici, R-N.M., and Sam Nunn, D-Ga., called a news conference to oppose it. Two letters asking Clinton to steer away from a carbon tax went to the White House from Capitol Hill in early February, one from a House group coordinated by Robert E. Wise Jr., D-W.Va., and Frederick C. Boucher, D-Va., and the other from a cluster of Senators led by Kent Conrad, D-N.D., and Alan K. Simpson, R-Wyo. Meanwhile, Rep. Fortney H. (Pete) Stark, D-Calif., has reintroduced his bill to impose a carbon tax, and Sen. J. Bennett Johnston, D-La., proposed a bill that would require an oil import tax when imported crude falls below $25 a barrel.

The chairmen of the congressional tax committees, Rep. Dan Rostenkowski, D-Ill., and Sen. Daniel Patrick Moynihan, D-N.Y., have shown support for a higher gasoline tax, though Moynihan recently said he also favors a broad-based energy tax, which he said might be fairer.

A gasoline tax has the appeal of being easy to collect; because it's already in place, it's just a matter of raising it. And a broader energy sales tax would bring in significant revenue: A 5 per cent energy tax would raise $92.7 billion from 1994-98, according to a preliminary estimate by Congress's Joint Committee on Taxation. A carbon tax has the strongest environmental rationale. Some are suggesting that Clinton should propose a mix. That could be the best way to divide and conquer the special interests.

"People are starting to dig in," a lobbyist said. Still, despite all the activity, everyone agrees that the *really* big guns won't be drawn until Clinton puts a concrete proposal on the table, probably in his Feb. 17 speech to the nation. ■

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# Hyping the Dangers of Oil Spills

LONDON — Environmentalists may not have won as much of a publicity coup as they had hoped for after the Braer ran aground in the Shetland Islands a month ago.

Despite all their dire claims that Europe was facing one of its worst ever pollution disasters, the atrocious storms that were responsible for the tanker crashing onto rocks also helped to disperse the ship's cargo of crude oil.

**EUROPE VIEW**

Janet Porter

When the hurricane force winds finally subsided, the beaches had been virtually washed clean and the sea was no longer murky brown but its natural blue.

For a week, as dramatic television pictures of the stricken tanker were flashed around the world, the greens hogged the headlines with a non-stop stream of accusations against shipowners, oil companies, flags of convenience and maritime regulators.

Public opinion quickly swung against the shipping industry as environmentalists displayed grim photographs of dead or dying seabirds and seals smothered in thick black oil. They warned the food chain would be contaminated for years to come as fish digested the toxic crude that leaked from the ship.

But it became apparent that nature had taken care of itself to a very large extent, and had managed the cleanup much better than the chemicals sprayed onto the massive slick, which may have caused much more damage to the Shetlands' ecology than the spilled oil. As that became increasingly clear, opinion started to shift against some of the more extreme pressure groups.

"Have we been conned by hysterical environmentalists," asked an editorial in The Independent newspaper as it became clear the green reaction to the Braer accident was overdone. "Can nature protect itself better than we thought?"

The editorial went on to warn the green movement that it was in danger of losing support if the more fanatical element continued its "irresponsible scaremongering."

A report in The Times newspaper also admitted the environmental disaster predicted as a result of the Braer spill "had not happened" and that "the experts who rushed to judgment and pronounced the beauty of the Shetland Islands had been lost to the next generation of islanders had been proved wrong."

In fact, the Shetlanders themselves, while naturally concerned about health hazards caused by the chemical dispersants and the oil blown ashore by hurricane force winds, made far less fuss about the spill than the dozens of environmentalists who flew in to condemn the oil and shipping industries.

Oil has made the Shetlanders rich. However much they may regret the accident, the Shetland Islanders have lived with the threat of an environmental disaster for the past 20 years and so far have escaped very lightly.

For the environmental lobby groups, though, a major tanker accident in British waters, involving a U.S.-owned ship flying the Liberian flag, classed in Norway and with a Greek and Filipino crew, seemed the perfect opportunity to draw public attention to the ecological vandalism of the shipping industry and the dangers of transporting oil around the world.

For the week it took the Braer to break up, environmentalists bewailed the loss of bird, animal and marine life. But when 51 people died after a Polish ferry capsized in the Baltic Sea two weeks ago, not a word was heard from environmentalists.

According to the Baltic and International Maritime Council, which represents a wide range of shipping interests, research has proved that oil pollution offers no long-term threat.

The rapid dispersion of the cargo from the Braer is a reminder that while oil pollution is serious, unpleasant and a disaster for those personally concerned, it is almost never an "environmental catastrophe" or an "ecological horror," the council said.

Research by pollution cleanup experts, scientists and marine biologists shows that while the effects of spilled oil are likely to be fatal to sea creatures and bird life in the vicinity, its effects are almost certain to be short-lived, according to the council.

But for all the encouraging news as far as the effects of maritime oil spills are concerned, there is no sense of complacency within the European shipping community.

After three major shipping accidents in Europe within six weeks, the Braer and Aegean Sea tanker accidents and the Polish ferry disaster, the shipping industry undoubtedly faces stricter controls as European politicians respond to public concerns about the condition of many of the ships sailing in European waters.

The message the industry is trying to hammer home, though, is the fact that sufficient regulations already exist. Drawing up yet more rules probably would do little to improve safety at sea.

Instead, what governments should do is make sure existing International Maritime Organization regulations are ratified, implemented and enforced.

*Janet Porter is chief European correspondent for The Journal of Commerce.*

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# Making Emissions Markets Work

By MARK BERNSTEIN & ALEX FARRELL

On Monday, the world witnessed the first open market in environmental quality. The Chicago Board of Trade auctioned off more than 275,000 sulfur dioxide "emission allowances" for the Environmental Protection Agency.

This auction marked the beginning of a change in environmental regulation from inefficient command and control techniques to market-based methods that will improve the environment, spur innovation and save money.

The emissions trading program developed under the Clean Air Act Amendments of 1990 assigns pollution "allowances" to each electric utility power plant; for every ton of sulfur dioxide the plant emits, it must turn in one allowance. Since each plant is given fewer allowances than its historical emissions level, every plant must either reduce pollution or buy allowances from another plant, which will have to reduce its pollution even more. Plants that can clean up cheaply will do so and sell their excess allowances to plants with higher costs, lowering overall pollution control costs. All polluters will have incentives to invent new, cheaper ways to clean up.

There are, of course, doubters who believe that "pollution swaps" for sulfur dioxide will prevent the 1990 clean air law from reducing acid rain, especially in the Northeast. The truth is that the emissions markets created by the law will improve the condition of lakes and forests in New England and Canada. And the act can save billions of dollars at the same time.

The three-year-old law permanently reduces sulfur emissions from the nation's electric utilities to half of their 1980 levels. The law is a breakthrough in U.S. environmental policy that uses market forces to keep the costs of acid rain cleanup as low as possible. This flexibility helped win over a skeptical industry and broke the political gridlock that had threatened passage of the act.

The emissions trading program is also a very visible test of a market-based method of pollution control, which may be crucial to reducing the costs of future problems like carbon dioxide reductions.

As promising as this approach is, however, it won't succeed if state regulators step in and prevent the emissions trading market from working. Likewise, the program is doomed if timid utilities are reluctant to participate.

The main problem with sulfur dioxide is that large quantities of it are emitted into the atmosphere by Midwestern power plants, where it travels to the Northeast and Canada, falling as acid rain. This damages forests and lakes.

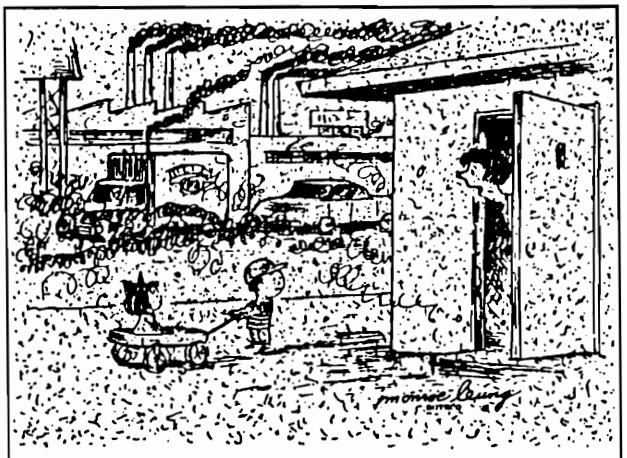
Some Easterners worry that Midwestern plants, rather than cutting their emissions, will simply buy available allowances from utilities in other parts of the country and go right on emitting just as much sulfur dioxide as they do now. To prevent that, some environmentalists and government regulators in the Northeast want to block their utility companies from selling allowances.

Despite their fears, a close look at the numbers shows there just aren't enough allowances available for sale to let Midwest utilities avoid emissions reductions. Even if Midwest power plants could buy every allowance available from the rest of the country, they still would have to reduce their emissions by more than 1.1 million tons in 1995, with further reductions later.

A study recently completed by the Center for Energy and the Environment at the University of Pennsylvania shows that if the emissions market is allowed to operate unencumbered, the bulk of emissions reductions will come from the Midwest, regardless of what any individual Northeast state does.

Our work clearly shows that if individual states ban or restrict allowance trading, the only real effect will be to raise the costs of the program and to raise utility rates, both in the Northeast and in the rest of the country. We expect the Midwest to reduce sulfur dioxide emissions by more than 1.4 million tons a year between 1995 and 2005, representing 38% of the national total reduction.

Despite the threatened trading restrictions by Northeastern states, utilities in that part of the country control only about 3% of the available sulfur dioxide allowances. Selling a portion of those will have little effect on the air quality in the region, but the costs of preventing sales will be high and will hit ratepayers hard.



"Come in, and get some fresh air!"

Since electric companies can do virtually nothing without oversight by state utility commissions, regulators could interfere with sulfur dioxide reduction plans to save local coal mining jobs or out of fear of adverse environmental effects. In our study, however, we found that such restrictions could cost the nation more than $1.3 billion in the first five years alone, with no environmental benefit. If regulators go even further and mandate specific compliance strategies, as some have indicated they will, the costs could be even greater.

Beyond interference by regulators, there is a real concern that utilities will be hesitant to rely on the market, both because it is so new and because of the difficulty of predicting allowance prices. Predicting the future, to be sure, is difficult, but managing risk is exactly the function of financial markets. This is why several firms have begun to set up allowance trading systems. These markets will allow risk-averse utilities to shift the risk of changing allowance prices to others. So far, however, utilities seem reluctant to enter the market, adding to the potential that it may fail.

This combination of shortsighted intervention by regulators and uncertainty by utilities could drive up the cost of reducing acid rain by more than $4 billion. This would help no one.

Properly designed and applied to the right pollutants, emissions trading will work. Environmentalists, economists, consumers and policymakers should be encouraging the proper use of markets to efficiently reduce acid rain, urban smog and agricultural runoff. Self-interested intervention by state regulators and excess caution by utilities will not clean the air. It will only raise the price of electricity.

*Mark Bernstein is a professor in the Energy Management and Policy program at the University of Pennsylvania. Alex Farrell is a doctoral candidate there.*

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THE INDEPENDENT SECTORS'

# NETWORK

NUMBER 22
January 1993

# NGOs MEET WITH GEF IN ABIDJAN BEFORE GEF PARTICIPANTS' ASSEMBLY

**The first Global Environment Facility (GEF) Participants' meeting after the Rio Earth Summit, took place in Abidjan, Cote d'Ivoire, on December 3 and 4, 1992. Government delegations from about 50 countries came to Abidjan as either participants or observers at the fourth bi-annual meeting of the Participants' Assembly of the GEF.**
**Aside from approval of the work programme for the fourth tranche of GEF projects, the participants discussed the restructuring of the GEF. This discussion is to be continued at four planned Participants' meetings throughout 1993, as no final restructuring decisions were made in Abidjan.**

*by Korinna Horta*

The restructuring of the GEF first became an agenda item at the special Participants' meeting on GEF governance which took place in Geneva in February of 1992, where participants expressed the need to "increase [the GEF's] transparency and accountability, without adding new structures". In June, at the Rio Earth Summit, the Climate and Biodiversity Conventions adopted the GEF as an interim financing mechanism, provided that the GEF be fully restructured to ensure an equitable representation of all parties and a democratic and transparent system of governance.

As far as NGO participation is concerned, the meeting of the GEF Participants in Abidjan once again took place behind closed doors with NGOs being denied observer status. However, for the third time, the GEF meeting was preceded by a two-day consultation between the GEF implementing agencies (World Bank, UNDP and UNEP) and the NGO community. The fact that members of many government delegations arrived early in Abidjan to participate in this consultation and expressed their appreciation of the NGO contribution to the GEF restructuring debate, contributed to making it a useful consultation.

### NGOs Were Well Represented

More than 50 NGO representatives from about 30 developed and developing countries came to the consultation. Despite the extraordinary variety and wide spectrum of NGO interests present in Abidjan, there was a clear NGO consensus about the institutional and operational characteristics that the restructured GEF must have if it is to be an effective instrument in addressing the environmental crisis.

One distinct undercurrent at the NGO meeting was the conviction that the Climate Change and Biodiversity Conventions are legally binding instruments which define the conditions with which the restructured GEF will have to comply (and not the other way around). As such, they will determine the governance, legal framework and priorities of the GEF or any other mechanism used to finance their programmes. In addition to equitable participation and transparency, the Conventions require that funding be provided in a predictable manner. This indicates that the Parties to the Convention will not only set the priorities and provide overall programmatic guidance, but will also want to have a decisive voice in determining how funds will be raised and in earmarking funds for their specific programme areas.

A draft legal framework paper on the GEF presented at the Participants' Assembly in Abidjan heightened NGO concerns about the predominant role that the World Bank plans to play in the restructured GEF. According to the proposed legal framework, the restructured GEF, including all determinations on funding and organisational arrangements, would be legally established by a resolution of the World Bank's Board of Executive Directors, dominated by the G-7 countries. The other two GEF implementing agencies, UNDP and UNEP, would simply be expected to endorse the restructured GEF as approved by the World Bank's Board. The straightforwardness of the legal framework paper not only drops all pretenses of an equal partnership between the GEF implementing agencies, it also demonstrates the institutional difficulties that both the GEF Participants' Assembly and the Parties to the Conventions will have to struggle with. For example, the intention of the GEF Participants' Assembly to promote universal membership to the GEF and establish an equitable voting structure in the Participants' Assembly, a structure which takes into account both donor and recipient country agencies, conflicts with the proposed GEF legal framework, unless the Participants' Assembly accepts having only consultative status and a very limited field of competence.

### More Equitable Partnership Needed

NGOs are advocating that the three implementing agencies act on the basis of equal partnership in the management of the GEF and that the Participants' Assembly play an active role in ensuring GEF project quality. Nevertheless, one of the key obstacles to project quality control in the GEF continues to be the World Bank's policy of withholding project documents that are critical for informed decision-making, from the Participants, the Scientific and Technical Advisory Panel (STAP) and the communities directly affected by the projects. In addition, about 80 per cent of all World Bank sponsored GEF projects will be directly attached to regular World Bank loans which frequently contribute to environmental degradation and are inconsistent with global environmental goals. Yet the draft of a new information disclosure policy circulated in Abidjan confirms that information on these loans will be kept strictly confidential within the Bank. This draft does not respond to the Participants' and NGOs' requests for transparency and public availability of documentation on GEF and associated World Bank projects throughout the project cycle.

NGOs are also concerned that the concept of having the GEF fund the incremental costs of achieving global environmental benefits is being used to have the GEF pay for environmental mitigation efforts of unsustainable development projects. Although the question of what "incremental costs" really means is still being debated, the GEF will do little good if its serves as an excuse for development projects not to internalize their environmental and social costs.

The validity of NGO concerns about the World Bank's predominant role in the GEF received further confirmation through a recent internal World Bank document, known as the Wapenhans report (after the Bank's vice-president who headed the task force that drafted the document). This report concludes that on-the-ground quality of World Bank projects has run into serious problems and that the situation is worsening. The GEF, in its current form, suffers from the same problems identified in the Wapenhans report as responsible for the Bank's poor performance record, namely a highly centralized management structure which is more focused on rapid project processing than on developing country needs and quality control of projects. While these pervasive problems can be addressed if projects are identified and designed in close consultation with local communities so as to respond directly to their needs and priorities, there is little evidence so far that the World Bank is equipped [and willing] to do so.

Summarizing the views to the GEF Participants in Abidjan, the GEF Chairman's report states "We must make sure that the GEF matures to become a transparent and effective entity that serves its purpose of integrating global environmental concerns into the development process..." NGOs fully endorse this objective. In order to enable the GEF to meet this goal, however, NGOs recommend that an open and independent evaluation of the GEF pilot phase be conducted. This evaluation should analyze the GEF's centralized governance process, as well as examine the on-the-ground impacts of GEF projects in consultation with affected communities. The results would assist the Participants in restructuring the GEF before final decisions on expanding the scale and scope of the future GEF are taken.

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## OUTCOME OF THE FOURTH MEETING OF THE PARTICIPANTS TO THE GLOBAL ENVIRONMENT FACILITY (GEF)

**Abidjan, Cote d'Ivoire, 3 - 5 December 1992**

The latest meeting of the Participants to the Global Environment Facility took place in December when the fourth tranche of GEF funding was endorsed. This included US$64.2 million for global warming projects (56% of the tranche), US$28 million for biodiversity (25%) and US$18 million for international waters (16%). Added to that was US$6 million for targeted research and US$8 million for support of the objectives of the Biological Diversity Convention. Total pledges to the GEF (the first four tranches) stood at approximately US$1,227 million by September 30, 1992.

The Abidjan meeting also endorsed the GEF work programme for the next year. This includes translating the climate and biodiversity conventions into GEF priorities, policies and procedures; a new programme entitled the Program for Incremental Costs for the Environment (PRINCE) which has received some bilateral funding already; developing criteria for setting investment priorities in the absence of an overarching international waters convention; and work on operationalising the Montreal Protocol guidance on CFC phase-out for the Eastern Europe/NIS Region, where many producers and users of ozone depleting substances are ineligible for funding from the Interim Multilateral Fund of the Montreal Protocol.

Beyond this, the major topic for discussion was on the governance and management of the GEF, especially following the moves for a restructured Facility that should be more transparent and democratic. The principle of universal membership of the restructured GEF was endorsed by the participants, but no final agreement was reached concerning the GEF's decision-making structures. A paper based on participants' suggestions will be prepared for a special one-day meeting in March 1993 that will discuss decision-making and priorities for transition.

The transitional phase of the GEF will start in May 1993 after which the agreed elements of the restructuring will gradually be implemented. In terms of an independent evaluation of the Pilot Phase, the secretariat will prepare a proposition and terms of reference for the participants' consideration.

Negotiations on the replenishment of the Global Environment Facility will start in early 1993. They are to be held "in parallel with, but separate from" the discussions on restructuring and decision-making processes, which formed the major topic of the Abidjan meeting.

The fifth regular Participants' Meeting is scheduled for May 1993. The government of China has offered to host the meeting in Beijing.

(For a more detailed summary of the GEF Participants' Meeting in Abidjan, see *The Bulletin* #18, SF4)

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— GUEST EDITORIAL —

## WHY A CONVENTION ON DESERTIFICATION?

*By Y. M. Katerere*

The call for an international convention on combatting drought and desertification gained momentum at the Rio Summit in June 1992. The African countries mobilised the support of other developing countries, particularly in South America, and eventually succeeded in getting the Main Committee of UNCED to support its proposal. A request to the UN General Assembly to create an inter-governmental negotiating committee (INC) on combatting desertification was approved. The request went futher to recommend that such a treaty be concluded by June 1994.

Opposition to the treaty came from the EC and United States who tried hard to link a treaty on desertification to an agreement on forests. The strategy of the North was to 'trade' an agreement on desertification for an agreement on forests. This was a last minute effort by the developed countries to save face following the rejection by the developing countries of a legally binding agreement on forests.

### THE PROBLEM

Quite clearly the problem of drought and desertification is not just a technical one. Africa's human and environmental crisis is also about social, economic and political factors, both internal and external. It is influenced by the state of the world economy, commodity prices, interest rates, energy imports and inappropriate and misplaced aid. These external factors are exacerbated by internal ones such as population growth which leads to poor land management in the form of over-cultivation, over-grazing, deforestation and poor management of irrigated lands.

The above factors have widened the social and economic gap between the people in the developed and developing countries. The purpose of an international convention has to be to narrow this gap against a background of renewed commitment and action. The narrowing of the gap must recognise the need for a more equitable flow of social, economic, environmental and technological resources. The debate around desertification is not simply a question of human rights or social equity but is about poverty alleviation. These issues can only be addressed within the framework of an international convention on drought and desertification. The international community has to guarantee the minimum conditions for human survival, be they material, social, technical or technological, economic, skills, institutional capabilities, information or cultural.

The convention on desertification is critical if the concept of sustainable development is to become a reality. The UNCED process cannot and should not be satisfied with setting principles and targets for resources such as forests, biodiversity and climate change without addressing those factors that affect human survival. The complex problem of desertification is due to the inability of poor countries to gain control over physical and financial resources. Lack of access to resources demands adaptive behaviour resulting in negative externalities such as over-grazing and deforestation. These are the issues that an international convention will need to address.

### ACTIONS BY AFRICAN COUNTRIES

1) African countries need to argue and agree on the principle of consensus on the responsibilities of all nations to address poverty in order to achieve sustainable development. Poverty is an issue of global concern and its alleviation can bring about efficient, comprehensive and integrated resource utilisation.
2) The Africans must establish the likely benefits of a convention. The causes of desertification can be linked to unequal trade terms and the dependence of Africans on exporting basic commodities into markets they have no control over. The benefits of natural resource endowments consequently do not accrue in the developing countries which have to bear all costs of negative externalities. Furthermore, attempts to shift the focus of national economies from exporting raw materials towards national subsistence economies is being hampered by the imposition on African countries of export driven structural adjustment programmes.
3) The Africans must argue convincingly that "desertification is neither drought, nor soil erosion, nor the destruction of vegetation cover, nor the cutting of trees, nor even the degradation of the living conditions alone. It is all that and much more."[1] Any attempts to link the convention on desertification with forest principles should be rejected on this basis.
4) African countries must promote appropriate instruments of good governance and display a commitment to the principle of popular participation. This will also hinge on flexible and appropriate policies that can address both macro and micro-level issues.
5) African countries threatened by desertification need to take brave decisions about promoting alternative livelihoods for their people and in so doing make commitments to long-term goals. These decisions will have to recognise the inter-linkage between poverty, environment and development.
6) African countries will also need to reach consensus on the role of multilateral institutions and how to relate to them. The multiplicity of institutions, decisions and programmes make it difficult for poor nations and people to achieve maximum benefits resulting in marginalisation.
7) African countries will need to organise a broad based lobby by increasingly involving NGOs and the private sector in the process and activities leading to the negotioations, during the negotiations and post convention implementation.
8) African countries will need to assess the state of the art on the process of desertification and the interaction between desertification and climate change.

The period between the UN General Assembly's approval of a desertification convention and its conclusion in 1994 is not going to be an easy one for the African countries. They will need to display a commitment towards achieving a common goal through collaboration and information exchange. Their approach will have to be both holistic and dynamic.

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# SURVIVING THE CUT: Natural Forest Management in the Humid Tropics

Nels Johnson
Bruce Cabarle

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## I. INTRODUCTION

During the past decade, tropical forests have been disappearing at the rate of tens of thousands of square kilometers per year. Over this period, the tropical deforestation rate increased by more than 50 percent,[1] and the world lost 10 percent of its tropical forests. In many parts of the tropics, logging is being repeated in the same "cut and run" patterns that typified North America's expanding agricultural frontiers a century earlier. As the forests shrink, developing countries lose—irreversibly, in most cases—some of their most valuable natural endowments. Forest products are not the only casualties. Tropical deforestation creates widespread social and economic turmoil, drives countless plant and animal species to extinction, and contributes to the atmospheric build-up of greenhouse gasses.

One of the principal challenges facing tropical countries today is finding productive investments to maintain their forests. Frequently, experts advise basing such investments on the sustainable production of timber from natural forest areas—so-called "natural forest management." The ideas behind this approach are that tangible goods and services in humid tropical forests can compete with alternative land uses that require forest clearing. Natural forest management can also preserve environmental and conservation benefits according to its proponents. Yet, natural forest management's critics question whether commercial timber production can be compatible with the preservation of biodiversity, indigenous cultures, and the wide range of environmental benefits that healthy natural forest ecosystems provide. To be sure, most attempts at forest management in the humid tropics have so far been largely unsustainable. The question now is whether experience affords insights that could be used to revamp natural forest management so that it can make the use of humid tropical forests more sustainable.

Of course, forest management failures are not unique to the humid tropics. As more people realize that temperate and boreal forests are also being managed with little concern for long-term consequences, international forestry issues that were once synonymous with tropical forests will take on a broader meaning. Even so, questions surrounding tropical forest management are especially pressing simply because their role in economic development is so great and the resources available to manage them sustainably so limited.

This bind is probably going to get worse before it gets better. Growing populations and their countries' desperate needs for foreign exchange earnings will inevitably increase pressures on humid tropical forests. Recent increases in development assistance for forestry notwithstanding, only a minute fraction of the world's humid tropical forests is sustainably managed for timber production.

*To most tropical countries, whether to exploit forests is scarcely even a question.*

Already, the role of timber management is among the most controversial in the international debate over tropical deforestation. Faced with great uncertainties about how timber production can be practiced sustainably, the World Bank, USAID, and some other donors now avoid financing projects that involve commercial logging in primary forests. Several European donors have decided not to fund any forestry projects in natural forests. Meanwhile, a growing movement to boycott the use of tropical timbers has manifested itself partly in procurement bans by local governments in Western Europe and the United States. However principled these decisions, some observers fear that they could quash innovative attempts to harvest timber and other natural forest resources sustainably, making the destruction caused by advancing agricultural frontiers or "timber mining" unstoppable.

To most tropical countries, whether to exploit forests is scarcely even a question. Consider, for instance, the following statement by Appanah and

Weinland (1991). "That people have a right to exploit their natural resources for purposes of development and a higher quality of life is axiomatic. A case to cite will be North America, where timber from natural forests fueled much of its early development. Many countries in southeast Asia are currently exploiting their timber-rich dipterocarp forests for the same purposes." On the other hand, without sustainable natural forest-management practices, gains are likely to be limited and short-term and opportunity costs for future generations high.

The need for a firmer consensus on how natural forest management can help maintain humid tropical forests is urgent. The issue dominates current discussions about the International Tropical Timber Organization (ITTO), new multilateral development bank policies on forest sector lending, and the Tropical Forestry Action Plan. It figured centrally in recent negotiations at the U.N. Conference on Environment and Development (UNCED) over "Agenda 21" and a statement on global forest principles, and it is likely to emerge in various trade initiatives, including the General Agreement on Tariffs and Trade (GATT) and free trade agreements.

What should the pivot points in such a consensus be? For starters, governments have to be committed to defending a "permanent forest estate" based on secure, long-term land tenure for communities, concession holders, and forest agencies. Once such an estate is established, governments, conservation organizations and donors must be able to recognize where and when natural forest management projects are appropriate. For this, they need clear criteria, preferably developed in consultation with those who will be most directly affected. Where primary forests are currently inaccessible, human population densities are low, and deforestation is thus not an imminent threat, natural forest management is probably not the right conservation technique. But where the fit is good and natural forest management is embraced, it must become synonymous with ecosystem management—focussed on a variety of products and environmental services, not just timber. When planning begins, explicit management objectives and expected benefits should be spelled out and the appropriate monitoring indicators identified before logging begins.

If production of a commodity is a primary objective, it should be linked from the start to secondary ecosystem management objectives. To monitor progress toward both primary and secondary objectives "leading" environmental indicators on, for instance, the status of biodiversity, water quality, and soil nutrients must be developed to complement such traditional "lagging" indicators as timber yield, tree regeneration rates and composition, and non-timber forest product yield. (More specifically, leading indicators might include regeneration rates for important successional as well as dominant tree species, the status of key pollinators and seed dispersers, changes in micro-climates, levels of mineral, organic materials, and microfauna in soils, and the quality of water flowing from managed areas.)

***Natural forest management affords no guarantee that forest ecosystems will stay healthy and diverse. Ultimately, the institutions that manage forests determine their fate.***

Even if these steps are followed, natural forest management affords no guarantee that forest ecosystems will stay healthy and diverse. Ultimately, the institutions that manage forests—communities, concessionaires, and government agencies—determine their fate. Still, the chance that they will succeed can be strengthened. To build community support for sustainable forest use, the keys are recognizing the land and resource tenure of long-standing forest communities, developing organizational cohesion and management skills, and blending local knowledge with technical assistance to promote more sustainable management practices. To get concessionaires to buy into the proposition, governments must set forth incentives, coupled with enforceable guidelines, for sustainable forestry and build the capacity to make sure they are respected. Important incentives to practice sustainable forestry can be provided by voluntary and independent timber-certification programs backed by a scientifically and socially credible international standards board (such as the nascent Forest Stewardship Council). Designed by experienced foresters, ecologists, and social scientists, in consultation with interested community and commercial forest producers, such certification programs would allow producers of both tropical and temperate/boreal timbers higher prices and other incentives to make the system work.

These recommendations are only a partial list, and getting to the root of tropical deforestation will require initiatives outside the forestry sector. Along with natural forest management, the fate of humid tropical forests will depend directly on more appropriate and sustainable agricultural development, more and better job opportunities for rural and urban poor, and more effective protected areas networks. Indeed, the sustainable use of forests is bedeviled by the same problems that undermine all attempts at sustainable development in tropical countries—poverty, unemployment, rapid population growth, foreign debt, parochial allegiance to sectors within governments, undervalued natural resources, inequitable international trade relationships, and highly concentrated economic and political resources.

Even though any one of these factors can overwhelm sustainable natural forest management, the need to put the use and management of all forests on a more sustainable basis remains. Our best hope for doing so still lies with natural forest management. In the short term, the destructive impacts of logging in humid tropical forests could be reduced by adopting simple and well-known technologies and better management techniques. Over the longer term, such mechanistic changes must be linked to the social and economic needs of the local people for whom the forest means livelihood or home.

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The Wall Street Journal April 1, 1993

# A Forest Rises From the Ashes, Privately

By Dixy Lee Ray

When President Clinton flies into Portland, Ore., for Friday's Timber Summit, he may, weather permitting, get a spectacular view of Mount St. Helens. The still-simmering volcano that erupted with explosive force on May 18, 1980, leveled trees as far as 15 miles to the north and over a 156-square-mile area. Ten percent of the mountain's mass dissolved into ash, and more than one billion board feet of lumber were downed in a single moment. Most animal life was wiped out. But 13 years later, the area is a testimony to the success of a pursuit that this weekend's summit is likely to ignore: private-sector forest management.

For weeks after the big eruption, and amid all that gray and lifeless landscape, the question persisted: Will this area ever support a forest again? Most people, including many biologists, believed that years would pass, decades, or maybe even centuries, before the land could recover. How wrong they were.

On the government land, Congress in 1982 established a 110,000-acre National Volcanic Monument, where nature has been allowed to take its course, unperturbed and unaffected by human actions. But on neighboring private land, Weyerhaeuser Co. and others set to work immediately, salvaging the downed trees and planting new seedlings. They saved 850 million board feet of timber, enough to build 85,000 three-bedroom homes.

The stage was set for a grand demonstration: On similar but separate parcels of land, side by side, one could observe and compare natural recovery with managed and assisted recovery.

Within a year or two, the return of life, both plant and animal, was remarkable. Today, the differences between the "natural" and the managed areas are dramatic. Both are recovering, but the undisturbed public lands lag far behind.

Nature proved to be far more resilient than most people expected. On the private land, within weeks of the eruption, experimental plantings of tree seedlings were made to determine the ability of young trees to survive on the ash-covered ground. It was found that, as long as the seedlings' roots could reach the soil under the ash, the trees would survive. Using this information and scraping away ash where necessary, 18.4 million trees were planted on 45,500 acres by 1987. Today, the number of new plantings has reached nearly 16 billion.

THE TIMBER SUMMIT

The result of this effort is a lush forest. Most of the pre-1987 plantings are between 25 and 30 feet tall. Undergrowth carpets the ground and wildlife is abundant. Meanwhile on the public land, natural recovery has taken place at a considerably slower pace. The same species of plants, flowers and grasses have occurred, as have a number of trees, but the growth has been far slower and the trees more sparse than on the managed land.

Moreover, the reforested growth on private land is not significantly different from the original (pre-1980) forest below the slopes of the volcano. Before the eruption, there was an almost unbroken expanse of evergreens, including Douglas Fir (some of these were giants of 400 years in age), Noble Fir, Pacific Silver Fir, and Western Red Cedar. The undergrowth was also extensive and diverse. A four-square-mile remnant of this old growth was shielded by a ridge from the volcanic blast and remains as a striking example of virgin Northwest forest. It can be compared to the public and private reforested recovery areas closer to the mountain.

Who can say, except on a subjective, emotional basis, which forest is "better"—the old untouched one that evolved slowly over many decades or the newly replanted one? Both have approximately the same complex of tree species and varied undergrowth, and the same wildlife, birds and insects inhabit both. Deciding that one forest surpasses the other is a value judgment heavily influenced by what one believes a forest is "for."

It is true that the history of American private forest management has been mixed; but on the whole it has been extremely successful. Of the 3.6 million square miles that constitute the U.S. today, 1.13 million square miles, or 32%, are wooded.

From colonial days to the mid-19th century, there was considerable deforestation; most of the once expansive Eastern hardwood forest was cut before 1900 as the settlers cleared land for agriculture. Up to about 1920, the classic robber-baron "cut and run" philosophy dominated. But beginning early in this century, forestry started to change. In 1909 Henry E. Hardtner, owner of Louisiana's Urania Lumber Co., admonished his contemporaries to "protect your remaining forests and commence at once the reforestation of your denuded areas." Indeed, it was the forest industry itself that provided the leadership and capital to establish the reforestation movement—a movement whose outlook now prevails throughout the industry.

Today the evergreen-dominated forests of New England and the Old South have regrown. In the Southeast, many managed forests and tree plantations have extensively reforested the land. Reforestation in Maine makes that state our most heavily wooded: 90% of its surface area is covered with forests.

It's time to get rid of long-outdated stereotypes about rapacious timber companies that slash away at pristine forests without concern for their preservation.

President Clinton and Vice President (and Environment Czar) Al Gore are in a position to do just that. The White House says the purpose of the Forest Summit is to learn how the federal government can "provide leadership and encourage new, innovative and creative approaches" to addressing the forest-management controversy. But the Mount St. Helens case proves that private companies, employing state-of-the-art reforesting techniques, are leading the way in forest management innovation—as they always have. And they are doing it without the government's help.

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*Ms. Ray was governor of Washington state from 1977 to 1981 and is a former head of the Atomic Energy Commission. This article is adapted from her book "Environmental Overkill," due out this month from Regnery Gateway.*

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# Environmental Policies in the Dominican Republic Need Major Reform

Reduced farm yields in the Dominican Republic caused by rapid soil erosion could be avoided with better cultivation techniques and the development of a national water resource management plan. These are among the findings of a recent APAP II natural resource policy study led by Dr. Rubén Núñez, of Abt Associates.

The wide-ranging study, organized in the form of an inventory, provides an important overview of environmental policies in the Dominican Republic, focusing on four key areas: sustainable agriculture, water resource management, forestry, and wildlands and biodiversity. With input from a team of seven specialists, the inventory catalogues common problems in these areas and identifies major policies as well as agencies responsible for policy implementation. It also presents qualitative assessment of policy impacts and, most importantly, offers guidance for policy reform.

For example, policy reform for water resource management in the Dominican Republic must center on better delineation of institutional authority, according to the study. There must also be increased involvement of non-governmental organizations in water resource protection activities, more public education campaigns, and further studies to determine efficient water pricing.

Overall, the study found that many of the Dominican Republic's pressing environmental problems are closely linked to a lack of effective agricultural and natural resource policies and inadequate support within the country to develop improved cultivation practices. Without change, however, environmental problems will only multiply, with serious implications throughout the country.

Other policy-related resource problems identified as preeminent in the Dominican Republic are:

- siltation causing erratic supplies of water for drinking purposes and hydroelectric generation;
- destruction of coastal habitats due to tourism and urban development resulting in reduced fishery output and diminished water resources of recreational value;
- inadequate treatment of sewage and chemical effluents that deteriorate water quality; and
- a combination of poor reforestation incentives and heavy reliance on fuelwood for household cooking needs, resulting in a net depletion of forests.

*"Pressing environmental problems are closely linked to a lack of effective natural resource policies and inadequate support within the country to develop improved cultivation practices."*

These issues and others are discussed in the study's four focus areas, summarized below.

### Sustainable Agriculture

Growing awareness of the importance of sustainable agriculture has not been evident in the Dominican Republic. Agricultural research is in disarray. What effective extension exists is provided mostly by private companies to larger farmers and by agribusinesses to contract farmers. Liberalization of the credit system has resulted in more credit flowing to non-agricultural end-uses. Cumbersome titling procedures and non-transferable titles for land reform beneficiaries

*Continued on page 5*

# Environmental Policies in the Dominican Republic Need Major Reform

*Continued from page 3*

further inhibit rural land and credit markets. The adoption of new production techniques is impeded by a lack of technical knowledge and credit, and inappropriate cultivation practices persist. The combination of readily available pesticides, unenforced regulations, and ineffective quarantine measures has contributed to high rates of improper pesticide use. Ineffective policies have also resulted in limited use of hillside agroforestry and integrated pest management as well as skewed land distribution patterns, the absence of land use restrictions, and soil fertility loss due to erosion.

Specific economic policies which affect the sustainability of agricultural production have included foreign exchange policies, trade restrictions, patterns of public spending, taxes, input subsidies, and research and extension. Changes in macroeconomic policies, namely in the exchange rate and trade liberalization, have increased the real incomes of agricultural exporters, but current infrastructure investment does not include natural resource management, the new tax is environmentally counterproductive, and fiscal austerity has reduced expenditures in social and environmental areas, hindering education and enforcement efforts.

### Water Resource Management

Institutional paralysis is cited as the main reason for weak performance in water resource management. Institutions with overlapping jurisdictions are poorly coordinated and crippled by limited enforcement capabilities due to scarce budgetary and human resources. The value of coastal resources, for example, is better recognized thanks to various decrees on fisheries, mangrove protection, and shoreline construction, but several appointed commissions remain inactive and research shows that prohibition of construction within 60 meters of the shoreline is not widely enforced. A second major policy impediment is the underpricing of water both for irrigation and human domestic uses. Charges for irrigation water are based on area while charges for domestic water are on a fixed monthly basis per household connection. In the absence of volumetric pricing, there is little incentive to conserve and use water efficiently.

### Forestry

In the last 35 years, there has been a marked decline in total area forested even though sixty percent of the population is now urban based. The main causes of deforestation have been policies and traditional practices that allow slash and burn agriculture, the harvesting of lumber for the local furniture industry, and the harvesting of fuelwood. Private reforestation efforts are impeded by the reliance of roughly two-thirds of the Dominican population on charcoal and firewood for energy needs, the lack of readily available energy substitutes, and negative reforesting incentives due to public control of resource use through extensive use of permit systems.

*"Without change, environmental problems will only multiply, with serious implications throughout the country."*

### Wildlands and Biodiversity

The main constraint to preservation of wildlands and biodiversity has been a tardy conservation policy regime. The wildlands base is extremely small and widely dispersed in "pocket" enclaves. At present, eighty-nine species have been identified as threatened, and despite extensive hunting, fishing, and poaching laws, sale and export of endangered species continues unimpeded. Traditional wildlife management practices have emphasized protection and ignored the economic needs of neighboring communities, and there is no fundamental understanding of the value of ecotourism or the habitats and optimal size of reserve areas for forming sustainable ecosystems.

### Recommendations

Efforts to improve agricultural policies must begin with a comprehensive agricultural policy review. New policy initiatives should focus on sound agricultural investments, including community conservation programs and more active private sector participation in the dissemination of integrated pest management technologies.

Forestry policies can be improved by clarifying resource ownership rights to enhance incentives for prudent, long-term management and investment, reviewing timber concessions, bolstering environmental education programs in primary and secondary schools, and strengthening forestry research and management capabilities, especially in native species.

New policies for wildlands a biodiversity must be developed, based on detailed scientific inventories of flora and fauna in critical areas of the country. Likewise, studies of the economic and social value of specific wildlife species are necessary, as well as the promotion of better coordination among the four agencies with jurisdictional authority in wildlife areas. Finally, expansion of two national park areas is needed, and the development of integrated management plans that will financially benefit both neighbors of protected areas and the implementing agency. ■

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# Central Asia's Looming Water Wars

By Arun P. Elhance

AFTER signing the historic Camp David peace accord with Israel, the late Egyptian president, Anwar Sadat, is reported to have said that the only reason his country might go to war again with its neighbors would be a disagreement over shared waters.

In another part of the world, the break-up of the Soviet Union into many independent nations has created an unprecedented potential for conflicts over the ownership and use of increasingly scarce and deteriorating freshwater supplies – supplies earlier shared by some republics under the command of a central authority in Moscow.

In arid Central Asia, shared waters could quickly become the catalyst for armed contests within and among five newly independent nations: Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.

The two main rivers in Central Asia, the Syrdaria and the Amudaria, each now flow through four of the five independent nations before entering the Aral Sea. Agriculture is still the main economic activity in all of these countries, and waters of the two rivers are responsible for as much as 75 percent of their combined agricultural production. The rivers also provide most of the water for drinking and sanitation for a combined population of nearly 52 million, which is fast multiplying. At present, close to 90 percent of the population in much of Central Asia does not have piped water supply.

The Aral Sea, once the fourth largest body of freshwater on earth, with a surface area of nearly 250,000 square miles, is now half that size. It is likely to completely disappear by early next century. Twenty of the 24 species of fish in the Aral have already vanished; the number of animal species in the surrounding areas has fallen from 173 to 38, some of which are now endangered.

By the early 1980s, water flows into the Aral had fallen to zero due to prolonged overexploitation and withdrawal of the river waters upstream. Because of rapid evaporation of the remaining water, the shore-line has already receded nearly 40 miles, leaving behind abandoned fishing towns and a saline desert from which high winds now deposit 75 tons of salt, dust, and toxins on the surrounding fields every year, adversely affecting global climate in the process.

MANY environmentalists agree there is no way to save this dying body of water other than by stopping all upstream water withdrawals from the two rivers for at least the next 30 years. This is clearly impossible, since all the Central Asian republics are highly dependent on the rivers for the survival of their economies.

To deal with impending water shortages in Central Asia, schemes were proposed in the past to reverse the south-north direction of some of the major Siberian rivers in Russia with the help of a series of "controlled" nuclear explosions, if necessary. Had they been implemented, such schemes would have produced global ecological disasters. But now, with the collapse of the Soviet Union, the cash-starved Central Asian countries have no ability to initiate any large-scale water projects in the region. And that will remain the case for the foreseeable future.

One solution lies in creating a new supra-national authority, backed by international financing, which can manage and allocate the scarce waters of the Syrdaria and Amudaria in an efficient, equitable, and environmentally sound manner. The problem is that the Central Asian nations are very likely to resent and resist any dilution of their new-found national sovereignty, which the mandate, given a new regional water authority, would necessarily imply. One has only to look at the Western European nations, which are experiencing a host of problems on the way to creating regional institutions and legislation for collective action in the economic and environmental arenas, to realize what a formidable task such cooperation in Central Asia is likely to be.

In the meantime, water scarcity is accelerating in all five countries even as their economies deteriorate, despite or because of attempts at economic reforms. If the bitter historical legacies of unsettled boundary disputes and ethnic conflicts lead to further fragmentation in some of these countries – as is already happening in Tajikistan – the prospect of wars over shared river waters will increase.

Taking these tensions into consideration, the international community should watch out for the first signs of water conflicts in Central Asia. And let's not forget that Kazakhstan still has a huge stockpile of nuclear weapons and missiles; other countries in the region are also well armed.

■ *Arun P. Elhance is a professor of geography at the University of Illinois at Urbana-Champaign. His book, "Hydropolitics in the Third World," is to be published this year by the US Institute of Peace in Washington.*

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PERSPECTIVES ON AN ENERGY TAX

# Doing Good While Doing Well

**As we cut the deficit, we'd cut consumption and pollution. And—a bonus—we'd spur new conservation technology.**

By LEE SCHIPPER

Taxing energy to raise revenue, as proposed by President Clinton, would not only reduce the budget gap, but would also have the bonuses of encouraging of energy efficiency, addressing environmental problems and improving our energy security.

The size of the tax should be related to the twin goals of stemming the deficit and reducing the negative impact of using energy. A $50-billion initial target would mean taxes of 8 cents per gallon of gasoline, 0.6 cents per kilowatt hour of electricity or 60 cents for a thousand cubic feet of natural gas. On average, prices would increase 12%, leading to nearly a 10% decline in energy demand over the pretax level, once users adjusted their technology and behavior.

The decline in energy use from an energy tax would help mitigate such problems as pollution, emissions of carbon dioxide from burning fossil fuels and our heavy reliance on oil imports. Even with modern pollution-control technology, energy production and use still results in significant environmental damage.

Is such a tax regressive? While taxes on the 40% of our energy use that includes gasoline, electricity and household fuels are regressive, extending this tax to the remaining 60% of energy that is used to make the goods and services we buy compensates for most of the problem, since the wealthy buy so much. Keep in mind, too, that the hidden costs of the budget deficit (high interest rates, cuts in social services) are paid disproportionately by low- and middle-income households. And when we go to war over oil, it is these households that send their children.

Will higher energy costs hurt the U.S. economy? Our recent study shows that energy-intensive industries (steel, cement, chemicals, paper) actually produce a small share of output with an even smaller share of employment, and have enormous potential to save energy by adopting new technologies. Higher energy prices will accelerate the move to such improvements, which have been occurring on their own for the past 50 years but slowed when the price of oil crashed in 1986.

Others fear that energy taxes will affect our competitiveness. We found that U.S. industry paid less, on balance, for coal, oil and natural gas, and nearly the lowest for electricity, than industry in Europe or Japan. This suggests that cheap energy is not a vital ingredient to industrial success. In all, only about one-third of all the energy used in the United States is for manufacturing of products relevant to international competition.

In fact, energy taxes are common in Europe. The Nordic countries tax carbon dioxide and other pollutants from all fossil fuels and have various taxes on electricity. Germany, France and Italy have a variety of taxes on household fuels and smaller taxes on industrial fuels. And every country taxes both gasoline and road diesel heavily.

In the United States, we use far more energy than Japanese and Europeans in our overlit and overcooled buildings. Although we have pulled even with Europeans in the efficiency of heating homes, we still use more money to heat water, per person, and our appliances use more electricity. We use one-third more fuel per mile of car travel than Europeans, drive about twice as far per person and use significantly less mass transit. Clearly, we have much more energy fat to squeeze from our economy.

Are energy taxes inflationary? Energy costs represent less than 10% of our GNP. Energy is more than 15% of costs in only a handful of industries, like cement or certain chemicals. But there are countless ways for us to reduce energy costs that have not yet been exploited. To avoid being inflationary, such taxes should be gradually imposed. Ultimately, the impact on inflation will be small.

What about the gasoline tax? Even though it is directed at only 13% of the energy we use, this tax has merit because transportation has its own budget gap, with users of the roads not really paying their full social costs. The energy tax alone will only have a small impact on the price of gasoline. In the end, we probably need both.

Deciding the "right" level of environmental tax and revenue to be raised is no easy task, politically. Presidents Ford and Carter tried and failed. Even President Reagan struck out when his 1986 energy security study essentially recommended either a gasoline tax or an oil import fee.

Those who oppose energy taxes should ask themselves: Should we tax income or investment, both in short supply? And taxing labor means taxing jobs, another scarce resource. Avoiding any tax because we can't agree on the exact level means forgoing a ripe opportunity to close the budget gap, as well as the environmental and efficiency gaps. Let's buoy up the energy-tax idea before it sinks, and keep our children's future from being swamped by the deficit and foul air.

*Lee Schipper, staff senior scientist at the Lawrence Berkeley Laboratory, is the co-author, with Steve Meyers, Richard Howarth and Ruth Steiner, of "Energy Efficiency and Human Activity: Past Trends, Future Prospects" (Cambridge University Press, 1992).*

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COLUMN LEFT/
BENJAMIN F. CHAVIS JR.

# Environmental Justice Is Social Justice

■ The poor in America suffer disproportionately from hazardous waste sites.

*Injustice anywhere is a threat to justice everywhere. We are caught in an inescapable network of mutuality, tied in a single garment of destiny. Whatever affects one directly, affects all indirectly.*

— Dr. Martin Luther King Jr.
Letter from Birmingham Jail, 1963

Dr. King's words reveal the moral truth that we all have a mutual interest in promoting justice. That we share our interdependent planet ultimately means that a threat to anyone's environment is a threat to everyone's environment.

The convergence of basic survival with the struggle for equality is reflected in the increasing national demand for environmental justice. It is a movement that confronts the immorality of upper- and middle-class people consuming the most energy and producing the most waste, while it is the health of the poor that is most affected by the resulting pollution.

It is fueled by research such as the National Law Journal's findings that the federal government's Superfund program takes 20% longer to place minority communities on the priority list for Superfund cleanup, and that the EPA consistently imposes considerably weaker penalties on those who pollute minority neighborhoods. Our 1987 study, "Toxic Waste and Race in the United States," also identified race to be the most significant factor in determining the siting of hazardous waste facilities. Three out of five African-Americans and Latinos live in communities with one or more hazardous waste sites.

Environmental racism is graphically represented in both urban and rural communities—places like the 80-mile strip along the Mississippi River between New Orleans and Baton Rouge dubbed "Cancer Alley." An area predominantly inhabited by poor descendants of slaves, it is also home to 136 industries, petrochemical facilities and waste dumps that annually release more than 900 million pounds of toxins into the air, ground and water. The inhabitants of that corridor suffer some of the highest cancer rates in the nation.

Escaping poverty does not provide a shield from environmental degradation for African-Americans. Take the all-black, middle-class Carver Terrace development in Texarkana, Tex. The development was built on land once a chemical dump site for arsenic and other life-threatening contaminants. The community was placed on the Environmental Protection Agency's national priorities list for cleanup, and Congress ordered relocation of the residents, who are still fighting the government to gain fair value for their properties, which were appraised by the government below replacement cost. Meanwhile, the blue-collar white Mountain View Mobile Homes community in Globe, Ariz., facing similar health risks, received $80,000 to move from the asbestos-contaminated soil underneath their homes.

**'Three out of five African-Americans and Latinos live in communities with one or more hazardous waste sites.'**

East Liverpool, Ohio, provides yet another example. The nation's largest toxic-waste incinerator is slated to open near an African-American community. Vice President-elect Al Gore recently called for operations not to proceed until a study is conducted to ensure that the incinerator will cause no adverse impact on public health.

Gore sent an important signal. The best way for the new Administration to meet the challenge of supporting environmental justice is by emphasizing the critical connection between a healthy economy and a clean environment. This job does not fall to either the Administration or the environmental justice movement alone. Civil-rights, religious, labor and traditional environmental groups have a vested stake in crafting an effective strategy.

Our nation must be proactive in setting the long-term goals of a sustainable society that is economically viable and environmentally safe. Achieving that goal can offer hope and justice to the people and communities that have been marginalized under 12 years of trickle-down economics.

It is no accident that the civil-rights movement is redefining conventional definitions of the environment at the same time that many others are reformulating concepts of national economic priorities.

Ultimately, it will take the same type of creativity and passion that three decades ago enabled the civil-rights movement and the Johnson Administration to desegregate public accommodations, guarantee voting rights and forge a broad-based consensus that prodded America to live up to its Constitution. So much of that work is still unfinished. The civil-rights movement and the environmental movement can no longer afford to remain separate.

This new reality presents the new Administration with a precious window of opportunity. We can only open it together.

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THE WALL STREET JOURNAL THURSDAY, MARCH 11, 1993

# We Need to Unearth Environmental Felons

Environmental crime is a subject that seems to work remarkable changes on conservative politicians and commentators alike. Mention environmental crime and suddenly our most determined anti-crime warriors become unabashed conscientious objectors.

Recently, the editors of The Wall Street Journal questioned the very concept of an environmental crime and warned that the new administration should resist this "movement" before "executives and farmers" are charged with criminal acts. It seems that there are limits to the war on crime. Unfortunately, there are no such limits to the victims of environmental crime.

In New York, a group of eighth-graders

## Counterpoint

By Jonathan Turley

on a field trip, came across numerous broken vials of blood lying along a public beach. Testing later revealed that some of these vials contained blood infected with hepatitis B, an infectious virus that can cause serious illness and death. The vials were later traced to Geronimo Villegas, the co-owner of a blood testing center. Prosecuted for the crime, Mr. Villegas admitted that he regularly cleared out his laboratory by dumping hundreds of such vials into the waterway next to his apartment complex.

Mr. Villegas is an environmental felon, and there are thousands like him across the country. Mr. Villegas is different, however, in one respect: He was caught.

The number of environmental prosecutions in the past few years fell far short of the Bush administration's professed "get tough on crime" policy. Despite two years of intense congressional criticism of its failure to enforce these laws, the Justice Department has kept the number of pleas and convictions to roughly 100 per year. This means that the department is barely securing one plea or conviction per U.S. Attorney's Office in this country. Obviously, there is hope that this record will change with the new attorney general and her commitment to enforcement. Any shift to enforcement was made easier this week, with the release for public comment of new sentencing guidelines for environmental criminals.

While the editors of the Journal insist that they would support prosecuting "significant and conscious" acts of environmental devastation, their silence on past corporate malfeasance is deafening. Consider the case of PureGro Corp. PureGro was under indictment for the spraying of a populated area with a hazardous substance. Jack Downs, a local resident, may have died from the exposure and 23 people were injured. Facing major felony convictions, the company called senior officials in the Bush administration. Without informing state officials, and against the advice of their own prosecutors in the field, top Justice officials cut a deal with PureGro. Although the company had reportedly offered to plead guilty to a felony, the Bush administration apparently felt that this was unfair and accepted a plea to a small misdemeanor and a $15,000 fine.

The PureGro case is only one of as many as 30 cases, identified by Congress, that follow a pattern of reluctant prosecution by the Justice Department. A recent congressional report confirmed two earlier investigations that found a "culture" among high-level Justice officials to treat environmental crimes differently from other types of criminal conduct.

While new sentencing guidelines are long overdue, increased penalties will mean little unless they are actually applied to criminals. Any felon considers the likelihood of capture as well as the potential penalty for a crime. Unfortunately, most environmental criminals today escape investigation, let alone prosecution. With fewer than 100 convictions or plea bargains a year, environmental crime not only pays but pays well for most felons.

There is an obvious solution: Increase the chances of arrest. Once indicted, 40% of environmental felons plead guilty and the vast majority of the remaining cases result in guilty verdicts. Increasing the likelihood of arrest is simply a matter of fully funding the enforcement programs at the Federal Bureau of investigation and the Environmental Protection Agency. Both of these agencies have been repeatedly denied resources to investigate environmental crime.

*Unfortunately, most environmental criminals today escape investigation, let alone prosecution.*

Prosecuting environmental felons has actually proved a windfall for the government. Currently, every $1 spent for prosecution results in a $24 return to the government. This money goes into the general government coffers, not back to the environment. Ironically, this leaves the federal government as the primary beneficiary of environmental crime—after the felon himself.

The Drug Enforcement Agency and other police agencies are allowed to retain a large part of their captured criminal assets to finance further investigations and prosecutions. Environmental crime should receive no lower priority. By returning more money for the protection of the environment, the government could ensure that environmental felons help fund the restoration of the natural resources and communities they victimize.

Without such changes, using nature as a vehicle for crime is still a sound business decision. In Michigan, for example, Lawrence Welsh ordered his employees to illegally dump hazardous wastes at a flea market and along roadside ditches. Two victims went to the hospital and the federal government spent tens of thousands of dollars cleaning the various hazardous sites. For these offenses, Mr. Welsh was sentenced to four months in prison (largely suspended) and a $1,000 fine. This is less than the average sentence for criminal traffic offenses.

Environmental criminal penalties punish individuals and corporations by correctly labeling them as criminals. Some cases clearly do not warrant incarceration, but criminal penalties are the only deterrent for some environmental felons. Moreover, even short incarceration cannot be dismissed as a deterrent. Many corporate officers view civil penalties as simply "the price of doing business." Personal incarceration is another matter entirely. Nothing serves to concentrate the business mind more than a potential prison stint, even a brief one.

Expanded criminal penalties would add very personal costs to the decision to use nature as a vehicle for crime. They would also bring a needed balance in our criminal justice system. Few violent offenders could do the damage of an Exxon Valdez. Yet a person will spend more time in federal prison today for writing a single bad check than for severely damaging Prince William Sound. New criminal penalties will not end environmental crime, but they will end the false distinctions that help sustain it.

*Mr. Turley is an environmental law professor and director of the Environmental Crimes Project at George Washington University.*

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The Wall Street Journal April 1, 1993

# 'Frontline' Perpetuates Pesticide Myths

By Dennis T. Avery

"Frontline," the Public Broadcasting System's investigative journalism show, is famous for its controversial points of view. But it's now outdone itself. In an episode titled "In Our Children's Food," which aired in most markets earlier this week, a well-meaning Bill Moyers and his PBS colleagues made recommendations that would increase our cancer and heart disease rates, increase the risk of world hunger, and plow down millions of square miles of wildlife habitat. Apparently the "Frontline" staff didn't realize that those calamities would be the result of giving up the farm chemicals it warned us against.

The show was prepared to celebrate the 30th anniversary of Rachel Carson's book, "Silent Spring." Miss Carson blamed farm chemicals for wildlife losses that we now know were due to lost habitat and to industrial pollutants like mercury and PCBs. In her ignorance, she also feared that pesticides caused human cancer.

We now know that farm pesticide residues contain less cancer risk than mustard and pickles or even than the environmentalists' beloved mushrooms. We now know that 99.9% of the cancer risks in our food supply come in the foods themselves. So much for the cancer risks in pesticides.

But the indictment against "Frontline" is worse than an omission of these facts. Medical practitioners across the country tell us today that the best way to reduce both cancer and heart disease is to eat twice as many fruits and vegetables. Fruits and vegetables contain powerful chemicals that inhibit cancer. They are low in fat and high in fiber; their consumption works against heart disease.

But organic farming—farming without chemicals—can't produce low-cost, attractive fruits and vegetables. Organic farming produces expensive fruits and vegetables because the insects and diseases eat most of them before they can be harvested. The few that survive look shabby, and it's hard to get kids to eat shabby-looking produce. On that basis, organic farming would produce more cancer, not less.

Biotechnology may eventually help us engineer the pest protection into plants and creatures so we won't have to spray anything anymore. But most of the ardent environmentalists say they are against biotechnology, too.

The worst indictment of an organic farming system is that it could not provide enough food to supply even the current human population of the world. By 2050, there would be billions of organically induced starvation deaths. (The U.S. is one of the few countries that could survive organic farming without risking starvation, but we have more farmland than almost anybody else.)

Yes, the world could plow more land to make up for the low yields on organic farms. But already, the world is cultivating about 5.5 million square miles (the land area of South America) for food. With organic farming, by 2050 we would plow down and cultivate 30 million to 40 million square miles of land. That's the combined area of South America, North America, Europe and most of Asia!

Even Rachel Carson might have thought that a strange way to preserve wildlife.

As evidence of farm chemical dangers, "Frontline" offers one farming town in California that for years has had an unexplained high rate of cancers. But this town is famous in medical circles because its cancer pattern is unlike any other town's. Medical studies have tried to tie the famous "McFarland Cancer Cluster" to pesticides. All have failed.

Next, Mr. Moyers cuts to a guilt-ridden California farmer whose son came down with leukemia 10 years ago. The farmer is afraid that his use of pesticides might have caused the leukemia. But farmers and farm kids have lower rates of leukemia and cancer than nonfarm kids. Where is the medical evidence to tie the California farm boy's disease to farm chemicals? The "Frontline" hosts don't tell us anything except how "worried" they are.

The program also ridicules a Public Health Service toxicology study that reported: "There is no evidence that the small doses of pesticides that we do get are causing any harm. The only effect that can be measured . . . is the storage of one of them—DDT—in the tissues of most people. This storage has not caused any injury which we can detect."

Then Mr. Moyers crows: "DDT would be banned 10 years later, just as Rachel Carson had predicted." This was in the early 1970s.

But Mr. Moyers fails to tell us that DDT was banned against the recommendation of scientists and the Environmental Protection Agency's own hearing examiner. The dozens of experts who testified at the EPA hearing overwhelmingly said DDT should keep its EPA approval because it wasn't dangerous to people or birds. The political appointee who headed EPA feared a public outcry if he concurred with the hearing examiner because so many people had read Miss Carson's book.

Is the rest of PBS's widely noted environmental reporting based on evidence this shaky?

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# African employers urge tripartite solutions

***As the process of structural adjustment continues in Africa, employers will play an increasingly important role, including helping to alleviate eventual negative consequences. Tripartism will be an integral element in adjustment strategies.***

These are the main conclusions of an ILO symposium held in Abidjan last October and attended by delegates and observers from 38 African employers' organizations.

Invited to discuss the role of their organizations in the economic and social transformations presently taking place, the employers agreed that the structural adjustment process was both inevitable and irreversible. They also felt that the private sector would be called upon to play a more important role than in the past. According to Mr. Mamadou N'Diaye, of the Senegalese National Employers' Council, "the private sector plays a determining role in the promotion of economic growth and in development".

Several participants cited examples where privatization had brought very positive results at national level. Dr. Abel Gazarin, Egyptian Employers' Representative (*see box, opposite page*), spoke of the changes that had come about in his country over the past two years, including the partial dismantling of trade barriers; administrative reforms introduced in public enterprises involving separation of ownership and management; a guarantee of broad freedom of action for the top management of such enterprises; and withdrawal of the State from participation in all joint ventures.

To alleviate the negative social effects of this program, a corporate fund was established, financed by external donors. This corporate fund was used to set up job-creation, training and recycling programs for workers who had been laid off. Financial deregulation measures included the free floating of the Egyptian pound and the removal of all Government controls on interest rates. The results were spectacular. Investment increased, hard currencies become readily available and economic growth returned.

## Negative effects

Despite this positive note, the symposium did not present unlimited optimism. A number of speakers expressed serious concern over the negative effects of structural adjustment programs. Many felt that the social aspects should be taken into account from the beginning and, in fact, be an integral part of development strategy. In order to provide a better guarantee of the social acceptability of such programs, it would be necessary to make sure that the social partners were fully involved in program planning, formulation and execution.

According to Jean-Jacques Oeschlin, President of the International Organization of Employers, "tripartism is an essential element in any strategy of structural adjustment".

For the tripartite approach to be successful, it was agreed, all participants must assume their responsibilities and speak with authority. The social partners must be strong, independent, open to compromise and empowered to commit themselves fully. Only under these conditions would it be possible to overcome the economic crisis. It was generally agreed that there could be no lasting improvement in the economic situation without truly competitive enterprises. Likewise, without these there could be no full employment, no satisfactory economic development and no real social progress. ❑

## THE ROLE OF THE ILO

**The ILO program of aid to African employers' organizations should be aimed principally at strengthening their structure, permitting them in this way to play a full role in bringing about desired economic and social changes.**

**ILO support was solicited particularly for the following activities:**

- **Training in leadership as well as in most of the other fields in which the ILO is competent.**
- **Training in the setting up and management of small enterprises, with particular attention to the needs of women, youth, refugees and migrant workers.**
- **Basic assistance for those organizations and enterprises which are weakest economically.**
- **Training, advice and equipment for supervisory and management personnel.**
- **Publication of a manual, as well as courses on how to set up and manage employers' organizations.**
- **Special programs of assistance to African regional and subregional employers' organizations.**
- **A job creation program: promotion of small enterprises by employers' organizations, training in the informal sector, training of young people, population programs.**
- **Information on the labor market: research, collection and dissemination of data, computerized data banks, etc.**

**The symposium also recommended that the ILO assign a still higher priority to programs designed to strengthen the social partners in a balanced way in order to improve the effectiveness of tripartite action.**



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# AFRICA AND THE New World Dis-Order

## Rethinking Colonial Borders

FRANCIS M. DENG

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As the drama of the fall of the Berlin Wall and the breakup of the Soviet Union begins to recede into memory, overtaken by the Persian Gulf War, the wars in Yugoslavia, and the landing of U.S. troops in Somalia, the notion of sovereignty within national borders becomes an ever more pressing issue.

The world seems to be of two minds—and moving in contradictory directions—regarding national borders. On the one hand are moves, as in the European Community, toward overriding national borders in favor of enlarged unity. On the other hand are moves toward fragmentation, whereby new and sometimes deadly borders are erected *within* old states, as in the former Soviet Union and in the former Yugoslavia. These two contradictory models would seem to suggest that in this new world order, those who have been oppressed by the concentrated power of the centralized system of the nation state are asserting the need for self-determination, while those already free are choosing to modify sovereignty and move toward larger cooperative frameworks.

Nowhere is the tension between the opposing trends of unity and autonomy or independence as pressing as it is in Africa, where the colonial borders have been perceived as both artificial and sacrosanct. The signal from the developments at the international level is that old assumptions about borders and nationhood are now under severe scrutiny, to say the least. Ethiopia, which appears set to give its ethnic groups the right of self-determination, may well prove to be a test case for the future. The time seems ripe for revisiting the colonial borders drawn on the map by European powers nearly one hundred years ago.

### The Constraints of the Old Order

During the Cold War, the debate on conflicts around the world, and especially in Africa, centered on whether they were internally rooted or provoked by the ideological rivalry between the superpowers. The question was critical to how those conflicts should be addressed and managed. If the causes were internal, then remedies had to be sought internally. If they were related to the superpowers' rivalry, then not only had the solutions to be sought through them, but their support for their allies was a given. The debate generally dichotomized positions between those who welcomed and even sought external intervention as necessary and those who resisted it as an undesirable complication and aggravation of internal or regional conflicts.

Now that the Cold War has ended, from the point of view of strategic and ideological considerations, the major powers have largely withdrawn from third world concerns—bearing out early fears of Africans that the end of the bipolar confrontation would result in what is now popularly conceived in Africa as marginalization. External strategic and ideological considerations thus having been removed, African problems now exist in regional and national, but not international, contexts. Causes and effects of conflicts are increasingly recognized as primarily internal, a development with both positive and negative implications.

In the past Africa was tied into global structures and processes, first by colonial intervention and then by Cold War ideological linkages into a chain of interdependent dependency. Absent those ties, self-reliance both in the resolution or management of conflicts and in development, is increasingly imperative. However having been dislodged, by their colonial past, from the indigenous values and institutions that permit building from within, Africans are left hanging between the local and the global systems.

With the striking exception of recent developments in Somalia, devastating conflicts in Africa no longer seem to draw world attention. The decolonization of Namibia, the dismantling of apartheid in South Africa, and the peace process in Angola all took place under the watchful eyes of the world at large. The United States played a catalytic role in the



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transition in Ethiopia following the downfall of Mengistu Haile Miriam's government in May 1991. In contrast, Liberia, Mozambique, and the Sudan endure their crises, set in motion as central governments lost control of the countryside, in virtual isolation, although recent proposals at the United Nations for support of the peace process in Mozambique are encouraging if implemented.

The only areas in which the world still manifests interest in Africa are South Africa and the drought-stricken and war-ravaged countries in desperate need of humanitarian assistance. And of course the International Monetary Fund and the World Bank adjustment programs keep the continent tied to the dictates of the international financial and economic system.

Africans are reacting in a pragmatic way that points at two seemingly contradictory, but in fact complementary, lines of action. First, they are recognizing that the world does not care much about them and that they must take their destinies into their own hands. At the same time, the imperatives of global interdependence propel them to resist marginalization. Their aim is to put their house in order and get back to the international scene with a renewed sense of legitimacy.

The moves are not sequential but concurrent. Recent years have witnessed a wave of earnest self-criticism in Africa among intellectuals and even incumbent political leaders. Promoting democracy and human rights has become a high priority in the African debate. The Organization of African Unity Charter on Human and Peoples' Rights, the so-called Banjul Charter, was a symbolic step in this process. The Conference on Security, Stability, Development, and Cooperation in Africa, Africa's so-called Helsinki process, was initiated by General Olusegun Obasanjo's African Leadership Forum, endorsed by the Kampalla Conference in 1991, and is now under consideration by the OAU. Also envisaged is an African Council of Elders, mostly former heads of state and government who have retired respectably and can continue to offer leadership, primarily in mediating between parties to domestic and regional conflicts.

The OAU Secretary-General has also revived the dormant Commission on Mediation, Arbitration, and Conciliation and has established a conflict resolution unit in the Secretariat. Current OAU involvement in mediating civil conflict in Rwanda suggests



ILLUSTRATION BY ELIZABETH WOLF

that the organization may find a more activist role.

If these moves can succeed, Africa will be in a better position to resist marginalization at the international level.

### The Challenges of the New Order

African problems, whether in conflict management or development, must be approached from the perspective of their local, regional, and national contexts. Politically, the starting point, as in most matters pertaining to Africa, has to be the colonial nation state, which brought together diverse groups that it paradoxically kept separate and unintegrated. Regional ethnic groups were broken up and affiliated with others within the artificial borders of the new states, with colonial masters imposing a superstructure of law and order to maintain relative peace and tranquility.

The independence movement was a collective struggle for self-determination that reinforced the notion of unity within the artificial framework of the newly established nation state. Initially, independence came as a collective gain that did not disaggregate who was to get what from the legacy of centralized power and wealth. But because colonial institutions had divested the local communities and ethnic groups of much of their indigenous autonomy and sustainable livelihood and replaced them with a degree of centralized authority and dependency on the welfare state system, once control of these institutions passed on to the nationals at independence, the struggle for control became unavoidable. The outcome was often conflict —over power, wealth, and opportunities for development—that led to gross violations of human rights, denial of civil liberties, disruption of economic and social life, and consequent frustration of development.

As the Cold War raged, however, these conflicts were seen not as domestic struggles for power and resources, but as extensions of the superpower ideological confrontation. Rather than help resolve them peacefully, the superpowers often worsened them by providing military and economic aid to their allies.

Although the end of the Cold War has removed this aggravating external factor, it has also removed the moderating role of the superpowers, both as third parties and as mutually neutralizing allies. As Liberia, Somalia, and Sudan illustrate, the results have been unmitigated brutalities and devastations.

It can credibly be argued that the gist of these internal conflicts is that the ethnic pieces put together by colonial glue and reinforced by the old world order are now pulling apart and reasserting their autonomy.

Old identities, undermined and rendered dormant by the structures and values of the nation-state system, are reemerging and redefining the standards of participation, distribution, and legitimacy. In fact, it may be even more accurate to say that the process has been going on in a variety of ways and within the context of the constraints imposed by the nation-state system.

From the dawn of African independence, such slogans as Senghor's Negritude, Nkrumah's Consciencism, Kenyatta's Uhuru, Nyerere's Ujamaa, Mobutu's Authenticité, and Kaunda's Humanism have symbolized African leaders' search for cultural legitimation of their political and economic objectives and strategies. Often the slogans were rationalizations for preconceived ideas and practices adopted from foreign prototypes and dressed up in local garbs, but they nonetheless expressed a genuine yearning for building on the culture of the people.

With the end of the Cold War, this yearning is gathering strength. Endowed with a deeper sense of the real world that mere slogans can no longer manage, Africans are now called on to find workable solutions to real problems—and in the framework of the new world order.

It is in this context that the revivalist Islamic trend in North Africa should be understood. In the Sudan, for example, the movement sprang up in reaction both to colonialism, which promoted Christianity and Western concepts of secular nationhood, and to the collaboration of traditional Muslim leaders with foreign powers, which reinforced conservatism in a situation that called for radical transformation. A twin movement in this direction, indeed the first to be born, was communism. Both were first and foremost reactions to domestic conditions, and both used ideological links to their international dimensions only as tools of management in an interconnected world.

In the Sudan, with the demise of communism, first locally after the abortive coup of 1971, which was used to justify a debilitating blow to the Communist party, and then internationally with the collapse of the Soviet Union and Eastern Europe, Muslim fundamentalists remained the only credible alternative to outmoded traditional political forces. The Muslim Brothers, who politically transformed themselves into the Islamic Charter Front and the National Islamic Front, infiltrated the army and won the support of the officers who took over on June 30, 1989, in the name of the Revolution for National Salvation, with Islamic revivalism as their agenda.

Islam in the Sudan has been closely associated with Arabism as a composite racial, cultural, and religious identity. Seen in the context of pluralism, however, the challenge that faces the Muslim revivalists is how to reconcile their religious legitimacy and basis of power with diversity and conflicting value systems within the nation state and the still interdependent world.

Western values and institutions, including the separation of religion and the state, that have thus far dominated the nation-state system have been widely adopted and internalized even by much of the Muslim community. In the South of the Sudan, national identity has evolved along indigenous African, Christian Western, and secular lines that contrast with the Arab-Islamic model of the North. Indeed, the two appear to thrive on their mutual antagonism and struggle for survival.

These complexities, however, do not invalidate the quest for cultural legitimation and the need to undertake nationbuilding and development from within the cultural context. The search for workable formulas must consider the conflicting demands for autonomy and equitable unity being made by various groups within the nation-state system. The operative princi-



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ples in this respect must be autonomy, equity, and justice. But the observance of these principles requires a third party as mediator, moderator, peacemaker, and lawgiver. While regional organizations have a role to play, the most obvious institution called on to play a pivotal role is the United Nations.

It must be admitted that once the colonial powers accomplished the brutal task of conquest and pacification, they established a system of public order and justice that brought peace to interethnic relations that had been afflicted by chronic violence throughout recorded history. While colonial intervention understandably provoked nationalistic reactions that ultimately culminated in the independence movement, the postulated role for the United Nations—establishing peace, justice, stability, and prosperity—has a more compelling and disarming justification. A political, economic, social, and cultural system that autonomously uses local resources and resourcefulness within the framework of regional and global interaction and interdependency can be designed to reconcile the lofty ideals of unity with the imperatives of segmentation and fragmentation. As units of participation and social orientation, the family, the clan, and the tribe can indeed be complementary rather than antagonistic to the nation and the global order.

### The United Nations in the New Order

Before the Persian Gulf War, the West saw the United Nations as a third world club and a forum for bashing the West, in particular the United States. The Gulf War and its aftermath turned the organization, in the perception of the third world, into a Western, specifically a U.S., tool for global control.

The United States, or more appropriately George Bush, did not shy away from the role of leadership that the new view of the UN places on the West, especially the United States. Despite resentment by many member states of the inequalities of a system that has hitherto paid lip service to the principle of equality among members, the real test is the extent to which the United States lives up to the ideals of political, economic, and moral leadership, whether it operates individually or through international institutions.

Although states are usually assumed to be motivated by national interests, the role of a world leader certainly carries with it burdens that should transcend those interests. There is obviously considerable controversy in the United States about what George Bush meant by a new world order, what responsibilities he envisaged for the U.S. leadership in that order, and what financial baggage that leadership entails. Generally speaking, not much has been read into Bush's rhetoric, especially its financial implications. When that controversy is resolved, the United States will have to be clearer on what the new order means, whether and how the United States will assume the leadership role, what the guiding principles of that leadership will be, and how it will translate itself in the specific regions of the world where international action is needed to address urgent issues. Somalia already has imposed itself on the international agenda, and the former Yugoslavia is competing for attention, but there are many more candidates, and the ultimate objective should be a comprehensively peaceful, just, and orderly world.

### A New Berlin Conference

If progress is assumed to be an integral part of human development, then the emerging new world order must signify an improvement on the way things have been. The central themes of this improvement must be realizing seemingly contradictory trends, the quest for autonomy and the need for broadening circles of cooperation regionally and internationally. Leadership at the international level must pursue the ideals of freedom, democracy, justice, and prosperity for all nations and peoples worldwide. World leaders cannot discriminate between their own favored nationals and the marginalized nationals of foreign nations, at least not to a degree of dispossession. Liberating Kuwait must be defended only on universal principles, not in terms of limited national strategic objectives, if the role of the United States as the driving force behind UN action is to be viewed as global leadership. The same principle is more glaring in the case of protection for the Kurds in Iraq. This in turn imposes an obligation on the United States and the United Nations to exercise the same responsibility in comparable situations of need for international action.

> World leaders cannot discriminate between their own favored nationals and the marginalized nationals of foreign nations.

As the Somali case indicates, tragic situations of that magnitude cannot be left to local actors when the extent of human suffering and destruction of life and property far exceeds what should be tolerable even by minimum standards of human dignity and global responsibility. If the international community does not extend the logic of action in Somalia to other areas of massive suffering, what we are witnessing may prove to be a new world disorder. Nearly a century ago, in 1884–85, the major European powers met at the Berlin conference and carved the African continent into pieces of real estate over which they extended colonial dominion. Perhaps the time has come for another Berlin conference, at least a metaphorical one, with a different venue, participants, and guiding principles.

Rethinking the borders does not necessarily imply dismantling existing ones. What is required is a comprehensive strategy for addressing realistically the problems that threaten those borders from within. Only if it proves impossible to find workable solutions within unity can the revision of borders be justified. But when that conclusion is reached, borders should no longer be regarded as untouchable. If we are to rethink the colonial borders to give greater meaning to self-determination and the principles of democracy and human dignity, policy analysts must begin to clear the way in what is now a tangled thicket. ■



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POLICY ESSAY NO. 7

# UNITED STATES AND AFRICA:

## INTO THE TWENTY-FIRST CENTURY

CAROL J. LANCASTER

OVERSEAS DEVELOPMENT COUNCIL
WASHINGTON, DC

# Executive Summary

Despite the end of the Cold War and the resulting reduction in U.S. security interests in Sub-Saharan Africa, it still makes sense for the United States to remain diplomatically engaged in the region. Although U.S. economic interests in Africa are small and likely to remain so for the foreseeable future, the values underlying U.S. foreign policy—promoting peace, development, and democracy abroad—argue for active diplomacy. Ten percent of all Americans trace their ancestry to Africa and a growing number of Americans are concerned with events in Africa. This reinforces arguments for U.S. engagement in the region, despite demands on the time and attention of U.S. policymakers that emanate from domestic problems and crises in other parts of the world.

Three major issues confront the United States in its relations with countries of Sub-Saharan Africa now and for the remainder of this century: 1) how to help Africans avoid or resolve civil conflicts, 2) how to assist them to extend and consolidate democracy, and 3) how to support sustainable development in the region.

Civil conflicts have been spreading in Africa over recent years. To help Africans resolve their internal conflicts, the United States should take a two-track approach. In the short run, U.S. action may be needed to mediate conflicts or to intervene directly, as in the case of Somalia. But the United States cannot become the policeman of Africa. It must also persuade or prod the United Nations, the Organization of African Unity, and other appropriate international and regional bodies to develop guidelines for resolving internal conflicts—for example, the circumstances under which external intervention should occur—and to create mechanisms for the resolution of those conflicts, possibly including African or internationally based intervention forces for this purpose. The United States should commit funds to help support peacekeeping forces and appoint a temporary ambassador-at-large to promote international and African action on developing the guidelines and mechanisms needed to deal with these spreading conflicts.

To support the extension and consolidation of democracy in Africa, the new administration should reiterate its commitment to supporting democracy abroad, including in Africa. This commitment should include specific programs such as financial help and training for democratic forces and for newly established democratic governments. Public statements and symbolic acts by the United States in support of democracy can still greatly influence the actions of African leaders and opposition movements. The administration, senior foreign policy officials, and U.S. ambassadors must all act in accord and with a consistent policy in this area. The administration must also ensure to the extent possible that the policies of European governments—above all, that of France whose influence in Francophone Africa remains strong—are coordinated with U.S. policies. Where the United States is alone in advocating democracy, its influence will be greatly diminished. Finally, newly established democracies will ultimately be judged by their peoples on their economic performance—how well they can improve their standard of living. Economic reforms are still urgently needed but must be shaped to avoid destabilizing the new governments. Particularly sensitive policies involve reductions in wages and employment of civil servants, usually organized in unions, which often wield considerable influence with the new regimes.

Development in the region has been very disappointing, despite the large amount of aid thus far provided to African governments. Some of these failures must be attributed to forces beyond the control of Africans, such as adverse trends in the international economy or natural disasters. However, much of the failure is a result of poor policies and weak governance. Economic reforms have not yet led to the increase in private investment that is necessary to drive future growth. The reforms, however, must be maintained and continued if that investment is eventually to come. Meanwhile, it is important that government austerity programs do not result in declines in public investment—especially, in human resource development and the maintenance and expansion of infrastructure—that will be necessary to support healthy future growth. The United States should concentrate its aid in these important areas in the future rather than use its assistance to finance reform programs which, in any case, are developed and negotiated largely by the World Bank and the International Monetary Fund.



In allocating its resources in Sub-Saharan Africa, the United States should most generously aid those governments implementing both political and economic reforms. Those implementing only political *or* economic reforms should receive less assistance. And those governments undertaking no reforms should receive no U.S. aid, except for humanitarian relief.

## AFRICA

**NOTE: Sub-Saharan African countries indicated in gray.**

# Africa's Children, Africa's Future

## Human investment priorities for the 1990s

Prepared by the Organization of African Unity
and the United Nations Children's Fund for the
OAU International Conference on Assistance to African Children
Dakar, Senegal, 25–27 November 1992

# Executive summary

The world knows Africa primarily as a continent in crisis. In recent years, drought, famine and political upheaval have dominated the news.

The reality is somewhat different. Few regions in the world so quickly made gains in improving the lives of their children as Africa did in its first two decades of independence, despite the fact that in 1960 it was the world's most economically deprived continent. And even when Africa was overwhelmed by the natural disasters and economic catastrophes of the 1980s and received special support from abroad, efforts and sacrifices to adjust were made, indeed are still being made, on a scale far beyond that of most countries in other continents. For instance, many African countries did make significant improvements in several areas of child welfare, such as immunization, so that by the end of the decade, coverage levels more than doubled, and 22 countries reached the target of immunizing 75 per cent of their infants.

Nevertheless, the fact remains that fully one third of the 40,000 children who die worldwide every day are African, although they constitute little more than 10 per cent of the world's child population. More children die every year in Mozambique than in all the countries of the former Soviet Union. Moreover, for most African countries the 1980s were a lost decade for development. Living standards declined, school enrolment ratios fell, the quality of health care and basic services deteriorated — even while health and nutrition needs were rising. The stark reality is that unless urgent action is taken to reverse this deterioration with a major new effort for child survival, protection and development, the human foundation for Africa's progress in the 21st century will not exist.

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But a new impetus for human development is available once again within Africa — and for Africa's external partners. The impetus stems from Africa's determination to push ahead with tough policy reforms even though the major powers, whose support is vital for the success of these reforms, are preoccupied with other, more 'strategic' regions. It stems from the intensifying international consensus that the provision of health, education and other basic social services is not only a compelling moral concern, but also a requisite for economic growth. And not least, it stems from the national programmes of action (NPAs) drawn up by African countries to implement the goals and specific objectives that were agreed to at the World Summit for Children, held at the United Nations in New York in 1990.

The World Summit for Children adopted 7 major and 20 supporting goals for the survival, protection and development of children — targets for progress over the decade in key socio-economic sectors. Nowhere is the attainment of these goals as challenging, or as critical, as in Africa, if the basis for the continent's sustainable development in the 21st century is to be assured.

NPAs translate World Summit goals into the realities of each country, with particular attention to the phasing and prioritization of specific actions. In some cases, important additional targets or areas for progress have been established, for example in the areas of gender disparity reduction and the control of AIDS and malaria. NPAs also respond to the World Summit challenge of restructuring national budgets in order to direct more resources towards children, and to seek ways to mobilize additional resources at both the community and national levels while using existing ones more cost-effectively.

If the decline of so many countries in an entire continent is to be arrested, the human basis for revival must be rapidly established. Basic health, basic nutrition, basic education — and necessary supporting services — are the core of this human foundation. The Summit goals provide the practical guidelines for establishing such a foundation.

The opportunity now exists for new approaches, and a number of countries already have clear examples to show what is possible. Africa's determination to turn the range of examples into a much more widespread process of social and economic progress needs a new compact of focused, long-term support from donor countries.

## Africa's children: today's tragedy, tomorrow's promise

In recognition of the urgency of the needs of Africa's children, the continent's leaders called for the convening of an International Conference on Assistance to African Children in November 1992, to promote dialogue with the international community on ways to achieve the goals. Having been a strong impetus behind the 1990 World Summit, African leaders have reaffirmed their commitment to the goals in various international forums. Most significantly, they have adapted the goals to their own economic, social and cultural conditions in NPAs for children, which have been completed by a score of countries, and are in the process of preparation in many others.

The African NPAs lend concrete expression to the growing commitment of Africa's leaders to give 'first call' to children, and they provide a foundation for launching partnerships at the national and subnational levels that can start and sustain a process for moving towards the goals for Africa's children over the 1990s.

## Context of crisis

The context for Africa's children, however, has become more and more difficult, making attainment of the goals that much more challenging. African families and governments have struggled persistently to care for, feed and educate their children, and have made advances in reducing infant mortality, raising life expectancy and increasing access to primary education, safe water and health care. But during the 1980s, a worsening economic environment slowed social progress to a halt in most countries, with set-backs and declines in others. The capacity to make essential investments in children has now been weakened to an extreme by a critical shortage of resources, compounded by economic recession, the debt burden, civil conflict, pandemic disease and natural calamities, among other factors. Africa's children are now being born into a crisis of human development intensified by the struggle for economic revival. Africa is the only continent where the status of children has deteriorated in recent years and is currently expected to worsen in the 1990s, as the weight of economic stagnation and decline takes its toll.

An inadequate international response to Africa's crisis has resulted in the increasing marginalization of the continent in the global setting, manifested by an insufficient inflow of resources, inadequate debt relief and a continuing shortage of investment and loan capital. Domestically, inappropriate economic policies, high levels of military spending in some countries, urbanization, population growth and



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worsening environmental conditions have all exacerbated the present crisis.

But a new sense of realism is prevalent among African leaders, based on the hard lessons of the past and a realistic appraisal of the present. There is now a widespread demand that governments must be democratically elected and accountable to those who elect them. African leaders have increasingly acknowledged their role in the current crisis. Nigerian President Ibrahim Babangida, in addressing the 1991 OAU Summit which he chaired, pointed out clearly that there was "no lasting substitute for a profound and painful commitment at home to reconstitute our societies, to reform our political systems, and to restructure our economies." He referred in particular to the distance that had developed between the leaders and their people, "leading to the exclusion of millions of citizens [from] the process of governance."

In the earlier complex national and international circumstances, it was not surprising that the prospects for children slipped back. As a condition for achieving the goals in the 1990s, all parties will need to mobilize fully a priority agenda of human development as the only effective basis for economic recovery.

### Women: key contributors

Inadequate attention has been given to improving the status of African women, the main caregivers and decision makers regarding the welfare of children. African women fulfil multiple roles — supplying 70 per cent of the labour for food production, and heading between 25 and 50 per cent of households in many countries, but receiving only one tenth of the continent's income. These multiple roles impose severe strains on their health, resulting in high maternal mortality and fertility rates and poor nutritional status. Furthermore, women are largely excluded from decision-making and lag behind men in access to education. Increasing shared parental responsibility for children, provision of safe water and labour-saving technologies in food production and preparation will reduce demands on women's time and labour, liberating an underused resource for Africa's development. Furthermore, improving the health, access to social services, and education of women will pay large dividends in child survival, growth and future productivity.

### Responses to crisis

At a time when governmental efforts have been hampered by an inadequate resource base, Africans have nonetheless attempted to address manifestations of the development crisis through local and family initiatives, including local development organizations and civic groups. These groups have increasingly been called upon to shoulder the burden of the needs of children at a time when public service provision has been inadequate due to reductions in real expenditures at the national level.

At the African intergovernmental level, various economic initiatives to address the causes of the development crisis have been devised; however, these have not succeeded in making the desired impact. Although over 30 countries have applied structural adjustment measures, total net resource flows to Africa stagnated in the 1980s in real terms. At the same time, non-governmental financial and technical support has been of growing importance, along with emerging grass-roots organizations and regional economic groupings. Greater economic realism and more efficient resource use on the part of governments, together with stronger civic and community initiatives, provide a basis for improved development partnerships with a focus on children and women.

### Human development: foundation for 21st century

The World Summit for Children goals form part of an increasing consensus that human development must be the central objective and focus of the development process, especially in Africa. The past decade has shown that a focus on economic stabilization and aggregate growth has failed to achieve the necessary structural transformation in African economies, let alone revive human development. The number of least developed countries in Africa has grown.

NPAs for children form a central element in the formulation of human development strategies, which have as their ultimate objective the improved welfare of all people in society. This is especially important for Africa. The World Bank has identified two immediate priorities in developing Africa's human resources: improving educational standards and redirecting public resources towards basic education and health care. But the basis for implementation of a human development strategy in Africa, while key to the future prosperity of the continent, has yet to be fully put in place.

### Key elements and conditions

A growing consensus, however, starting from the 1980 Lagos Plan of Action and continuing up to the 1990 World Summit for Children Declaration, has identified some of the central elements of such a strategy for Africa. Many of the elements relate directly to the seven major goals, but some are broader. Taken together, their impact, along with the goals, within an overall human development strategy, will strongly promote future productivity and increased incomes.

Economic growth that enables poor people to participate is vital for providing the resources for an increased investment in people. A variety of approaches, based on the context of each African country, is needed to mobilize resources to achieve the goals. As a broad target, there is a need for an increase in domestic expenditures on social priorities to levels equal to 8–10 per cent of gross national product (GNP) and for donors to increase their expenditures on social priorities to over 20 per cent of official development assistance (ODA), along with measures to improve aid effectiveness and programme delivery. Involvement of women and community organizations, enhanced political freedom, attainment of peace and support for the relief and recovery of victims of natural disasters are key enabling conditions for people-centred development in Africa.

## Agenda for 1990s

The need to invest in Africa's children stems from a convergence of three arguments. First, it is a moral and humanitarian imperative, as embodied in the Convention on the Rights of the Child and the African Charter on the Rights and Welfare of the Child. Second, a high rate of economic return can be obtained from the improved health, education and nutrition of children and women. And third, the futures of the children of Africa and the children of more privileged regions of the world are inevitably and inextricably linked.

## Programme strategies

African countries are already putting into practice a range of relatively low-cost and cost-effective programme strategies to attain the goals. For example, during the 1980s almost all countries mobilized resources to increase the level of child immunization in Africa. Additional resources are now needed to extend these achievements, as well as others such as breastfeeding and oral rehydration therapy (ORT).

## Health and nutrition

The drive towards immunization, by strengthening the delivery of basic health systems, provides an opportunity for additional actions to pursue the goals in health and nutrition, including improving access to family planning, launching safe motherhood initiatives, providing vitamin A supplementation for children, controlling iodine deficiency disease and iron deficiency anaemia, and enhancing health education and awareness. Efforts to increase primary school attendance rates offer another opportunity to inform children and adolescents about healthy lifestyles, family planning and prevention of HIV/AIDS, and to monitor their nutritional status.

Health systems in Africa are being strengthened at the district level by decentralized approaches drawing on the Bamako Initiative. In a similar manner, during the past decade community-based nutrition and child survival programmes in the United Republic of Tanzania have reduced malnutrition among children and provided day-care facilities which promote improved child feeding and adult education.

## Water and sanitation

Advances have also been made in the provision of low-cost safe water and sanitation systems — a key to disease reduction, including control of diarrhoea and elimination of dracunculiasis (guinea worm disease). Standardization of technology is a critical factor, as well as hygiene education and demonstration of available technologies. The role of government as facilitator is pivotal, but so is a decentralized approach and the participation of the community in maintenance and 'ownership' of the system used.

## Basic education

Not only does the coverage of primary education need to be extended, but children, especially girls, must stay longer in school. Constraints on educational achievement, such as inadequate skills among teachers, shortages of classroom materials, lack of teaching assistants and the low level of teachers' salaries, must be addressed — ultimately through the achievement of sustained economic growth. Reforms in the educational system can reduce the costs of providing universal primary enrolment and obtaining improved quality. These can include: reducing teacher/pupil ratios through double shifts; increasing private and community contributions to recurrent and construction costs; and freezing higher education subsidies.

Basic and adult education, early childhood education and day care can be enhanced by forging links to the wider community. The strengthening of community organizations — with the strong participation of women — is key to the implementation of cost-effective programme strategies for African children, in particular the millions in especially difficult circumstances.

## Requirements for achieving goals

It is estimated that total financial resources of around *US$12.7 billion* will be needed each year during the 1990s in addition to current spending if the goals for children in Africa are to be achieved. About two thirds of this amount — *US$8.8 billion* — is required for major sectoral programmes in the areas of health, education, nutrition, and water supply and sanitation. Almost *US$4 billion* more is needed per year for supporting programmes to improve the situation of the poorest households, especially in countries recovering from war, drought or other disasters.

However, it is not only more resources that will solve the problems or meet the goals. A strategic framework and the political commitment to implement it are needed, along with assessments at the country level of real resource needs and possibilities for reallocations and enhanced domestic flows. Governments and external agencies must give priority at the highest level to achieving national goals for children, building concern for children and human development into activities such as the budgetary process, aid negotiations, planning and service delivery. Putting a priority on women and children must go beyond traditional social sector institutions and programmes to all ministries.

Moreover, children's welfare is not solely a governmental responsibility; a new level of commitment will be needed from families, communities and civic groups. Decision-making and action for children should be decentralized to the voluntary, community and household sectors. The growing democracy movement has increased the potential for mass participation in Africa's development, and this needs to be reflected in the design and delivery of priority programmes for children. At the programme implementation level, the education of households is important, as is ensuring women a greater role in the development process. The objective of strengthening personnel and institutional capacity may be the most difficult to achieve. Thousands of trained staff will be needed throughout Africa to ensure that programmes in the

**Indicative annual costs for achieving the goals 1993–2000**

| | (US$ millions) |
|---|---|
| **Key sectoral programmes** | |
| Basic health care | 1,550 |
| Basic education | 1,875 |
| Nutrition-focused programmes | 825 |
| Water supply and sanitation | 4,600 |
| **Subtotal** | **8,850** |
| **Targeted cross-sectoral actions** | |
| Focused poverty alleviation programmes | 900 |
| Environmental preservation | 250 |
| **Subtotal** | **1,150** |
| **Special postwar and post-disaster support** | |
| Postwar livelihood rehabilitation | 2,500 |
| Post-disaster support | 200 |
| **Subtotal** | **2,700** |
| **Total annual costs** | **12,700** |

education, basic health, water and sanitation, nutrition and livelihood enhancement sectors are carried out.

Although the exact amounts of additional financial resources required for achieving the goals can only be determined country by country, global estimates can be useful in providing illustrative orders of magnitude, as shown in the adjacent table.

As described earlier, the major social sector needs fall in several key areas. Perhaps 50 per cent of Africans lack effective access to *basic health care*. Family planning and prevention of HIV/AIDS are also required, introducing additional costs. Many children in many countries have no access to *basic education*. Action to achieve the goal of education for all — at least four years of primary schooling and a reduction in adult illiteracy — will require an improvement in and expansion of basic education programmes. Community-based *nutrition programmes* to reduce the numbers of malnourished children and improve household food security are required, as well as programmes to eliminate deficiencies of iodine and vitamin A. *Water supply and sanitation* will entail the most substantial extra costs over the decade, including increased costs per year for the rural and peri-urban populations. The total additional support for the above key sectoral programmes to meet the goals over the 1990s will thus amount to approximately *US$8.8 billion per year.*

Beyond the social sectors, further efforts will be needed to establish the conditions at household and community levels for achieving the goals. *Focused poverty alleviation programmes* include actions to promote the growth of incomes among poor households, along with provision of a minimum social safety net for those households without opportunities to earn adequate incomes. Focusing on means of livelihood will help address the needs of children in especially difficult circumstances, who often come from very poor homes that lack income to feed, clothe and house them. Key to enhancing the income-earning potential of the poor will be the implementation of a people-centred development strategy. Support will also be needed for *environmental preservation and improvement programmes* of relevance to increased production among poor families, such as locally based agroforestry. The total additional support for targeted cross-sectoral actions addressing poverty and environmental preservation will amount to approximately *US$1.1 billion per year.*

Some 7.5–10 million households in Africa have had their livelihoods wiped out by war, and an additional 5 million have been devastated by drought or impoverished by apartheid. Rehabilitation of livelihoods after *war* is a first priority. Advance planning for coping with *natural disasters*, such as drought, is needed, and support during calamities should ensure adequate provision for children, as health services and education are often disrupted. The total additional costs of special support for those affected by war and natural disasters could represent some *US$2.7 billion per year.*

## Mobilizing domestic and international resources

In order to implement NPAs for children, additional funding from both domestic and international sources is required. Although Africa as a whole suffered economic set-backs in the 1980s, there are wide variations in national per capita incomes, as well as in the domestic resources available for social priorities. However, in many countries, resources can be freed up to achieve the goals by *reallocating existing domestic spending* to sectors and activities based on their contribution to the achievement of human development objectives. In addition, poverty alleviation and social goals can be introduced into structural adjustment programmes.

Other domestic savings can be achieved by *effective debt relief, peace dividends* and *reduction of subsidies* to unprofitable state enterprises. But the availability of additional domestic revenue for social priority spending will depend on overall budget growth and economic performance. If the UN target of an annual 6 per cent growth rate is achieved, government resources to be allocated through the budget could therefore be increased by at least the same percentage. Increasing expenditures in some categories by less than the average budget increase would allow for expansion in priority sectors by 7–8 per cent or more.

There is further, although limited, scope for enhancement of domestic revenue through *tax reform*. In addition, *user charges*, including fees and other mechanisms, particularly in the education, health and water supply sectors, can make a positive contribution to the social sectors. Outside the framework of government financing, the most important means of resource generation is *mobilization of additional, locally managed resources* from beneficiary households and communities. Decentralized approaches, such as community-based nutrition programmes and the Bamako Initiative for health care, help to promote

expansion of the resource base for activities at the local level.

Potential financing from national sources over the current decade is in the range of 45–55 per cent of the additional costs for sectoral programmes, or roughly US$4.4 billion. This leaves approximately the same amount remaining to be obtained from external sources. The US$3.8 billion for targeted cross-sectoral actions and special post-disaster support will also need to be funded from national and international sources, according to each country's situation and capacity.

*Priorities for international cooperation* must therefore be reformulated to address the immediate needs of children and the conditions of poverty faced by their families. In 1990, less than US$2 billion of total ODA actually went to social priorities in Africa, compared to the annual additional resource needs of US$4.4 billion estimated for key sectoral programmes.

If the additional resources for human development in Africa are to be found, donor policies will need to give increasing attention to social priorities, through targeted assistance to the least developed countries and to the poor within better-off countries.

Exact aid allocations can best be decided at the country level. However, assistance for social priorities currently averages only about 6.5 per cent of total aid. There is a particular need to move steadily from this low proportion to the target level set by the United Nations Development Programme (UNDP) of 20 per cent of total bilateral and multilateral aid for social priorities. An essential facet of this shift will involve *reallocation of intersectoral assistance.* Major donors could agree on standards for untied aid similar to those for grant elements, allowing for better balancing of aid with national priorities, such as poverty alleviation and human development.

A reduction in expatriate personnel is one way in which cost savings and national capacity-building can be achieved if it is combined with reallocation of aid resources and increased employment of national staff. Another way is more private foreign investment in the productive sectors, leaving aid previously allocated for those purposes to be spent on human development priorities. Non-ODA credit and loans for military purchases could also be converted to social sector aid flows.

There is room for shifts in *intrasectoral aid allocations* in favour of social priorities, through greater efficiency in the use of aid resources in the health and water supply sectors, for example. Furthermore, intersectoral allocation in favour of poverty alleviation can be applied in non-social sectors, such as labour-intensive construction and civil engineering projects.

However, reallocation and refocusing of existing levels of external funding are not sufficient to meet the resource gap for essential investments in Africa's children. To increase ODA to Africa, donors and some African countries might also consider directing part of their peace dividend to international development. ODA could double if only 10 per cent of military expenditures were reallocated for this purpose. Increasing the access of developing countries to developed country markets and mobilizing private resources would be additional sources of funding for Africa's children.

These various measures, nationally and internationally, would pave the way for mobilizing the additional resources required to meet the goals.

## New modalities for international cooperation

Beyond additional funding, achievement of the goals will require a strong and sustained commitment to human development, a renewed dynamic for African economic growth, an intensified assault on poverty, and more effective economic management, on the part of both African governments and international cooperating partners.

New modalities for cooperation would also be helpful in moving towards the goals for children. These might include *national compacts for children*, with the main objective of developing a relationship between a core of donors and a recipient country committed to steady progress towards the achievement of national goals for children, and to ensure adequate resources for this purpose. The national compact would support AIDS implementation and could take various forms: bilateral, multi-bilateral, or a mixture of bilateral and multilateral assistance.

As a follow-up to the International Conference on Assistance to African Children, a possible framework for action might be the establishment, under OAU auspices, of a *Forum for African Children* to monitor overall formulation and implementation of NPAs and compacts. Appropriate monitoring and coordinating mechanisms would be promoted by the Forum and established under the auspices of various regional bodies.

Concerning the Conference itself, Africa's international governmental and non-governmental partners are invited to indicate new approaches, commitments or contributions, planned or under review, for achieving the goals for Africa's children. Donors are also urged to support the forthcoming International Development Association replenishment as a major source of semi-concessional funding for the least developed African countries. African governments should also examine possibilities for restructuring and reallocation of national budgets to address the goals for children.

## The impact of achievement — and the price of failure

It is not in the world's interest to have most of a whole continent continue to suffer from malnutrition, poverty, illiteracy, disease and death. A sustained, joint effort among African communities, their governments and the continent's international partners is necessary to promote and increase investment in human development and the welfare of Africa's children and women. This is urgently needed to provide a way out of the current development crisis and lead towards sustained economic growth. Greater inflows of international resources and a solution to the debt crisis are priorities.

Significant improvements in child survival and the status of women can spark a 'virtuous cycle': falling population growth, rising incomes, further gains in child survival and more resources for investment in the growth and development of each child. The returns on investments in Africa's children will include an estimated 21 million young lives saved and many more spared debilitating childhood diseases. For the

women of Africa, achievement of the goals would save over 100,000 lives each year by the end of the decade — lives that would have been lost due to pregnancy-related causes. Over 90 million girls and women would have access to basic education and literacy and would have new opportunities to participate in the development of their countries. Most important, with renewed attention to education, health care and social welfare, Africa will regain the pride its history warrants, and its children will grow up strong and confident in their future.

The foundation could — and should — be laid in the 1990s for restoring broad-based development n Africa in the 21st century.

CHILDREN

BY PETER DA COSTA

# SECURING THE FUTURE

Margaret A. Nowicki

Debt, drought, socio-economic problems, and wars—Africa's four plagues—have taken a heavy toll on the continent's people, especially its most vulnerable, the children. Meeting in Dakar recently, Organization of African Unity members forged an agreement with donor nations and multilateral institutions to spend more money on children's health, food security, and related issues in an effort to save a million young lives annually.

Members of the Organization of African Unity (OAU) have entered into an ambitious contract with international financial institutions and donors aimed at improving the depressing lot of Africa's children, in line with the development goals set by the 1990 New York World Summit for Children.

At a conference held in Senegal's capital Dakar—hailed as the largest and most important gathering on the plight of children since New York—ministerial delegations from 44 OAU member states agreed with representatives of 18 donor countries and officials of international financial institutions on specific targets to be met by the year 2000 which could help save a million young lives annually.

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The 10-page "Consensus of Dakar" sets a two-fold challenge. Africans are to implement major policy reform—including restructuring of government budgets and mass social mobilization so as to directly target child-beneficial programs. This internal action is to be matched by donors, who are expected to more than double current levels of official development assistance (ODA) earmarked for children.

UNICEF—which assisted the OAU in organizing the conference—estimates Africa will need an estimated $12.7 billion annually in the 1990s, in addition to current spending, to achieve World Summit targets. Of this figure, $8.8 billion a year is needed for disasters like war and drought.

OAU secretary-general Salim Ahmed Salim described the commitment as "a compact for a human development strategy on the part of African governments and their development partners with the emphasis on first call for children" and made much of the fact that Africa is the first continent to respond to the New York summit call. Behind the concern and urgency demonstrated by the impressive array of delegations is the fact that Africa's children are at greater risk and distress than any other.

The statistics make for bleak reading and put into perspective the mammoth challenge facing the continent. Although they constitute little more than one-tenth of the world's child population, Africa's young make up one-third of the almost 13 million who die worldwide every year. This disproportion, say experts, is on the rise despite continuing strides in reducing child mortality in recent years.

Africa brings up the rear in key development indicators. It has the worst under-five mortality rate, lowest life expectancy and worst rate of primary school enrollment, and is second only to south Asia in under-five malnutrition. Life expectancy of babies born in Africa between 1990 and 1995 is still 20 years behind the West with malnutrition currently affecting a quarter of under-fives and 39 million stunted by lack of proper nutrition. With the average African poorer now than a decade ago when there was more food per person than today, urban unemployment as high as 60 percent and a sole doctor for every 24,000 people, it is small wonder children are so vulnerable.

Salim identifies the culprits behind the figures as debt, drought, socio-economic problems, and wars. Conflict, particularly internal, Salim told participants, was the

most tragic conspirator against the child. "One common characteristic of all conflicts—from Liberia to Somalia, from Angola to Sudan, and from Rwanda to Mozambique and South Africa—is that it is the most vulnerable groups which are most affected, and the most vulnerable of them are the innocent children who get caught in the cross-fire."

These conflicts have ensured one out of every five world migrants and one of every two refugees is African. Africa now has six million refugee and 12 million displaced persons, the majority women and children. Participants responded by backing OAU efforts to institutionalize conflict management. They reiterated that principles of the Convention of the Rights of the Child—among them the prevention of conscription of under-15s—be observed. Dakar also called on African countries to step up commitment to safeguarding civilians and humanitarian assistance during war through special mechanisms such as "corridors of peace" and "days of tranquility."

There are also medium-term targets, to be achieved by 1995: A rise in Africa's immunization coverage level from 75 to 80 percent against diphtheria, whooping cough, tetanus, polio, and tuberculosis; 90 percent coverage against measles and, for women, 90 percent against tetanus toxoid; 80 percent usage of oral rehydration therapy (ORT) to prevent dehydration caused by diarrhea; virtual elimination of iodine deficiency and its consequences; and exclusive breast-feeding for four to six months and sustained breast-feeding for at least two years.

The Consensus says these are low-cost goals mostly achievable with modest levels of additional external support if there is strong political commitment and widespread social mobilization. James Grant, Unicef's executive director, told *Africa Report* measures like immunization, which were "80-90 percent political mobilization", and ORT promotion (the salt/sugar solution saves 500,000 lives a year) would be in line with the New York emphasis on "what it is that countries themselves can do."

Evidence of self-reliance in Africa would, said Grant, mobilize public opinion support in the industrialized world. "When you tell the audience in the U.S. today that immunization levels in sub-Saharan Africa are equal to and better than in most American states, they can't believe it. But it demonstrates what could be done." It is this support (the Consensus sets a target for donors of 20 percent of ODA for child-specific programs) that will help achieve costlier longer-term goals.

These targets for the year 2000 include: slashing severe protein-energy malnutrition by half and achieving household food security, universal access to clean water and safe waste disposal; reducing infant mortality by one-third and maternal mortality by half; and lowering the number of children in especially difficult circumstances.

While a continental follow-up mechanism to the Dakar Consensus is envisaged, to be supported by UN agencies and NGOs—allowed for the first time to join bilateral discussions between donors and governments—implementation at country level will be through national programs of action (NPAs). Organizers say nearly 40 completed NPAs were presented in Dakar with several more in the pipeline. Many will be re-drafted as a result of the conference and will eventually be incorporated into bilateral and multilateral consultative processes and development programs.

Participants say the conference's success will be evident in the extent to which countries will prioritize the concerns of their children in the coming months. As Kenyan educationalist Eddah Gachukia told *Africa Report*: "You only have to look at the increase in NGOs flocking to help Nairobi's street children after the World Summit on Children in 1990 to realize the tremendous interest this conference will generate." Be that as it may, skepticism will dog the implementation process, with donor commitments a subject of much speculation.

Immediate effects of the Dakar conference have however raised hopes that commitments will be met on both sides. Norwegian Development Cooperation Minister Karl Norheim Larsen announced her country would be giving an additional $1.4 million to Unicef over the next year for the implementation of NPAs in Africa. With 1.09 percent of its GNP devoted to ODA Norway is the world's leading development donor. DANIDA chief Birte Poulsen also announced Denmark would pump an extra $2.5 million to Unicef for sub-Saharan children in especially difficult circumstances. Others are expected to follow the lead of the Scandinavians.

In mid-conference the African Development Bank (ADB) signed a landmark agreement with Unicef to make available funds for NPAs. Between now and 1996, the ADB says it will spend $2.5 billion on the social sector, an amount predicted to increase to $7 billion by the year 2001. Some 100 NGOs—a significant constituency since 30 percent of development aid to Africa is either channeled through or generated by them—participated in Dakar, in addition to 40 mayors from Canada, Nigeria, Italy, and Senegal who pledged the commitment of municipalities in implementing child-friendly programs.

Zimbabwean leader Robert Mugabe—apart from host president Abdou Diouf the only head of state in evidence—gave participants food for thought when he listed as part of a five-point proposal the freeing of aid for children from political conditionality. Mugabe, whose country is among Africa's most progressive in child survival, protection, and development, said the majority of Africa's $280 billion foreign debt should be cancelled and urged that cost recovery requirements should be removed or softened where primary health care and education were concerned. He also categorized as special categories child refugees and AIDS orphans.

The Dakar Consensus reflected some of Mugabe's concerns, especially giving the nod to "debt-for-children" swaps—the conversion into local currency by creditors of monies owed by an individual country which would be used to support NPAs and other child-related actions. ○



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WORLD BANK NEWS

# Senegal Brings More Rural Girls into Classrooms

Rural girls in many developing countries often face barriers to attending primary school. Economic needs, social expectations and cultural norms keep girls out while school systems often do not reach into rural areas.

In Senegal, less than one-half of all girls attend primary school while more than two of every three boys are enrolled. In the country's rural areas, the female attendance rate is even lower. But thousands of rural Senegalese girls will enter the classroom with the help of an innovative project supported by a credit of SDR 29.1 million ($40 million) from the International Development Association.

The project aims to improve overall primary education in Senegal and boost national primary school enrollment of both boys and girls by 7 percent by 1998. The plan focuses on building new classrooms and repairing old ones in rural schools but will also launch a handful of educational initiatives designed to enroll more girls in school.

"The idea is to improve primary education but also to provide incentives for girls to enroll, allowing them to take advantage of the increased educational opportunities," says Rosemary Bellew, education planner in the World Bank's Africa Sahelian Department.

## Aiding Development

To bring more girls into school, the project will launch programs targeted toward the home, school and community in regions where girls make up less than 41 percent of enrollment, which is the national average.

Programs will include a national information campaign aimed at advertising the benefits of educating girls, studies of barriers to girls' enrollment and an evaluation of school policies and textbooks to remove those barriers. Educating girls helps development efforts in many ways, says Bellew. Fertility rates fall, child mortality rates decline and maternal and child health improves when more girls attend school.

Senegal's overall primary school enrollment is slated to rise from 58 percent to 65 percent under the new project. By building 1,310 new classrooms and repairing 1,080 rooms, the plan will help create 65,000 new openings for primary school students.

Bellew says the construction will be carried out by Senegal's innovative non-governmental contract management agency set up under previous World Bank-supported projects, the *Agence d'Execution des Travaux d'Interet Public* (AGETIP). By tapping AGETIP, school construction will be much cheaper and faster than if the government had done the work.

One part of the project aims to greatly increase the limited amount of textbooks

*See* SENEGAL, *page 6*

# Senegal Boosts Girls' Enrollments

SENEGAL, *from page 3*

available in schools by contracting out to private book publishers. The plan would increase the distribution of books and cut prices throughout the country. In an ongoing project, the plan has reduced average book prices by some 70 percent, says Bellew.

"Books you find in the bookstores in Senegal are published by French publishers and are very expensive, so price is one main problem. The other problem is that distribution is very limited. The only place you could find a textbook was in the main libraries in the big towns," she says. "If the plan works, the textbook shortage will no longer exist in a few years."

An experimental "School Development Fund" is another big innovation under the project. The fund would help decentralize the school system by awarding money to schools which develop innovative plans that improve primary education and raise female enrollment.

The project will also improve the quality and efficiency of secondary and higher education by funding studies for a long-term development program for general secondary education.

The project is part of the government's education reform strategy adopted in 1985. □



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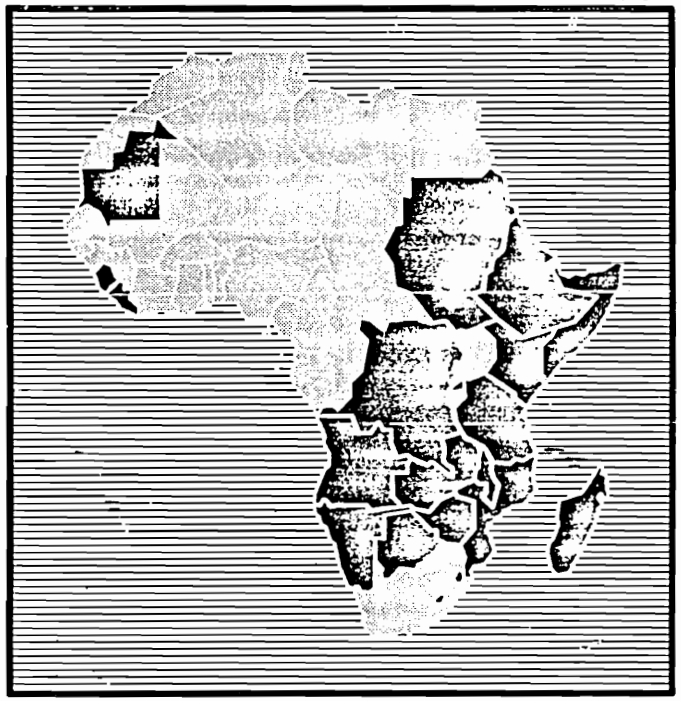
Global information and early warning system on food and agriculture

# FOOD SUPPLY SITUATION AND CROP PROSPECTS IN SUB-SAHARAN AFRICA

## Special report

No 4 December 1992



*Countries facing exceptional food emergencies:*
*Angola, Botswana, Ethiopia, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mauritania, Mozambique, Namibia, Rwanda, Sierra Leone, Somalia, Sudan, Swaziland, Tanzania, Zaire, Zambia and Zimbabwe*

FOOD AND AGRICULTURE ORGANIZATION OF THE UNITED NATIONS



## PART I: OVERVIEW

In recent months there have been promising developments in a number of the food insecure countries of sub-Saharan Africa. In famine-devastated Somalia, the distribution of relief assistance is gradually expanding as the security situation improves. Peace in Mozambique brings with it a marked improvement in internal food distribution and some alleviation to the suffering. Above-average to record harvests gathered or forecast for Ethiopia, Eritrea, Sudan and most of the Sahelian countries of western Africa point to a substantial reduction in the import and food aid needs of these countries in 1993. Despite these developments, sub-Saharan Africa will require extensive emergency assistance throughout 1993 to cover the needs of large numbers of refugees, displaced and drought-affected people and demobilized soldiers. A crucial factor in coming months will be the development of the 1992/93 coarse grains crop in southern Africa; prospects are already unfavourable in Angola and Mozambique, and shortages of seeds and draught oxen have reduced planted area in several countries.

### DISTRIBUTION OF RELIEF ASSISTANCE GRADUALLY EXPANDING IN FAMINE-DEVASTATED SOMALIA

In Somalia, more than 300 000 persons are estimated to have died from hunger-related causes so far in 1992 and some 1 million people remain at grave risk of starvation and will continue to be reliant on food aid at least through 1993. However, the recent arrival of 1 800 United States marines backed by use-of-force provisions of the UN Charter and the prospects of the deployment of some 30 000 troops from more than a dozen UN member states in the next few weeks are expected to improve the security situation and to allow an expansion in the scale of relief operations.

This massive international effort follows the launch in October 1992 of the UN 100-Day Action Programme for Accelerated Humanitarian Assistance which was further reviewed during a follow-up conference in Addis Ababa in early December 1992. The Action Programme stresses the need to protect key installations and gateways, internal distribution routes and national and international relief workers and also calls for an immediate cease-fire in all parts of the country. Nevertheless, security conditions remain precarious in many up-country locations, several of which can so far only be supplied through air lift operations.

As a result of the collapse of the agricultural infrastructure and a livestock population sharply-reduced by drought and war, only a slow recovery of the agricultural sector can be expected. The output of the der (secondary season) crop to be harvested in early 1993 will be well below pre-war levels despite favourable precipitation and will have no significant impact on the overall food situation. To support food production, programmes have been developed by FAO, ICRC and a number of NGOs to provide seeds, handtools and other farming inputs by March 1993 in time for planting of the gu (main season) crops. Considerable efforts will also be required for the clean-up and rehabilitation of irrigation canals and the repair or replacement of water pumps, as well as support to the important livestock sector. The food supply prospects over the next two to three years remain a cause for serious concern and substantial relief assistance will continue to be required.

### ELSEWHERE IN EASTERN AFRICA LARGE SECTIONS OF THE POPULATION REMAIN AT RISK DESPITE GOOD HARVESTS

Despite bumper to record harvests in Eritrea, Ethiopia and Sudan (see Box on page 3), huge numbers of drought-affected and displaced persons, refugees, returnees and demobilized soldiers will continue to require relief assistance in 1993.

In **Ethiopia**, while the recent meher (main season) harvest points to a marked improvement in the overall food situation, pockets of food insecurity will persist in 1993. Food assistance will be required by some 1.1 million returnees from settlement areas and persons displaced by ethnic conflict, and a total of 840 000 demobilized soldiers and their dependants. A further 2.4 million persons are estimated to have been affected by crop and livestock losses. This number includes much of the pastoral population of Borena and Ogaden, affected by prolonged drought and civil strife, and people living in the areas of Tigray, Wollo, Gondar and Eastern Hararghe, which have suffered severe localized crop losses. In **Eritrea**, the much improved security condition is expected to lead to an increase in the numbers of returnees requiring relief assistance in 1993 to a total of 200 000 persons. Despite the good rainy season, livestock numbers will take at least another year to recover, some 160 000 pastoralists and agropastoralists will require food rations for a period of at least 6 months.



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In **Sudan**, despite an above-average cereal harvest, an estimated 2.78 million displaced and drought-affected people will require 324 000 tons of food assistance in 1993. Some 1.7 million displaced persons - including 1.23 million in the north and in Government-held areas of the south, and 0.47 million in non-Government held areas of the south - require an estimated 184 000 tons of food. About 14 000 tons of supplementary food are needed for 395 000 displaced people in vulnerable groups, mostly children under five. An estimated 1.08 million persons living in food deficit areas will require 126 000 tons of food assistance. While most of these areas are drought-affected, some had crops which suffered from severe infestation from insects and rats late in the growing season.

Drought earlier in the year in northern and eastern areas of **Kenya** has threatened the livelihoods of pastoral communities. Widespread malnutrition is reported and livestock losses have been severe. An estimated 1.7 drought-affected people will be reliant on relief assistance at least until the next main season harvest from August 1993 and there are some 400 000 refugees encamped in the country. Similarly in **Tanzania** acute local food shortages persist, notably in the drought-affected central and lake areas. Relief operations are targeting some 600 000 persons, but efforts to transport grain from surplus areas continue to be hampered by financial constraints. In **Uganda** localized drought affected 1992 crops in Masaka, Mpigi and Rakai districts, while a combination of drought and civil disturbances led to food problems in Soroti. Some 350 000 displaced persons in **Rwanda** will continue to require food assistance well into 1993.

## FOOD SUPPLIES HAVE IMPROVED IN MUCH OF SOUTHERN AFRICA BUT EARLY PROSPECTS FOR 1992/93 COARSE GRAINS ARE UNCERTAIN

The food supply situation across much of **southern Africa** has improved somewhat, following substantial commercial and food aid imports. The signing of the Mozambique peace treaty has allowed relief assistance to be targeted to areas which, until recently, have been inaccesible to agencies; food convoys are moving with much greater freedom and up-country stock levels have improved. Emergency food aid needs for 1992/93 have been increased by large numbers of returnees and demobilized soldiers and their dependants. A major catastrophe has been temporarily averted in Malawi by an increase in the cereal import delivery rate. Livestock and crop losses from the 1991/92 drought have necessitated large scale emergency programmes in all the countries of the sub-region. However, in Angola, the recent renewal of hostilities has hampered relief distribution efforts to drought affected rural populations in the south and is likely to lead to acute shortages in rural food deficit areas.

Although land preparation and planting of the 1992/93 coarse grains crop has commenced in most parts of southern Africa, rains were generally late and have been below normal in several areas. Shortages of seeds are reported, particularly in Angola, Mozambique and Zimbabwe. In all the developing countries of the sub-region the number and quality of livestock was reduced by the 1991/92 drought. Consequently, draught oxen have been in very short supply and recent improvements in pasture conditions came too late to improve the situation significantly. Reductions in planted area are reported from Lesotho and are anticipated in several other countries. Prospects are bleak for cereal production in Mozambique and Angola. In the former, the peace treaty will allow a gradual return to the land, but labour supplies will remain inadequate for this season. Seed distribution has fallen well short of requirements, draught oxen are scarce and the rains were late in southern and central areas. In the latter, the recent renewal of hostilities has lead to further population displacement and has disrupted seed supplies. Despite good rains to date, cereal production is expected to be below the 1991/92 level. Growing conditions in South Africa have been generally satisfactory following ample rains in the main maize areas in November and early December.

## FOOD SITUATION SATISFACTORY IN MOST SAHELIAN COUNTRIES BUT LOCALIZED DIFFICULTIES PERSIST

Following generally good harvests, the food supply situation in most of the **Sahelian countries** is expected to be satisfactory in the 1992/93 marketing year, except in north-western parts of the Sahel. In Mauritania, following successive poor harvests, the situation will be tight for drought-affected populations and pastoralists. In addition, Tuareg refugees in the eastern regions are putting pressure on the available supplies. Food distribution programmes are underway. In the cities, the food supply situation is better, following substantial commercial cereal imports in 1992 but the recent devaluation of the national currency resulted in





## RECENT CROP AND FOOD SUPPLY ASSESSMENT MISSIONS TO SUB-SAHARAN AFRICA

FAO and WFP mounted joint Crop and Food Supply Assessment Missions to Sudan, Eritrea and Ethiopia between November and December 1992. The Missions conducted extensive visits to the main growing regions and consultations with the relevant government departments, donors, U.N. Agencies and NGOs. In October, a series of Joint FAO/CILSS in-country Crop Assessment Missions evaluated the 1992 cereal harvests in all the Sahelian countries of western Africa. The findings of these Missions are summarized below.

**Eritrea**: The Mission reported that an excellent cereals and pulses crop of some 260 000 tons had been gathered, compared to 70 000 tons in 1991/92, following abundant and reasonably well distributed rainfall from June. Nevertheless, substantial cereal imports of some 190 000 tons will be required of which 140 000 tons will be food aid. Some 56 000 tons of food aid will be required for emergency assistance to target groups.

**Ethiopia**: The Mission provided preliminary forecasts of production from the 1992 meher crop, and national import requirements (including food aid needs) for the 1993 marketing year. The Mission estimated a record meher crop of some 7.15 million tons, well up on the average level of around 6.5 million tons. Planted area increased as cereal prices were favourable, security conditions have generally improved and the return to the land of displaced persons and demobilized soldiers boosted the labour supply. Despite insect infestations, belated rains and poor belg (short) rains, yields were marginally higher, mainly reflecting increased fertilizer availability and generally abundant and well-distributed meher rains. The total 1993 food import requirement is provisionally estimated at 580 000 tons, well down on last year's. Food aid needs amount to some 530 000 tons, of which 380 000 tons will be for emergency relief assistance.

**Sudan**: The Mission estimated the 1992/93 harvest at 5.5 million tons, some 16 percent higher than last year and 63 percent above the average for the period 1985/86 to 1989/90, mainly reflecting generally favourable rainfall. This estimate includes 4.32 million tons of sorghum and 0.42 million tons of millet plus an early forecast of 0.76 million tons of wheat, currently being planted and to be harvested in April 1993. Production is higher in all states, but particularly in Eastern State and Central State, the areas which normally generate a surplus for use in the deficit areas, in Kordofan, Darfur and the south. Despite this bumper harvest an estimated 2.78 million displaced and drought-affected persons in the west and south will require 324 000 tons of cereal and non-cereal food assistance in 1993. Food aid carryover stocks of 106 000 tons will meet part of this requirement while the Government of Sudan has decided to donate a total of 158 000 tons of cereals to the 1993 Sudan Emergency Programme. Non-cereal food aid will cover the balance of 60 000 tons.

**Sahelian countries**: The Missions, comprising staff or consultants of the GIEWS and the Comité Permanent Inter Etats de Lutte contre la Sécheresse dans le Sahel (CILSS), estimated the aggregate output of the nine CILSS countries of western Africa at 8.8 million tons. This is 4 percent less than the 1991 record crop but well above the 1986-91 average. Above-average to record crops were gathered in Burkina Faso, Chad, the Gambia, Mali and Niger. Despite unfavourable growing conditions in the north, production remained close to last year's average level in Senegal, but late and below-normal rains resulted in another poor harvest in Mauritania. In Cape Verde, production increased substantially from 1991's poor level but remained below normal.

significant price increases of food items and will severely affect the poor segments of the population, notably slum dwellers around Nouakchott. In northern Senegal, the situation is also difficult following another poor harvest and the transfer of cereals from surplus areas in the south are required. In Cape Verde, a below-average harvest is anticipated but the country has already planned substantial commercial imports or food aid deliveries in 1993. In the other Sahelian countries, following two successive above average or record crops, farmers' stocks will be replenished. Localized deficits in some areas can be covered by transfers from surplus areas. Exportable surpluses are also available, and triangular transactions can be organized, notably from Mali to Mauritania.

## BELOW-AVERAGE HARVESTS GATHERED IN SEVERAL OTHER COUNTRIES OF WEST AFRICA

Following unfavourable growing conditions, below-average harvests have been reaped in several countries along the Gulf of Guinea. As a result, their aggregate cereal production is likely to decline substantially and the import requirements, mostly wheat and rice, will increase sharply. In Côte d'Ivoire, an exceptionally long dry spell between mid-June and early September seriously affected staple food crops. In Nigeria, most areas had poor rains and the production of cereals in 1992 is estimated at 3 percent less than last year and below average. In Liberia, the harvesting of the paddy crop has been hampered by the recent heavy fighting. Following massive displacement of people from rural areas, and shortages of seeds and farming implements, plantings were below normal. As a result, the 1992 cereal harvest is estimated at 100 000 tons, similar to last year's poor outturn and some 50 percent below the average of the past five years. With this poor cereal harvest, the food supply situation in 1993 will remain serious. The food aid requirement in 1993 will remain substantial given the large number of displaced people and other vulnerable groups whose needs will not be met through commercial imports. In Sierra Leone, weather conditions were generally favourable for the 1992 cereal crops. However, plantings were again below normal due to the displacement of a large number of people following the civil strife, shortages of seeds and farming implements and flood damage to swamp rice in some areas. Consequently, production of cereals in 1992 is estimated to be below-average. As a result of this poor harvest and the country's reduced capacity to finance imports, the food supply situation in 1993 will remain serious. By contrast, following favourable growing conditions, above-average crops have been gathered in Benin and central and northern parts of Togo, while a record harvest is in prospect in Guinea.

## SUBSTANTIAL PLEDGES FOR 1992/93, BUT DELIVERIES HAVE BEEN SLOW

Aggregate cereal production in 1992, for the 26 countries that are in their 1992/93 marketing years, is estimated at 37.4 million tons, some 12 percent lower than in 1991. The food aid requirements for these countries in 1992/93, estimated at 5.2 million tons, are substantially higher than in 1991/92, mainly reflecting the sharp increase in the needs of the drought affected countries of southern Africa.

Food aid pledges for 1992/93 cover some 80 percent of the estimated requirements. At the corresponding time last year a significantly smaller proportion of the needs had been covered. However, less than half of the pledges have actually been delivered and there is an urgent need for donors to expedite shipments, particularly to Kenya, Malawi, Mozambique and Somalia.

GIEWS estimates of the 1993 needs of the 20 countries which are still in their 1992 marketing years (January/December) will be available early in 1993. Initial indications are that, while remaining high, food aid requirements for these countries in 1993 will fall from the 1992 levels, mainly on account of increased cereal production in Ethiopia and Eritrea.

# Food Security and U.S. Aid to Africa

## *U.S. Food Aid Is Only a Short-Term Response to the More Serious Problems of Poverty and Decreased Agricultural Production in Africa*

*by Winston J. Allen*

Today, in a continent plagued with extreme poverty, more and more Africans are finding it difficult to satisfy their basic human needs, including food consumption. The Food and Agricultural Organization estimates that 44 percent of all Africans do not consume enough calories to sustain an active working life, including 25 percent who do not have enough food to prevent malnutrition and stunted growth among children.

The World Bank estimates that 25 percent of the population of sub-Saharan Africa in both urban and rural households is "food insecure" where the "access by all people at all times to enough food for an active, healthy life" is insufficient. The World Bank and the United Nations World Food Program have reported that the need for food aid to Africa will become critical in the 1990s. Citing Africa's limited ability to finance the commercial importation of food, the organizations have stated that without further aid the number of undernourished people in sub-Saharan Africa will increase from 142 million in 1983-85 to 200 million by the year 2000.

The fundamental cause of hunger on the continent is poverty—the poor simply do not have access to land or employment. The number of poor in Africa was estimated in 1991 by the United Nations Development Program to be about 360 million people. Their poverty is exacerbated by their countries' inability to either produce or import adequate stocks of food for their populations. Rapid population growth, drought, civil wars, and misguided economic policies have resulted in stagnating or declining agricultural output in sub-Saharan Africa where per-capita production has dropped during the last decade. And few African nations can provide rehabilitation support or safety nets during or after catastrophic events such as drought and war.

### Responding to Crisis

The drought of 1968-1974 in the Sahel region of West Africa dramatized sub-Saharan Africa's poverty to Americans. Established private relief organizations were flooded with donations and new organizations were formed to both encourage and channel the flow of funds to drought-stricken areas. In general, however, sub-Saharan Africa has not received a high priority in the development assistance policy of the United States. In 1992, the entire region received $878 million in U.S. foreign aid obligations, compared to $815 million received by Egypt and $1.2 billion received by Israel. By contrast, France, Germany, and Japan contributed a much larger proportion of their development assistance to African countries.

Moreover, foreign aid from the United States over the years has been tied to diverse and sometimes conflicting objectives, including opposition to Marxist or leftist governments. However, now that Soviet expansionism is no longer a threat in Africa, U.S. foreign aid should once aga focus on basic human needs. Attention need no longer b limited to political allies, as it was during much of the Co War era. If the U.S. were to reduce support for Africa, it would be unwise strategically as well as morally. As Johr W. Sewell, president of the Overseas Development Council, pointed out, "The continuation of poverty in the developing world is not only a humanitarian concern, [bu also poses a serious threat to the long-term economic anc physical security of the post-cold war world."

Over the years, the U.S. government has responded to Africa's food crisis through the "Food for Peace" program Public Law 480 (PL-480), enacted in 1954, America's large foreign food assistance program. The program is adminis tered by the U.S. Agency for International Development which channels assistance to needy countries through several private voluntary organizations based in the U.S. 1990, out of $956 million these organizations received fro the agency, 27 percent was from Food for Peace.

While this program may alleviate the short-term food crises, a long-term solution must be achieved through other means. Sharon Pauling, policy analyst for Bread fo the World, a private food assistance program based in Washington, D.C., says, "In the long run, Africa needs to base food security much more on the resources of the continent itself, and much less on imports and food aid." Several U.S. voluntary organizations provide developmen aid to sub-Saharan Africa, but their efforts are likely to be more effective if they work in partnership with indigenou African voluntary groups toward the goal of sustainable human-centered development.

Responding to the need to redirect American policy, President Bill Clinton said in a speech during his election campaign that he "will reorganize and redirect [U.S.] foreign assistance programs...stress[ing] not only sustainable development but also the development of skills, of values, and the institutions of free societies." Fulfilling these objectives could be a prescription for improved foo security in sub-Saharan Africa, and for achieving the goal of sustained development. ■

Dr. Allen is a research associate at the Joint Center.

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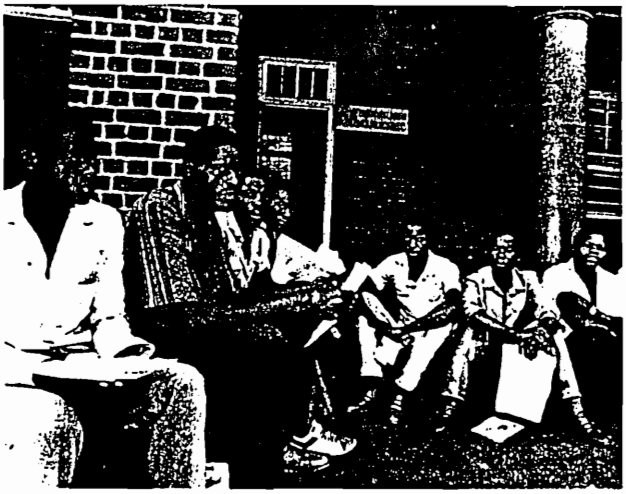
# From school to jobs: Africa's dilemma

*The population explosion and persistent economic crisis mean that thousands of young men and women all over Africa join the ranks of the unemployed upon leaving school instead of going off to work. Now, action is being taken to tailor training to employment, in order to put an end to this waste of financial and human resources*



Jacques Maillard

Between 1978 and 1987 there was a 60 per cent reduction in the number of students in technical education in Burkina Faso, for example, while numbers in secondary education more than tripled. In Mauritania, primary school pupils recently accounted for nearly 60 per cent of school-leavers, while barely 5 per cent completed technical and vocational training.

In most countries in French-speaking sub-Saharan Africa, instruction at the general level has benefitted most from the progress in education. But it is not at this level that any form of vocational training is provided to help young people find work. The training programs that do exist are aimed largely at the modern sector, where already limited openings have been even further reduced in recent years because of economic crisis and structural adjustment.

## Unprecedented unemployment

The result is an unprecedented level of unemployment among young school-leavers, while at the same time there is a shortage of skilled labor in other occupations.

This situation has led a number of African countries, with the help of the ILO, to start reforming their vocational training programs in order to make them more flexible and more easily adaptable to economic realities and the requirements of businesses.

## Targetting jobs for young people

In practice, it is not easy to carry out improvements with this background of unemployment and economic crisis. The diversity of conditions between one country and another calls for case-by-case solutions. An ILO survey conducted in Burkina Faso, for example, suggested that what that country needed to start with was polyvalent initial training, so youngsters could find employment in craft trades, modern sector companies and, more particularly, in the informal urban and rural sectors, which offer the greatest employment and self-employment opportunities.

In general the ILO feels that young people should be guided towards quality training leading to future job opportunities and activities. The programs should also include orientation cycles and recycling possibilities from general education to vocational training.

As the vocational training centers do not cover the full range of occupations, on-site training could form a key element of the programs. A reform currently under way in Togo aims at reinforcing the practical content of technical training and encouraging on-site training. It also provides for enabling training centers to analyse the real manpower requirements of the market. In addition, an apprenticeship and basic and advanced vocational training budget is to be established for direct funding of projects evolving from the results of regular labor-market evaluations.

A similar solution is also generating increasing interest in African countries. This is alternating training, whereby trainees divide their time between classroom and shop floor.

The fact is, there is no direct relationship between training and employment: much depends on complex economic and social mechanisms. This is all the more true in a period of crisis, which is why many African countries have started to explore new ways of putting their young people to work.

Senegal, for example, has taken some spectacular measures which, since 1987, have resulted in the creation of 200 small enterprises providing 500 jobs for secondary school-leavers in baking, commerce, transport, market gardening and small-scale fishing. A network of small retail shops has been set up for technical training graduates. A similar endeavor in the informal sector has generated nearly one thousand new jobs.

## Mixed results, operating problems

Unfortunately, after some years of operation, the results from this program are mixed. In the transport sector alone, 35 small businesses are in difficulty. Operating problems of one kind or another developed over time: lack of company spirit, insufficient legal backing, inappropriate institutional support structures. Banks, acting as financial intermediaries, did not respond very well to government encouragement. It would seem that youngsters stand a better chance of success if they work with adults who already have business experience as small-scale entrepreneurs.

In the light of such varied experiences, the ILO recommends the establishment of a well-organized national employment and training program co-ordination structure, involving representatives of government, employers and workers, and more particularly of enterprises, who contribute so importantly to the creation of jobs.

Madeleine Moulin-Acevedo

### FOR MORE INFORMATION

*Particularly* L'Emploi et la formation dans un contexte de crise economique: le cas de l'Afrique d'expression française, *by Jean-Bernard Célestin. ILO, ISBN 92-2206528-X (available in French only). This work deals with an ILO regional project designed to improve employment market information systems.*



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## Viewpoint

# Structural Adjustment Spurs African Development

by Edward V.K. Jaycox
Washington, DC

The past ten years could be described as the era of structural adjustment in sub-Saharan Africa. Under structural adjustment programs, the countries of the region have achieved significant progress. Growth has resumed. Economies have become more responsive to market signals. Boosting agricultural productivity has reoccupied center stage. And rhetoric has been turned into policy on critical issues such as population, the environment and the role of women in development.

The process began in response to the economic crisis facing Africa at the beginning of the 1980s. The oil shocks of the preceding decade had placed a heavy burden of debt on African countries, whose economic structures and capacities were already weak. The region had no industrial base; its management capacity was thin; its infrastructure was meager and aging; and it was rapidly losing competitiveness to other developing countries.

These conditions would not necessarily have presented Africa with a crisis had they not been compounded by misguided policies on the part of African governments: exchange rates were grossly overvalued; exports were excessively taxed; price controls and subsidies were rampant; the state interfered in commerce and trade; and revenues from earlier commodity price booms were poorly managed.

In May 1986, at the United Nations Special Session on Africa, African leaders took responsibility for their policy mistakes and committed to undertake the necessary reforms. Today the reform effort has gained widespread acceptance, and 28 countries have adjustment policies in place.

Statistics from a core group of 15 currently adjusting countries that comprise the bulk of Africa's population and income show the following results:

• Movements in real producer prices have been favorable for farmers, despite the decline in international prices of primary export commodities.

• The Gross Domestic Product (GDP) growth rate increased considerably, averaging almost four percent from 1986 to 1990 and three percent in 1991 – and the positive response is likely much greater than demonstrated by conventional GDP data, which tend to exaggerate the relative importance of the official, public economy and underestimate that of the unofficial, private economy.

In 23 currently adjusting countries, average inflation rates halved, deficits declined, military expenditures have been slashed and exports are up.

The overriding mission of the World Bank is to alleviate poverty, and its adjustment programs aim first and foremost to improve the quality of life for the majority of Africans who live in abject poverty. There is no doubt that, over time, reform measures will succeed in stimulating economic growth, and the poor will gain from the opportunities available in a more vibrant economy.

However, even in the short run, most of Africa's poor have benefited from reforms. Eighty percent to 90 percent of the continent's poor are small-holder farmers who are net producers of tradable goods. Adjustment policies – which usually include elimination of agricultural marketing monopolies, higher crop prices and lower taxation of agriculture – have increased the income of this group. This, in turn, has led to greater food production, greater production of export crops and higher rural employment.

Contrary to some claims, the increase in the production of cash crops has not come at the expense of food production. In Nigeria, Ghana, Guinea, Mali and Burkina Faso, for example, per capita food production is much higher today than in the pre-adjustment period, while the volume of agricultural exports has risen at the same time.

> *The overriding mission of the World Bank is to alleviate poverty.*

Africa's urban poor, who number between four percent and 20 percent of the poor in counties in the region, have suffered in some cases, especially as a result of higher food prices. In the medium to long term, however, the urban poor will benefit from accelerated growth spurred by adjustment, because most of the demand for goods and services they produce and trade originates from the rural poor whose incomes rise under adjustment. It is no accident, for example, that where adjustment has been consistently pursued and growth is being restored, as in Ghana, urban wages have begun to recover as well.

Another clear indication of the benefits of adjustment for the poor is that, with only a few exceptions, real levels of government expenditures for education and health increased in adjusting countries. In recent years the bank has been paying increasing attention to such spending. In 1989-90, a third of adjustment loans mandated social sector spending, up sharply from seven percent in the first half of the 1980s. The restructuring of social expenditures to favor primary education and health services, as well as safety nets, offers substantial scope both for mitigating the short-term costs of adjustment and for improving the poor's human capital and earning potential in the long run. The bank is also intensifying its collaboration with governments to design and support social-action programs aimed at protecting the poor who might otherwise be adversely affected by structural adjustment programs.

Overall, the bank can claim a number of achievements in promoting economic reform in sub-Saharan Africa. It has succeeded in creating a group of economic managers on the continent who are knowledgeable and confident about what has gone wrong and what is required to fix it; it has encouraged a revitalization of economic activity, as domestic actors in the economy have responded to new market opportunities; and through the reform effort, it has been instrumental in rejuvenating the donor commitment to Africa, ensuring that African countries receive enough external funding to sustain progress.

Notwithstanding these achievements, there are a number of important lessons which the bank, the donor community and African governments must consider if the reform effort is to be successfully consolidated and deepened. The most important of these is the realization that changing the structure of an economy is a long-term process. Many of the mistakes made by governments and donors over the last 30 years were caused by an unrealistic view of the time required to create the necessary conditions for development in Africa, resulting in programs which were overly ambitious. *This is why it is absolutely critical in the coming years for donors and African governments to maintain the commitment and the stamina for reform, even where progress is only modest.*

Another important lesson is that ownership of reforms, not only by the government, but by the incipient economic actors in the country, is crucial to their success. No amount of externally imposed conditionalities, however benign and beneficial, will turn an economy around. The bank is actively seeking to increase the number of private sector, non-governmental, labor and other groups in its projects and programs.

The 1990s will be a critical decade for the region. Those countries that have recovered must do so fully in order to sustain progress into the next century, and those that have not must recover in order to avoid economic and social chaos.

While the challenges are enormous, this is not an insurmountable task. The dialogue among and between governments, international organizations and beneficiaries has vastly improved. The lessons of experience have been powerful. The strategic agenda has by and large been set. And the mechanisms for achieving Africa's development objectives are in place. The task now is to strengthen what has been accomplished and to ensure that future investments work with maximum efficiency. ■

*Edward V.K. Jaycox is vice president, Africa Region, World Bank.*

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# World Bank Remedies Cause Misery In Africa

By Victoria Brittain
INSIGHT/Guardian News Service London

In a serious challenge to the prime position of the World Bank and the International Monetary Fund (IMF) in African policy-making, two new books examine the continent's dramatic decline over a dozen years and challenge the orthodoxies of these, the two most powerful institutions on the continent.

*Alternative Development Strategies in Sub-Saharan Africa*, edited by Frances Stewart, Sanjaya Lall and Samuel Wangwe, and *Africa's Recovery in the 1990s*, edited by Giovanni Andrea Cornia, Rolf van der Hoeven and Thandika Mkandawire, both are published by Macmillan in Britain. The studies are published against the background of Africa's deep economic crisis, which worsened in the 1980s and has continued into the 1990s with little or no sign of improvement.

Richard Jolly, deputy executive director of the United Nations children's agency, Unicef, says Africa remains the highest priority for Unicef's aid because it is the one continent where the health and education status of children has deteriorated in recent years and is projected to worsen further in the 1990s. However, other donors are becoming more inclined to cut their losses and target their aid to places with less record of failure.

The grim economic situation in three-quarters of African countries is disputed by no one, but a bitter intellectual battle rages over the recipes for improvement. Some long-term goals such as industrialization have disappeared almost entirely from current thinking, preoccupied as it is with crisis management.

For over a decade, Structural Adjustment Programs (SAPs) drawn up by the World Bank and the IMF have been the key policies for Africa. They have focused on the stabilization of macroeconomic imbalances, removal of structural bottlenecks, and economic growth.

Although SAPs have been judged successful in Chile and Indonesia, the programs have had little success in Africa beyond middle-income countries such as Cameroon and Mauritius. And, while bank officials claim at least fragile achievements across the continent, other analysts – particularly Africans – blame the harsh regime of SAPs for cuts in employment and in health and education budgets, which have put the entire social fabric at risk.

In the past few years, under pressure from Unicef, SAPs have been modified to include the social dimension – particularly the protection of the poorest, most vulnerable groups. But the decline in per capita Gross Domestic Product (GDP) continues, and social service cuts mean new generations of less educated, less healthy citizens for the next century.

"There is a greater consensus about the importance of the social dimension, but total consensus certainly has not been achieved," says Dr. Giovanni Andrea Cornia, an economist at Unicef and one of the editors of the optimistically titled *Africa's Recovery in the 1990s*.

Frances Stewart introduces *Alternative Development Strategies* by looking at the contradiction between current policies and long-term objectives. She cites three long-term objectives for Africa: industrial development, increasing food production and human resources development. She then asks how the well-known effects of current policy – falling employment figures, declining school rolls and shrinking investment in infrastructure – can be reconciled with those objectives.

*Structural adjustment programs have little success in Africa.*

The bank and the fund are responsible for the policy advice that has brought about these effects.

In addition, the same advisers encouraged increased production of the primary products that make up 90 percent of Africa's exports, so that their prices have fallen disastrously. Coffee, copper and cotton all have dropped by about 25 percent over the past 30 years. Ten of the continent's 13 major export commodities fell still further last year, including losses of ten percent to 30 percent or more from 1991 levels for cocoa, coffee, cotton and peanut oil.

These price trends are not going to be reversed. What could be, Stewart says, is the structure of exports. Her book shows that, compared with South Asia – where between 1965 and 1987 primary products fell from 63 percent of exports to 36 percent – in low-income African countries the proportion rose from 92 percent to 94 percent.

Among other major problems Stewart identifies is the reduced local control that is a result of the privatization encouraged by SAPs, and the excessive liberalization of imports, which has led, in Ghana for instance, to de-industrialization as the textile industry has collapsed under the impact of imported second-hand clothes from Europe. "African countries basically lost control of their policies in the 1980s," she comments.

Both books emphasize new strategies that the authors – who include distinguished African economists – believe could work. These include:

- encouragement of indigenous food crops by such policies as subsidies on fertilizers and other inputs, while halting lending to traditional export areas such as coffee;
- commodity price support schemes;
- support for rural non-agricultural development;
- a serious bid for industrialization; and
- boosting human resources by increasing the proportion of aid to education and health.

Most importantly, these strategists propose outright cancellation of at least part of Africa's debt, as well as conversion of what Africa owes the World Bank and the IMF into low-interest, long-term loans. This could reduce such anomalies as the fact that poor African countries paid nearly $200 million more in loan repayments to the IMF last year than they received in assistance.

The measures could free more than $1 billion for African development each year.

Many of these ideas have been put forward repeatedly by Unicef, the United Nations Development Program and the Economic Commission for Africa. But this approach has a long way to go before being accepted as a real alternative to the unsuccessful World Bank/IMF prescriptions for Africa's desperate situation. ■

*Victoria Brittain is an editor of the London newspaper the* Guardian.

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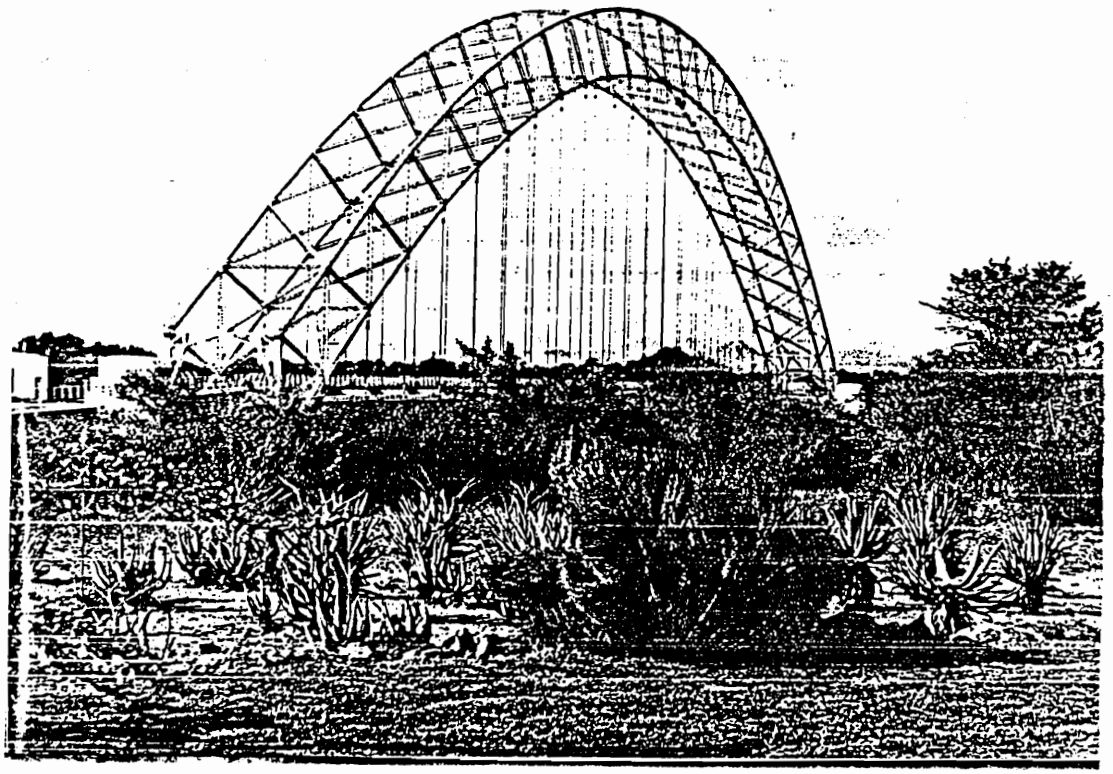
ECONOMIES

BY ANNE SHEPHERD

Integrating African regions economically may be the only way that small and weak countries can compete in a world market increasingly made up of powerful economic blocs, such as those in Europe and the Pacific Rim. But there is doubt on how to do it in southern Africa—whether to support the newly created Southern Africa Development Community with the imminent membership of the region's economic giant, South Africa, or achieve growth through the Preferential Trade Area or Customs Union agreement, or perhaps a combination of all options.

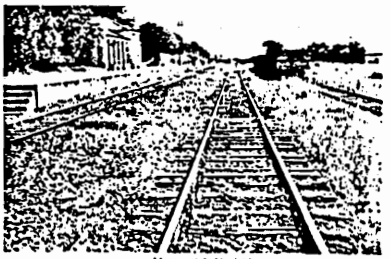
# BUILDING A BLOC



No one said so in so many words, but when 10 southern African countries signed a treaty in August to work toward a common market, they also dashed hopes of a more rational approach to integration efforts on the sub-continent.

At their heads of state summit in Windhoek, Namibia, members of the Southern African Development Coordination Conference (SADCC), citing the likelihood of South Africa becoming a member, committed themselves to becoming the "Southern Africa Development Community" (SADC).

Until recently largely a coordinator of $3.4 billion worth of projects funded by donors anxious to help the region strengthen its economies vis-à-vis that of South Africa, SADC says it will now promote the free movement of goods, capital, and people across its borders. No timetable is given for this, but a background paper cites SADC as one of the building blocks in the Organization of African Unity Abuja



Margaret A. Novicki

*Above, the Limpopo railway line in Mozambique*

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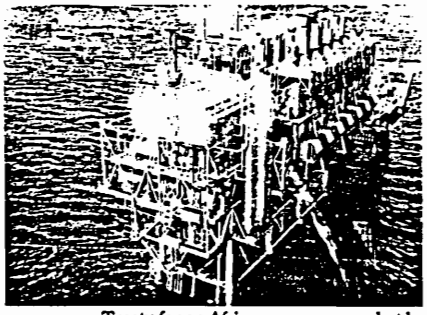

*Left, Chevron oil rig in Cabinda, Angola*

Margaret A. Novicki

Treaty for an African common market by 2025.

Ironically, the 18-member East and Southern Africa Preferential Trade Area (PTA), to which eight SADC members (excluding Botswana and Namibia) belong, has cast itself in the same role.

At its summit in Lusaka, Zambia, in January, heads of state of this larger organization resolved that "the PTA and SADCC be merged into a single common market for Eastern and southern Africa, within the context of the Abuja Treaty for the African Economic Community."

Meeting in Dakar, Senegal, in June, heads of state of the Organization of African Unity welcomed the PTA resolution to form a Common Market for Eastern and Southern Africa (COMESA). They urged other regions which had not yet "adopted similar decisions" to do so in order "to avoid wasteful duplication of efforts in the economic integration process."

*Anne Shepherd is a London-based journalist who has travelled widely in Africa and written extensively on African economic and political issues.*

Despite the fact that eight SADC heads of state signed the PTA communiqué, when they got to Windhoek, they had apparently changed their minds. The SADC communiqué, while acknowledging the PTA "proposal," reaffirms the "consensus of member-states that SADCC and the PTA had distinct objectives and mandates and must therefore continue to exist as autonomous, but complementary entities."

SADC officials claim that those of their members who belong to the PTA misunderstood the PTA resolution they signed and later distanced themselves from it. However, Zambia, which hosts the PTA, openly campaigned for the merger, and is understood to have signed the Windhoek treaty only under considerable peer pressure. In contrast, Botswana, which has gained international notoriety by hosting SADCC, canvassed against the PTA move, supported—naturally enough—by the SADCC secretariat.

Publicly, SADC says it will continue to coordinate with the PTA to avoid duplication. The Windhoek communiqué directs that a study be undertaken on "how best to harmonize relations between SADC and the PTA in the context of the process toward the establishment of the African Economic Community."

But, as the SADC theme document for this year, "Towards Economic Integration," concedes: "At the highest point of integration...it will not be practicable for countries to belong to more than one regional community." This also implies a choice for four SADC members presently also belonging to the Southern African Customs Union (SACU) revolving around South Africa.

SADC officials admit that by pursuing the Windhoek Treaty rather than the alternative course of a merger with the PTA, the swords are now drawn. They justify the duel as healthy competition. Economists, on the other hand, fear that instead of having one winner, the whole region might end up the loser.

On the face of it, there are strong forces gravitating in favor of stronger integration in southern Africa, and the continent more generally. Domestic economic reforms, coupled with the prospective emergence of powerful regional blocs in Europe, North America, and the Pacific Rim are sending home the message that small and economically weak countries cannot afford to go it alone.

The promise—albeit tentative—of a democratic South Africa emerging has sharpened the focus on regional integration for a variety of reasons. As this year's SADC theme document concedes, in the past, "a significant component of the international political and material support for SADCC and its member-states was predicated on the anti-apartheid struggle; and was justified in terms of supporting the countries of the region in the face of South Africa's destabilization and military aggression."

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With the "passing of apartheid," the document continues, "some cooperating partners will, in apparently good conscience, look elsewhere to give their assistance, where they believe they can derive greater political dividends."

Political change in South Africa, the document points out, is also likely to lead to new investment being attracted back to the region's economic giant. Unless structures are in place for a broader regional market, the argument runs, inequitable development will simply be perpetuated.

In effect, the region has now experimented with two broad approaches to regional integration. The first is the classic market-driven approach, beginning with the liberalization of trade, then factors of production, between a group of countries, such that they progressively transcend being a preferential trade area, to a common market.

Thus in the case of the PTA, members charge each other lower tariffs than those applicable to non-members, but customs duties are still levied on imports from other countries. In the next stage—a free trade area—which the PTA is aspiring to—no duties are applied on goods from other members, though each still determines its own tariff policy in relation to goods imported from outside the area.

The phase after this—represented in southern Africa by the Southern African Customs Union that revolves around Pretoria—is a customs union, in which trade with non-members is governed by a common external tariff. With the free movement of labor, in addition to capital (which flows freely between the five), SACU would become a common market.

Indeed, four countries—South Africa, Namibia, Lesotho, and Swaziland—share the same currency, which virtually makes them an economic union. The "highest," and most difficult, stage of integration in this model is a political union, in which—in addition to economic integration—the political institutions of member countries are also federated.

SADC began with a similar ultimate objective, but approached it through what it calls "development integration." This school of thought argues that it is pointless to liberalize trade if countries are producing the same sorts of goods and services, and don't have the infrastructure to facilitate trade (a problem particularly acute in southern Africa, because of South African destabilization of transport routes in Mozambique and Angola).

The SADC approach has thus been to first emphasize infrastructural projects, then investment and production, with an increasing emphasis on the role of the private sector. Moves toward the free movement of goods (trade) and factors of production (capital and labor) have come as a later, rather than initial, stage in the search for a common market, and ultimately political union.

Up until recently, the thinking seemed to be that all three regional organizations could co-exist, and indeed complement each other. In the initial stages, that was probably true. Infrastructural projects being carried out by SADC, for example, could help the PTA overcome the non-tariff barriers to trade that it confronted.

But as the two organizations focus more keenly on deeper integration, the potential for overlap has increased proportionately.

Should SADC, for example, transform itself into a free trade area, there would be a duplication in tariff policy. With regard to monetary harmonization, the PTA has already gone some way in this area with its clearing house and common unit of currency. The question that would arise is: Would SADC build on this in its own efforts (and if so what would happen to SADC members that do not belong to the PTA) or would it try a different tack?

It seems inevitable that there will be overlap and wastage. Now that the two organizations have declared themselves in competition, the other question that arises is which will outpace the other.

SADC's two main attributes as a model for integration have been its regional and political coherence, as well as its ability to involve all its members through allocating each sector to coordinate, while avoiding a massive centralized bureaucracy.

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## Three Into One Won't Go

Southern Africa's problem as it seeks more meaningful regional integration may well be that it is spoiled by choices. In all, there are three different regional organizations, each with its own distinct approach:

•Formed in 1980, Southern African Development Coordination Conference's (SADCC) approach to integration has evolved from project cooperation. An essentially political grouping which tapped the conscience of donors reticent over imposing sanctions against South Africa, SADCC initially focused primarily on coordinating donor-sponsored projects to rehabilitate transport routes destroyed in wars fueled by Pretoria. Cognizant of the problems that have faced overly ambitious and centralized regional organization in Africa, SADCC opted for a decentralized system in which each member took charge of a sector (such as transport, agriculture, industry, etc.).

With political changes in South Africa since 1990, and the growing attention in the West to Eastern Europe, donors have made it increasingly clear that they won't go on picking up the tab indefinitely. In addition, with a GDP three times that of the rest of the region, South Africa poses a potential threat to the smaller economies, unless ground rules for an equitable approach to regional integration are put in place. These factors have prompted SADCC, over the last three years, to pay more attention to production, investment, and intra-regional trade (which stands at a mere 5 percent of the goal).

The new SADC, which the group refers to as the "development integration approach," aims to deepen cooperation in these areas, through integrating systems of investment, production, and trade, "including promoting the freer movement of capital, goods, and labor." This calls for ceding national sovereignty to the broader regional good—a will so far not tested in the loose coordination of projects mostly paid for by outsiders. There are also practical problems: The wide divergence in inflation rates in the countries of the region at the moment, for example, rules out monetary cooperation.

•The Preferential Trade Area was initiated in 1981 by the UN Economic Commission for Africa as one of three regional organizations (the others being the Economic Community of West African States, and the Economic Community of Central African States) which would link up to form an African Economic Community, now scheduled (optimistically) for 2025. As its name suggest, the PTA's focus is on gradually reducing tariff and non-tariff barriers to trade. A common list of 200 items on which barriers were to be removed has been increased to 319 commodities, and the deadline extended from 1992 to 2000. A Harare-based clearing house, which aims to overcome the foreign currency barrier to trade by enabling countries to settle only their trade balances in hard currency, now handles 70 percent of intra-regional trade, and is envisaged as a precursor to monetary union. However, trade between the 18 countries, which stands at 6 percent of the total, has been hampered by the unwieldy size of the group, poor communications, complementarity of production, and fears of the bigger economies (Zimbabwe and Kenya) benefitting disproportionately from the arrangement. The latter has led to a new focus on production: The PTA has 51 industrial projects, and recently established an investment bank.

•The Southern African Customs Union (SACU), including South Africa, Botswana, Lesotho, Swaziland, and Namibia, is the oldest, and technically most advanced of the regional groupings. A customs union takes the free trade zone idea one step further by adding a common external tariff against outside countries, although it does not provide for the free mobility of capital and labor, as is the case in a common market. The arrangement has given South Africa guaranteed export markets in the smaller countries, although the protective barrier against external competition has reduced the efficiency of South African industry. Smaller countries profit from customs revenues, which are divided according to a formula that gives them a favorable share. However, the arrangement has tied them to South African imports, at prices that are not necessarily competitive. All the SACU members, excluding Botswana, belong to the rand Common Monetary Area. ■

—A.S.

Many question, however, to what extent SADC will continue to hold together as a unit without the anti-apartheid glue. Similarly, as SADC moves away from project coordination toward economic integration, its structure—though as yet undecided—will of necessity alter.

Achieving the goals that SADC has set itself will be no mean task. Although most countries in the region are undertaking structural adjustment programs, macro-economic conditions vary widely from debt-ridden Mozambique to Botswana, with its surplus foreign reserves.

With its past emphasis on reducing dependence on South Africa, SADC appears well placed to provide the framework for South Africa, which has a GDP three times that of the region, to rejoin the region on the basis of mutually beneficial development, but huge problems lie ahead.

As South African economist Rob Davies points out in a recent paper, *South Africa in the Region*, "SADCC does not possess an integrated direct production sector to balance the input from South Africa's much broader manufacturing base, nor does it have sufficient sectoral economic policy or macro-economic and overall planning coordination."

Despite the stated commitment of the African National Congress to balanced regional growth, economists point out that the initial focus of a democratic government will be on internal, rather than regional inequities. While donors funded projects, it was relatively easy to forge a consensus within the old SADCC. The "acid test," as one SADC official concedes, "is yet to come when countries are faced with the choice between short-term national, and long-term regional interests."

Because of its more practical, trade-oriented approach, the PTA has been attracting considerable interest of late among businessmen and donors.

Last year, the European Community, a major SADC donor, sent shockwaves through the organization when it stipulated for the first time that funds normally allocated to SADC only would have to be split with the PTA, which has been drawing increasing attention from the business community, including in South Africa.

Yet, as most donors and businessmen readily acknowledge, the PTA is far from perfect. Apart from the persistent lack of political will to implement its decisions, the 18-member group is hampered by its unwieldiness. As a Harare trade analyst puts it: "The PTA collects members as though they were smarties, with no regard for regional coherence."

Recent moves to resuscitate the East African Community, which includes three PTA members (Kenya, Uganda, and Tanzania), have been cited as evidence that successful regional integration must begin in small units.

Like SADC, the PTA also suffers from huge economic disparities between the economies of its countries. The PTA would become lopsided if South Africa joined, just as SADC will. Indeed, Davies argues that by joining the PTA, South Africa could slow down the organization's progress toward reducing trade barriers, since countries with some sort of manufacturing base like Zimbabwe would resist measures permitting South African goods to flood their markets.

There is also, at this point, a direct conflict between the PTA, which demands a most favored nation treatment among its countries, and SACU which does not allow its members to enter into concessionary agreements with other countries unless their partners agree. Lesotho and Swaziland, which belong to both, have been given two successive five-year exemption clauses, but will soon have to decide which regional organization to stick with.

Few doubt that when it comes down to it, they choose SACU, which, whatever its political connotat is the most coherent and advanced of the integra efforts in the region.

This has led some economists to argue that the way forward is to scrap both SADC and the PTA, gradually expand SACU outward. Mozambique, Ma and Angola have privately indicated an interest in S membership.

Although this is politically attractive to Pretoria idea is likely to be opposed by South Africa's purse-h ers, on the grounds that as larger economies join revenue-sharing formula would prove unafford Indeed, some economists question if it is in S Africa's interests to belong to any of the regional or zations in the sub-continent, since the African countr would most seek to trade with—like Nigeria—are n the sub-region.

The most likely scenario that economists emerging out of the present milieu is a multiplici bilateral trade agreements overlaying a weak reg organization.

Malawi, Zambia, and Zimbabwe (which has take hardest political line against South Africa) have rec signed preferential trade agreements with Pretoria. agreements are of mutual benefit. But, economists they lack an overall framework to deliver the regio dream of a place where people sharing the same cu cy, voting for a regional parliament, can trade and across boundaries without even noticing that they done so.

# Economic Premises Need Re-Thinking

by Winifred Armstrong
New York

Will more outside aid, trade and investment help the nations of Africa to overcome poverty and develop economically? It is unlikely.

Most African economies have deteriorated over the past decade, partly *because* of the policies that underlie the infusions of loans and aid. Trying harder using the same flawed premises won't help.

The major element missing from current economic policies is sustainability.

The ability of people to engage in productive economic activities through which they can make a living and build a life is not a goal of the global economic order. Neither is the sustainability of the earth's resources. Rather, the primary aim of international economic policies is an ever-greater output of products that can be sold for cash.

The "new global economic order" stresses comparative competitive advantage and export growth. The underlying assumption is that every country will have a comparative advantage in producing and selling *something* – and that more production will mean more wealth for more people. But that is not what is happening. In both Africa and the United States, the standard of living of the majority of people is dropping. Only the richest are getting richer.

Using the concept of comparative advantage, Western governments and international agencies have often urged African nations to produce export crops instead of food. The assumption is that with the money earned from export sales, cheaper imported food can be substituted for that which had been grown locally. Outside aid, investment and trade are often conditional on Africans' acceptance of the switch from local to export production.

Such recommendations conceivably might lead to increased prosperity if the former food producers became instead the producers of exports – and if they could sell those exports at prices that would enable them to purchase the food and other goods they need. Neither assumption has been borne out in the marketplace. Local producers often find there is no alternative product that they can successfully grow on the same land. Imported food is not "cheaper" if you have nothing with which to buy it.

Our current policies are further skewed by the limitations of economic policy formulation, such as economists' failure to value the food produced for the family table or for local trade. Food or informal trade that does not become part of the cash economy is not "valued" nor included in calculations of a country's gross national product. In Africa, subsistence agriculture and informal trade have accounted for perhaps 50 percent to 90 percent of what people live from; not to count it surely distorts the policies affecting those people. In addition, a community's state of health, level of education and a host of other quality-of-life factors may be the stuff of political conversation, but they are regarded as "externalities" and omitted from what is "counted" in economic policy decisions. Africans and Americans alike suffer the logic of these limited premises.

Most African countries cannot survive using a global model of comparative advantage, in my opinion. *Can* African countries be economically viable from their own resources? "Yes," said almost everyone with whom I talked in 17 African countries during a recent trip. But there was general agreement that that won't happen as long as Africa remains bound by an economic model that fails to place a premium on people and their environments, on education, health and community, and on building their future within available resources.

The dominant world economic models do not include these values, but they could. The recent U.S. election reflected a popular recognition that the current economic model is not working to meet the needs of people within a sustainable ecology – and that change is possible. There is important work taking place at academic and grassroots levels in both Africa and the Americas that supports a wider conceptual framework. We should join forces to bring it into the mainstream. ■

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# Successful Local Governments in Africa

PAUL SMOKE and DELE OLOWU

*In Dele Olowu and Paul Smoke, guest eds.,* SUCCESSFUL AFRICAN LOCAL GOVERNMENT *Special issue of* PUBLIC ADMINISTRATION AND DEVELOPMENT, *Vol. 12, No. 1, 1992.*

The public sector in most developing countries, especially in Africa, is considerably more centralized than in industrialized nations. As developing countries reduce the growth and scope of central government activities in response to economic reality and donor pressure, interest in stronger local authorities is on the rise. This special issue, edited by Paul Smoke of HIID and MIT and Dele Olowu of Obafemi Awolowu University in Nigeria, reviews local government reform lessons drawn from case studies of Benin, Kenya, Nigeria and Zimbabwe.

Analysts put forth three main arguments supporting more devolution in Africa. First, strong local government can help promote democratization. Second, given spatially diverse service needs, limited central capacity to run field offices, and Africa's tradition of self-government, local officials are best able to identify and serve many key local needs. Third, locally raised resources can relieve pressures on national budgets.

Unfortunately, the literature on African local government concentrates on failure. Efforts to nurture development-oriented, democratic local institutions were halted in many countries by post-independence leaders primarily interested in consolidating power. Subsequent neglect and poorly exercised control of local authorities have further undermined their performance. In spite of this, some African local authorities are successful in providing a range of basic services adequately. Several related factors are associated with the ability to do so.

***The case studies covered in the journal demonstrate the need to concentrate on a few key recurrent revenue sources, such as agricultural taxes, market, motor park and other service operations, or land rating.***

First, an adequate economic and legal base is necessary. All of the "success" cases are located in dynamic urban or resource-rich rural areas, and most are colonial era councils with significant roles long defined by law and tradition. Neither location nor legal status, however, is sufficient for success, as many local authorities with these characteristics perform poorly.

Second, there must be capacity to raise sufficient resources to support the local economy with basic services. The case studies covered in the journal demonstrate the need to strategically concentrate on a few key recurrent revenue sources, such as agricultural taxes, market, motor park and other service operations, or land rating. Successful local government units also tap reliable sources of development finance, such as annual budget surpluses, earmarked proceeds of productive taxes, central government or bank loans, and development grants. Infrastructure built and operated with these funds—both to serve the local area and link it to other regions—facilitates input procurement, production, and output distribution. As such activities expand, business taxes and licenses grow increasingly productive for the local treasury.

Third, since there is usually substantial central regulation of local activities, intergovernmental cooperation is critical. Limited local financial management and accountancy practices often justify some monitoring, but excessive control undermines administrative and economic efficiency. The "success" cases have largely avoided such negative effects by cultivating constructive relationships with central authorities. When key agencies perceive local officials to be competent, they tend to exercise control less strictly.

Creating joint projects between ministries and local authorities fosters cooperation. Some of the more capable councils court ministerial favor by helping to provide services that are central responsibilities. In cases where central government field administration and local government co-exist, local officials maintain close ties with field offices and special committees that coordinate area development projects.

Fourth, effective local authorities have competent and innovative managers. Although central support plays a role, success depends heavily on local attempts to recruit and retain qualified staff; minimize staff redundancy; create performance incentives; develop effective revenue collection and financial control, and keep adequate records for use in planning development projects and routine operations. Taking advantage of focused short-term training programs, ensuring continuity in key senior staff positions, and making efforts to understand the successes and failures of other local governments before undertaking new activities also contribute to effective management.

Finally, strong internal relations facilitate local performance. First, elected councilors need to cooperate with appointed managers, establishing policies and priorities, but not interfering with routine technical and managerial matters. Second, local officials must be responsive to their constituents. In contrast to the norm, the "success" cases consult residents when making major decisions, including service prioritization, location and design of new facilities, and setting service charges. This leads to greater support and more successful development projects.

In summary, local authority success is a complex, ongoing and cumulative process that requires both central and local action. The central government must establish a legal and administrative climate that clearly defines an appropriate role for local governments and encourages good performance, while simultaneously providing adequate and fairly distributed financial and technical assistance. Local governments must actively pursue innovative strategies to improve resource mobilization and service delivery, such as those used by the "success" cases reviewed here.

Experience suggests that major reform programs involving substantial increases in local responsibility should be implemented gradually, starting with more capable and innovative local governments. Such a strategy reduces the probability of overwhelming local officials and generating resistance from those whose power is threatened by decentralization. The challenge for future research is to define in a more operationally specific way the conditions and actions required to bring about effective local government reform. ■

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**Dele Olowu** *is a Senior Lecturer in the Department of Public Administration at Obafemi Awolowu University in Nigeria, and has published widely on local government in Africa.*

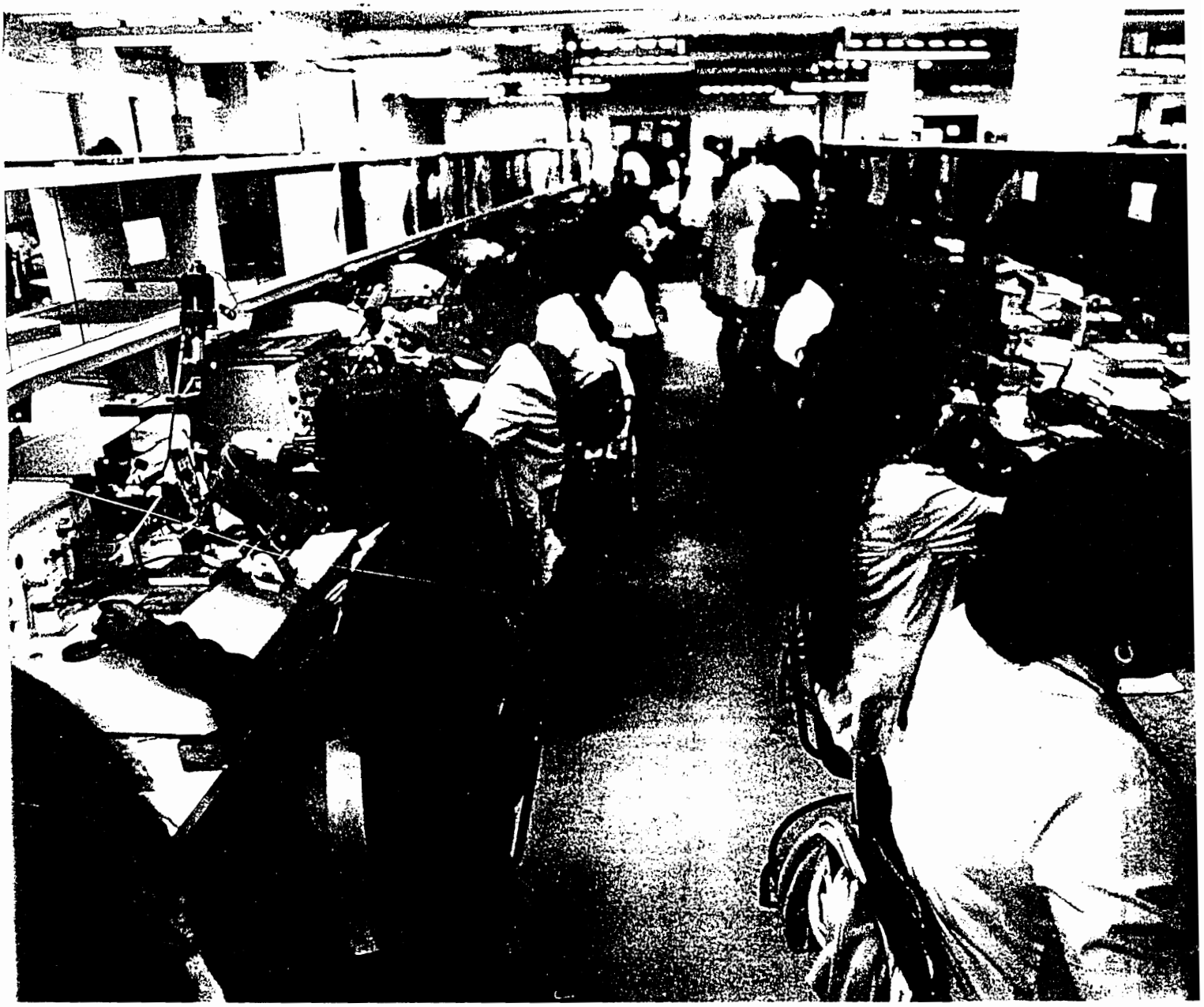
BEST AVAILABLE COPY

Television images of starving Somalis, which moved the American conscience last fall, are now replaced by those of suffering peoples elsewhere. The Somalis are a resilient people. They are returning to their villages and are planting crops. Markets are coming alive; children are leaving feeding kitchens, some to return to school.

But this picture of normalcy is deceptive. A tremendous amount needs to be done before Somalia is a normal society. The essential work of UNOSOM may well take place without great public pressure for international involvement. But if we are to avoid the risk of forfeiting the gains of Operation Restore Hope, continued American and allied assistance will be essential. This Administration is committed to such a course and looks forward to Congress' continued cooperation and support.

In this spirit, we welcome congressional support—as expressed in S. J. [Senate Joint] Resolution 45, for the efforts we have been making in creating a secure environment for provision of humanitarian relief alleviating the massive suffering of the Somali people. The dual catastrophes of famine and merciless civil strife have been devastating to Somalia. Although the Administration does not believe specific statutory authorization for the deployment of US forces to Somalia is necessary, we are immensely gratified that the Hill and the Administration have cooperated so well in delivering an appropriate and urgent response. ■

BY ANNE SHEPHERD



# SAVING THE 'TIGER'

Twenty-five years after independence, Mauritius is an economic success story. But the tiny Indian Ocean island has greater ambitions than just an economy based on cheap labor and sugar production. It wants to become



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Africa's first "newly industrialized country," and that will mean developing more sophisticated industries, such as electronics, and attracting increased investment, domestic and foreign.

Just as Mauritians thought they could sit back and revel in their hard-earned success, the island's leaders are warning that tougher challenges lie ahead.

On March 12, the island celebrated its 25th anniversary of independence from Britain. Few African countries, on similar occasions, have had so much to be proud of: a functioning democracy; consistent growth in GDP; full employment; low inflation; no arrears with the IMF; a manageable debt burden; population growth of less than 1 percent; free health care and education.

Yet in the run-up to the independence celebrations, Prime Minister Sir Aneerood Jugnauth spent most of his time reminding the islanders that none of this should be taken for granted. His favorite analogy is of an airplane which, having soared into the air, needs fuel to keep it going.

Mauritius is a victim of its own achievements. Its success in pursuing an export-led growth strategy led to a rapid rise of the textile industry exploiting the country's then-abundant cheap labor. But now the island is short of workers. Meanwhile, global recession, and threats to its preferential access to European markets as the Uruguay round of GATT talks proceeds, have led to a realization that this is no time for complacency.

The island's leaders also have ambitions far beyond their present level of success. Having climbed halfway up the development ladder, their most cherished goal is to see Mauritius become Africa's first NIC (newly industrialized country) by the turn of the century. Privately, they see Mauritius becoming to Africa what Singapore is to Asia.

But that implies a fundamental shift from a labor- to a capital-intensive economy, already evident in moves to mechanize and shift upmarket in the agricultural, industrial, and tourist sectors, as well as a new drive to develop the island into an offshore banking, business, and trade center. For an island marooned in the Indian Ocean 900 miles off the coast of Africa, the first challenge is to find new markets, sources of business, and investment, against a backdrop of the considerable economic problems still besetting its hinterlands.

Unlike the past, skills and not just hands are the key to success.

The "second phase" of the island's development also calls for a new "industrial mentality," which scares many of the gentle, beach-loving islanders. But it is a reality that must be faced.

*Anne Shepherd is a London-based journalist who has travelled widely in Africa and written extensively on African economic and political issues.*

"Until recently, we have sat back and thought it inevitable that we would become the tiger of Africa," said Pierre Yin, managing partner of Wilton Associates, a firm of economic consultants in Port Louis. "Yes, compared to other African countries we are an exception," he continued. "But in global terms we have barely started. The first phase was the easiest. What we have to face now will be the real test of our ingenuity."

The island's greatest hope is its historically proven ability to win against the odds.

A volcanic extrusion somewhat larger than Oahu and bearing no known mineral resources and rocky agricultural land, Mauritius was first sighted by Dutch sailors, whose only contribution was to feast on the now-extinct dodo, the friendly duck-like bird which has become the island's national emblem.

French, and then British settlers (who claimed Mauritius as a spoil of war in 1810) introduced sugar, and brought in slaves from East Africa and then, when Britain abolished slavery, indentured labor from India to work the plantations. Today, 52 percent of the 1 million inhabitants are descendants of Hindus from India; 17 percent are Muslim Indo-Mauritians; and 27 percent are Creoles, or Mauritians of French and African origin. Franco- and Sino-Mauritians make up the remainder of the population.

In many countries, such a mix of peoples has spawned endless bickering and even civil wars. Mauritius has managed instead to thrive on its diversity. Its people speak English and French interchangeably, and among Indo-Mauritians, usually an Indian language as well. Creole, a sort of pidgin French, is the lingua franca. At a restaurant, one can enjoy all at once the best French wines, Indian curry, and the distinctive dance of Afro-Mauritians—originally from Senegal and Mozambique—called the *seaga*. If there are any tensions in this society, they are kept well hidden below the surface.

Politics is a more vociferous affair, laced with intrigue and revolving-door coalitions which are difficult for the outsider to fathom. The present government is a coalition of the Mouvement Socialiste Mauricien, led by Jugnauth, and the Mouvement Militant Mauricien, led by Foreign Minister Paul Berenger, who had a serious falling out with Jugnauth 10 years ago.

The last elections, held in September 1991, were punctuated by the first cries—in years of faithfully holding parliamentary elections—of foul play. These have been championed by the leader of the Labor Party-led opposition coalition, Dr. Navin Ramgoolam, whose father was the country's first prime minister, Sir Seewoosagur Ramgoolam.



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Ramgoolam has put his case before the Supreme Court, respected internationally for its independent status. Western diplomats doubt that the young Ramgoolam stands much chance. He has similarly lost credibility over a campaign a year ago against the island's breaking ties with Queen Elizabeth II (as titular head of state) and becoming a republic within the Commonwealth. Ramgoolam argued that this move should have been preceded by a referendum. But public sympathy was overwhelmingly in favor of becoming a republic.

The Labor leader's party is privately annoyed with Ramgoolam, a medical doctor, for spending much of his time since the election in London studying for a law degree.

These details aside, the island's hyperactive political scene and independent media have provided Mauritius with a rare public eye on government. Political disagreement has also always stopped short of diverting the basic economic thrust.

Like many African countries, Mauritius initially adopted inward-looking strategies in attempting to address the typical problems of a one-crop economy: high unemployment, balance of payments problems, and shrinking standards of living.

However, as early as 1972, the island set up an Export Processing Zone (EPZ), which provided attractive incentives to local sugar barons, as well as foreign investors, to go into labor-intensive industries, primarily textiles and garments. These incentives were beefed up in 1981, when the island also made a determined effort to correct macroeconomic distortions under the tutelage of the IMF and World Bank.

The island's export-led growth strategy was greatly aided by the Lomé Convention between African, Caribbean, and Pacific nations and the EC. The Sugar Protocol appended to the convention permits 507,000 tons of Mauritian sugar (about 80 percent of total production) to be sold in Europe at a price equivalent to that received by European beet farmers (about double the world market price). The convention also allows duty-free entry into the European market of manufactured products satisfying certain rules of origin. This gave the textile business an important edge over emerging Asian competitors.

What is important is that Mauritius seized on these advantages, and provided an avenue for sugar surpluses to be invested in new areas. Some 45 percent of the investment in the EPZ is local, the rest coming primarily from Hong Kong, India, France, South Africa, and Germany. Between 1982 and 1991, agriculture as a share of GDP declined from 18.7 percent to 12.3 percent, while manufacturing rose from 14.9 to 23.3 percent, with the EPZ alone accounting for 12.8 percent.

Over the same period, GDP grew at an average rate of 5.6 percent per annum. Thanks to a vigorous family planning campaign, relatively high levels of education among women and the job opportunities open to them in the EPZ (where female labor predominates), the population growth rate fell from 3 to under 1 percent.

This means that standards of living have been rising by some 5 percent per annum. Per capita income stands at $2,600 a year, placing Mauritius in the middle income bracket, and unemployment is down to a negligible 2 percent. Inflation, which had reached 12 percent in 1991, has been brought down through prudent macroeconomic management to 2.8 percent.

Mauritius' newfound prosperity has been ploughed into improving social services. The island boasts a 95 percent literacy rate among the under-30s; provides free health care; and looks set to provide housing for all by 2000.

The IMF is not complaining: In May, Mauritius will become one of the few African countries to meet all its repurchase obligations to the Fund. The easing of foreign exchange restrictions has led to a surge of imports, causing a widening of the trade deficit. However, this has been covered by an increase in "invisible" foreign exchange earnings, primarily in the tourist sector, which until recently grew at an average rate of 10 percent per annum.

The result is a healthy balance of payments position, with foreign exchange reserves worth seven to nine months' import cover. Debt service rate (the proportion of debt repayments to export earnings) stands at a respectable 8 percent.

These achievements mask underlying tensions. Full employment has led to critical labor shortages in all sectors, especially agriculture, and has been accompanied by rising wages and absenteeism. A drought in 1991 hurt the sugar crop, which normally accounts for 30 percent of export earnings. Another drought appears to be on the horizon this season. World recession has affected both the tourist and EPZ sectors, which posted relatively low growth rates of 3 and 5 percent respectively in 1991, with overall growth in GDP slowing to 4.7 percent.

The long and short of it, said Ariff Currimjee, managing director of Bonair, one of the country's largest knitwear concerns, is that Mauritius can no longer count on free lunches or easy advantages. So far, he explained, the island has exploited its main advantage—cheap labor. The challenge now is to go into the relatively uncharted territory of growth based on investment and innovation.

The move upmarket is evident in every sector of the economy. Under the Sugar Efficiency Act of 1988, the government announced a series of fiscal incentives for modernization and diversification in the agricultural sector. Some 70 percent of the crop is now mechanically loaded, and research is going into improving yields so as to increase mechanical harvesting (which adversely affects yields).

Mauritius now produces 70,000 tons per annum of special sugars, which fetch high prices on the world market, and are becoming increasingly popular because of health concerns. Bagasse, a by-product of sugar processing, now



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supplies a quarter of the island's electricity. Most sugar plantations are also trying high-value, low-volume crops like flowers and fruit. The island is now the world's second-largest exporter of anthuriums, a distinctive, long-lasting flower that flourishes in the humid sub-tropics.

Within the EPZ, there has been some debate over whether to abandon textiles for higher value-added pursuits, or exploit new possibilities in this area. Currimjee firmly believes there is a lot of life left in the textile business, and his firm, which employs 3,500 people, proves it. Value added at Bonair amounts to 70 percent, compared to the EPZ average of 32 percent.

**THE EMERGENCE OF A DEMOCRATIC SOUTH AFRICA WOULD BE A BOON FOR MAURITIUS.**

To assist smaller producers to move with the times, the government has created an Export Processing Zone Development Authority (EPZDA), which one government official describes as the equivalent in industry of an extension service in agriculture. The parastatal, which is supported by the UN Industrial Development Organization, is determined to halt the series of closures in the EPZ (56 last year) by showing that quitting need not be the first option.

The authority is also determined to promote new areas of industrial development. The government has recently provided a series of fiscal incentives to the electronics industry. It is also building a state of the art informatics park, in which Mauritius hopes to put its high level of educational and bilingual advantages to good use in areas like translation, secretarial services, and desk-top publishing.

In addition to the three pillars of the economy—sugar, industry, and tourism—Mauritius is developing a fourth: financial services.

This has involved modernizing domestic financial services by abolishing credit ceilings and cutting interest rates from 11 to 8 percent in the 1992/93 budget.

Five years ago, the island set up a stock exchange which, with a capitalization of $300 million, is tiny in global terms, but is expanding rapidly. Recent measures to encourage local companies to go public, permit indirect investment in some parastatals, and allow foreign investment on the stock exchange through a country fund are all exciting new developments.

Four years ago the island passed legislation to allow the establishment of offshore banking units offering advantages like very low tax rates, free repatriation of profits, and complete freedom from exchange control. Seven banks, including Barclays Bank and Banque Nationale de Paris Intercontinentale, have set up offshore units.

The government has recently widened this drive to include offshore companies by offering similar incentives, backed by a legislative framework adopted in June last year. To spearhead promotion efforts, and act as regulator, the government has set up a Mauritius Offshore Business Activity Authority. Eighty offshore licenses have since been granted.

Alongside these developments, Mauritius has put in hand the legislative framework, and physical works, for a freeport in Port Louis. This aims to act as a bridge for trade between Asia and Africa by providing incentives for trans-shipment and reexport of goods.

A recently established Mauritius Freeport Authority, headed by Sir Edouard Lim Fat, who masterminded the EPZ, will oversee freeport affairs. Operations are expected to start later this year, and the authority reports that 15 applications have already been received.

Mauritians are realistic enough to accept that these sorts of activities, while providing high-quality jobs and some foreign exchange earnings, are not going to lead to the same rapid growth as when the EPZ came into being in the 1980s. "There are no quick results as we move into higher gear," noted Raj Makoond, deputy secretary-general of the Mauritian Chamber of Commerce and Industry.

The more critical question is whether the island can make the final leap to NIC status. The general consensus is that Mauritius has what it takes, but that there are considerable challenges ahead.

For one thing, businessmen point out that the island has to adopt a far more targeted approach toward seeking out investors and markets than in the past. Attracting investors to the electronics industry in a far-flung island like Mauritius, for example, will take more than the usual road show on Mauritius in foreign capitals.

Developing regional markets also assumes greater importance. The island's natural market for sophisticated products, and its main hope for establishing a freeport, is the east and southern African Preferential Trade Area, to which it belongs. Recent moves to bring down trade barriers in this group, as well as the existence of the Harare-based Clearing House, which eases foreign currency constraints to trade, are viewed with great optimism in Mauritius.

The emergence of a democratic South Africa would also be a boon for the island. Finance Minister Rama Sithanen pointed out that no region in the world has ever succeeded without an economic powerhouse. He predicts a free South Africa will be to Africa what Japan has been to Asia.

For the island, considerable investment must now go into high-level training and instilling a new industrial culture on an island where the day begins at 9 am, ends at 4 pm, and weekends are spent basking in the abundant sunshine.

As much as Mauritians revere Singapore, they cringe at the idea of the social engineering and programming which have been a part of the Asian tiger's success. That may be extreme, said economist Pierre Yin. But, he noted, "no plan to modernize has ever worked without corresponding changes in attitude." ○



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# The Stage is Set for OPIC's Tunisia Trade Mission

*By Corey D. Wright*
*Tunisia Desk Officer*
*U.S. Department of Commerce*

The United States and Tunisia signed a Bilateral Investment Treaty (BIT) earlier this month.

John T. McCarthy, the U.S. Ambassador to Tunisia, and Tunisian Foreign Minister Habib Ben Yahia, exchanged instruments of ratification of the Treaty on Jan. 8, which enters into full force on Feb. 8. At the exchange ceremony, Ambassador McCarthy welcomed Tunisia's commitment to encourage foreign investment in the promotion of economic growth and development through the attraction of capital, new technology, and marketing expertise. The Tunisian government is interested in attracting more U.S. investment, and American firms should find the investment climate most receptive in light of this treaty and other investment incentives.

The BIT is reciprocal in nature, and covers future as well as existing investments. It guarantees American investors:

- The right to establish investments on a basis no less favorable than that accorded to investors of third countries, and subject to existing laws, on a basis no less favorable than that accorded to domestic investors;
- Treatment of investment that is no less favorable than that accorded to domestic investments or to investors of nationals of any third country, whichever is more favorable;
- International Law Standards for expropriation and compensation;
- Free transfers of capital (with three-year balance of payments exception limited to the proceeds from the sale or liquidation of the investment); and
- The right to submit disputes to international arbitration through the World Bank's International Center for Settlement of Investment Disputes.

On Jan. 5, President Ben Ali convened a cabinet meeting to approve measures to make foreign exchange more available to Tunisian households and businesses and to simplify administrative procedures. He is also pushing the drafting of legislation and implementing regulations needed to allow current account convertibility by the end of 1993.

Over the next few years, American firms will be able to take advantage of Tunisia's strategic location and preferential access vis-a-vis the European and North African markets. Tunisia's skilled and plentiful labor force is one of the nation's major exploitable resources.

Tunisia has managed its external debt well and has never requested rescheduling of its foreign debt. The tourism, agribusiness, food processing, apparel, and computer software services and manufacturing sectors offer good possibilities for U.S. traders and investors.

American firms interested in trade and investment opportunities in Tunisia should consider attending a meeting of the U.S.-Tunisia Trade Mission on Feb. 16, in Washington, D.C. The Overseas Private Investment Corporation (OPIC), the U.S.-Arab Chamber of Commerce, and the Tunisian Agency for Promotion of Industry (API) are hosting this mission. The visit follows a successful OPIC investment trip to Tunisia in April 1992. The mission will also make stops in Baltimore and Miami. Tunisian companies are participating and will present their investment opportunities. The program also includes guest speakers from the Tunisian government who will discuss trade reforms and investment incentives. For more information, contact John Hereford at OPIC at tel. (202) 336-8630, the U.S.-Arab Chamber at tel. (202) 331-8010, or API at tel. (202) 223-8580.



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## NATIONAL ECONOMIES

# Tanzania Restores Economic Growth and Speeds Structural Change with IMF Support

*Socialism and self-reliance were the tenets of Tanzania's social and economic policies embedded in the Arusha Declaration of 1967, which aimed at creating a society based on the African concept of* ujamaa *(loosely translated as familyhood). In the economy, the Arusha Declaration was followed by widespread nationalizations and large-scale "villagization" of the rural population. Administrative controls were pervasive in all sectors.*

*A rapid accumulation of external debt, combined with the second oil shock of the late 1970s, created a severe balance of payments crisis and acute shortages of consumer goods in the early 1980s. Between 1980 and 1985, the economy experienced low or negative growth in real GDP as production and exports declined and capacity utilization fell. Inflation was high, averaging over 30 percent; the balance of payments registered large deficits; and the country faced a severe shortage of foreign exchange, leading to an accumulation of external payments arrears. In 1986, the Government announced an economic recovery program, which was supported by a stand-by arrangement from the IMF and a credit from the World Bank. The continuing reform efforts have been supported by arrangements under the structural adjustment facility (1987–90) and the enhanced structural adjustment facility, as well as by several World Bank loans.*

*In the following article, Roger Nord and Matthew Saal of the IMF's African Department discuss Tanzania's progress under the reform program and the challenges the country faces in the years ahead.*

### Economic Recovery Program of 1986–90

The initial priorities of Tanzania's adjustment program were to achieve real per capita GDP growth through a recovery of agricultural and industrial production, to bring down inflation, and to reduce dependence on exceptional foreign financing, leading, ultimately, to a viable external position. A pivotal role was assigned to the provision of appropriate price signals though flexibility in the setting of producer and consumer prices and adjustments in the exchange rate and interest rates, combined with fewer direct controls on marketing and distribution. The following specific measures were undertaken in major areas of reform:

***Exchange and Trade Policies.*** The exchange rate was adjusted sharply in the first two years of the program, leading to a cumulative depreciation of the real effective exchange rate of about 80 percent between 1986 and 1990. The parallel market premium fell from 800 percent to 30–50 percent, and the Tanzanian authorities reduced their reliance on quantitative restrictions on imports. Beginning in 1986, exporters of nontraditional products were permitted to retain a share of their export earnings and to freely transfer retained earnings among and between themselves and traders. The current account deficit of the balance of payments stabilized initially, and capital inflows, including from debt relief, increased.

***Fiscal and Monetary Policies.*** The authorities took steps to progressively reduce the central government deficit and to substantially reform the tax system and tax administration, with technical assistance from the IMF. Among the measures they adopted were sales and customs tax rationalization, reintroduction of the excise tax, and a lowering of rates on personal income tax and capital gains tax. These measures broadened the tax base from 15 percent to close to 20 percent of GDP. Public enterprises continued to dominate the Tanzanian economy, however, relying heavily on subsidies from the budget and captive credit from the banking system. Tight budgetary policies helped bring inflation down initially, but the lack of control over credit expansion precluded further progress in stabilizing prices.

In the financial sector, reform was limited to raising interest rates in several steps, until most key deposit and lending rates were positive in real terms. The Bank of Tanzania maintained a rigid structure of fixed interest rates and differentials, however, which continued to subsidize entities in certain sectors, such as agricultural cooperatives.

***Agricultural Policies.*** Agricultural reforms focused on creating a market environment with improved incentives for producers and more efficient marketing arrangements. The Government raised producer prices to bring them closer to world market prices and relaxed controls on agricultural trade and marketing. In particular, supported by an agricultural adjust-



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ment credit from the World Bank, it completely liberalized trade in food grains by allowing the private sector to buy and sell grain at freely determined prices. Accompanied by favorable weather, these reforms contributed to a substantial increase in grain production and to lower retail prices for maize and paddy.

Although marketing boards initially retained their monopoly over most export crops, the Government passed legislation to limit their role to that of marketing agents.

### Speeding up Reforms: 1991–92

Five years into the reforms, Tanzania had regained positive rates of per capita GDP growth. Its fiscal position had improved; the domestic marketing of food grains had been opened to the private sector, boosting production significantly; prices had been substantially freed; and the overvaluation of the exchange rate had been partially corrected. But major financial and structural imbalances remained, and the Tanzanian economy continued to be dominated by close to three hundred largely inefficient parastatal enterprises. In 1991, Tanzania accelerated its structural reforms, particularly those in the financial, exchange and trade, and parastatal sectors.

***Exchange and Trade Reform.*** The Government further liberalized the exchange and trade regime in 1991 and 1992. A far-reaching liberalization of Tanzania's foreign exchange legislation allowed Tanzanian citizens to hold foreign currency deposits in domestic banks. In April 1992, the Bank of Tanzania licensed the first foreign exchange bureaus, which are authorized to buy and sell foreign exchange at freely determined prices for most current account transactions. The transaction volume in the bureau market has steadily risen, and the exchange rate has been broadly stable, at a premium of about 20 percent over the official exchange rate. As an incentive to exporters, the retention rate for nontraditional exports was increased to 50 percent, which can either be retained in foreign exchange or exchanged through the bureau market.

The Government also accelerated import liberalization in early 1991 by converting the list of goods permitted under the open general licence import regime into a negative list of prohibited goods. The negative list has since been shortened considerably.

***Fiscal Reform.*** Based on a comprehensive study by a presidential commission, the 1992/93 budget introduced several substantial changes in the tax system. Most tax rates were lowered, and sales, excise, and corporate tax schedules were simplified. In addition, a wide range of tax exemptions, which had benefited the central and local governments and the public enterprise sector, were eliminated.

To improve transparency, the Government is broadening the coverage of the budget. At the same time, it is reviewing all development projects with a view to raising their generally low level of productivity. Together with a series of functional reviews of ministries and agencies started in 1992, the Government is thus reassessing its role in different sectors of the economy, with the ultimate aim of focusing its resources on a few key areas.

***Financial Sector Reform.*** In April 1991, Tanzania's Parliament approved the Financial Institutions Act, initiating a comprehensive reform of the financial sector aimed at establishing a competitive, solvent, and market-based financial system. The rigid struc-

**Tanzania: Selected Economic and Financial Indicators, 1980-92**

| | 1980 | 1985 | 1987/88 | 1988/89 | 1989/90 | 1990/91 | 1991/92 Est. |
|---|---|---|---|---|---|---|---|
| | (annual change in percent over previous year) | | | | | | |
| Real GDP | 3.1 | 2.6 | 5.1 | 3.6 | 3.2 | 3.7 | 3.8 |
| Consumer prices (annual average) | 30.2 | 33.3 | 29.7 | 29.0 | 22.1 | 21.7 | 21.0 |
| Money plus quasi money | 23.4 | 27.5 | 34.8 | 37.3 | 45.4 | 26.9 | 40.5 |
| External sector (on a nominal U.S. dollar basis) | | | | | | | |
| Exports, f.o.b. | -1.8 | -26.4 | 0.4 | 25.0 | -7.9 | 1.1 | 5.5 |
| Imports, c.i.f. | 12.2 | 11.9 | 7.3 | 14.8 | -0.6 | 2.6 | 4.6 |
| Real effective exchange rate | | | -27.9 | -11.6 | -19.8 | -8.5 | -2.6 |
| | (percent of GDP) | | | | | | |
| Government revenue (before grants) | 20.8 | 17.3 | 16.7 | 19.5 | 21.0 | 22.1 | 21.7 |
| Government expenditure | 34.1 | 26.8 | 26.3 | 25.5 | 28.0 | 25.2 | 24.4 |
| Overall government budget deficit | | | | | | | |
| Checks-issued basis (before grants) | -13.4 | -9.6 | -9.7 | -6.0 | -7.0 | -3.1 | -2.6 |
| Checks-issued basis (after grants) | -8.9 | -7.7 | -4.0 | -0.3 | -0.9 | 0.7 | 2.1 |
| | (percent of exports of goods and services, and private transfers) | | | | | | |
| External current account deficit | | | | | | | |
| Excluding grants | 94.3 | 84.3 | 77.1 | 84.1 | 77.6 | 86.7 | 83.7 |
| Including grants | 63.9 | 54.6 | 21.5 | 29.8 | 23.8 | 28.5 | 28.5 |
| Scheduled external debt service (including IMF, before rescheduling) | 17.7 | 55.7 | 50.6 | 49.0 | 42.3 | 41.5 | 35.1 |
| | (weeks of imports) | | | | | | |
| Gross official reserves | 4.3 | 0.8 | 3.2 | 2.0 | 4.8 | 7.5 | 13.7 |

Data: Tanzanian authorities; and IMF staff estimates.



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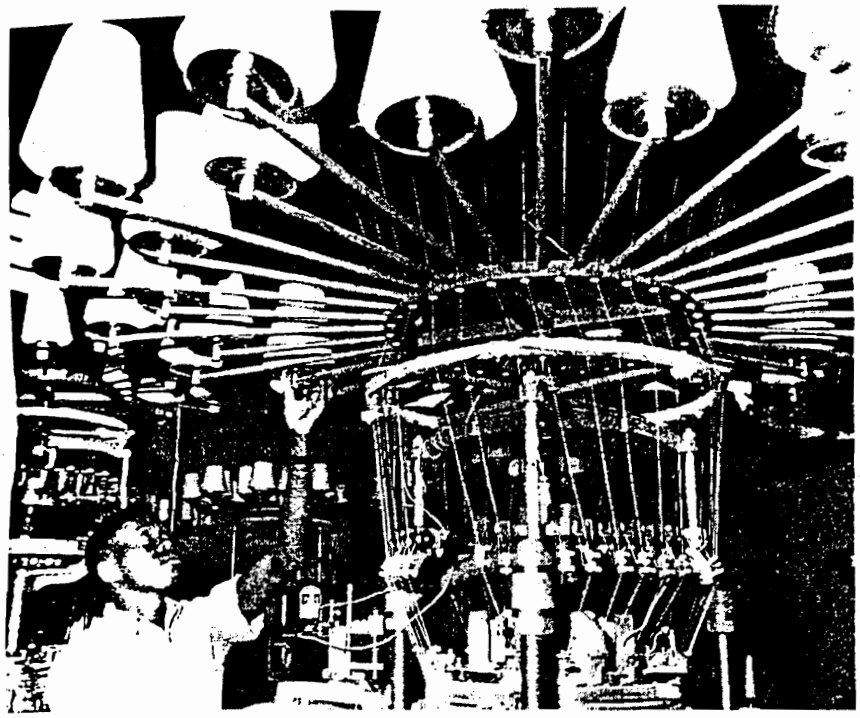

*A textile mill in Tanzania: the reforms have boosted industrial production.*

ture of interest rates was replaced by a single maximum lending rate, and the supervisory role of the Bank of Tanzania was strengthened. The financial sector was opened to domestic and foreign private institutions, and, by mid-1992, several applications for banking licenses had been received. The first private international bank should be operating by the end of the first quarter of 1993. At the same time, existing public financial institutions are being restructured. Notably, in 1992, the Government took a number of steps to clean up the loan portfolios of Tanzania's main commercial banks.

***Parastatal Reform.*** The large number of parastatal enterprises, which dominated the manufacturing and trading sectors, continued to represent a substantial drain on the Tanzanian economy. In late 1991, the Government announced its intention to divest itself of all commercial parastatal enterprises. Unviable enterprises for which a buyer could not be found would be liquidated, while the remaining enterprises would be sold to domestic or foreign buyers. The ambitious program has had a slow start, however, and few enterprises have been liquidated or sold so far.

***Agricultural Reform.*** The further liberalization of the agricultural sector has shifted the focus from domestic food crop marketing to the export sector. Addressing the virtual monopoly enjoyed by the cooperative unions in marketing and distributing the major crops, the Government enacted a new cooperative law in 1991 to introduce multichannel marketing, in which private traders operate alongside the cooperatives and farmers can decide to whom they will sell their crops. The implementation of the new marketing system has been slow in some sectors, however, particularly cotton. Domestic marketing of cashew nuts, on the other hand, was fully liberalized in 1992, allowing private traders to compete with the cooperatives in purchasing nuts from the farmers.

**Assessing the Reform Program**

The positive impact of Tanzania's adjustment program is evident. GDP grew by an average of more than 4 percent a year during 1986–92, mainly because of improved agricultural performance. Industrial activity has also begun to pick up as an inflow of funds for imports has improved access to spare parts and other essential inputs. Government finances have been strengthened by the restructuring of the tax system, which broadened the revenue base considerably, and inflation has declined to about 21 percent from 36 percent in the years before the reform program.

Despite declining terms of trade for traditional export products, Tanzania's export volumes increased during 1987–92, largely because of improved producer prices, better availability of agricultural inputs, and an expansion of nontraditional exports. Although the underlying balance of payments position remains tenuous, the strong adjustment program, supported by the IMF and the World Bank, led to an increase in assistance from bilateral donors and creditors. In addition, Tanzania was granted repeated concessional rescheduling under the Paris Club, including, in 1992, a multiyear rescheduling under its new menu of enhanced concessions, conditional upon maintaining an arrangement with the IMF. The lack of improvement in the current account is indicative, however, of Tanzania's continued dependence on foreign savings.

The Tanzanian Government has attached great importance to providing social services. It is currently formulating a strategy to improve the delivery of these services, particularly health and education and, over the next three years, will do more to develop

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human capital. At the same time, it is trying to protect the environment by increasing royalty fees for wood products from publicly owned forests.

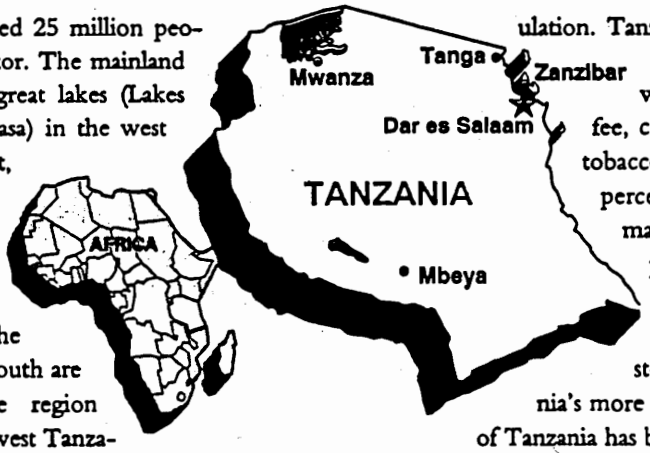
Despite the achievements of the past few years, Tanzania's economic situation remains precarious. Although central government finances have been strengthened, the remainder of the public sector, in particular the public enterprises and the agricultural cooperatives, has continued to contribute to monetary expansion. As a result, excess credit creation and accompanying inflationary pressures have persisted. The balance of payments, although fully financed, remains heavily dependent on foreign financing, reflecting Tanzania's continued reliance on foreign savings.

In the next few years, Tanzania will need to deepen its structural reforms. In particular, it will need to tackle parastatal reform to improve financial discipline and rein in inflation. Over the medium term, it must focus on using foreign savings more efficiently by improving the productivity of investment and attracting more private direct investment. These measures will help Tanzania overcome its excessive dependence on exceptional foreign financing.

**Photo Credits:** Denio Zara, page 49, for IMF; AP/Wide World, page 51; Tanzania Information Services, page 63.

## Tanzania - A Profile

Tanzania, home to an estimated 25 million people, lies just south of the equator. The mainland stretches from Africa's three great lakes (Lakes Victoria, Tanganyika, and Nyasa) in the west to the Indian Ocean in the east, covering 942,800 sq. km., and contains Africa's highest mountain, Mt. Kilimanjaro (5,895 meters). High plateaus cover much of the center of the country, while the north and south are mountainous. The lakeshore region around Lake Victoria in northwest Tanzania contains about one fourth of the population, reflecting the area's agricultural fertility. Zanzibar, Pemba, and the smaller Indian Ocean islands add 2,000 sq. km. to Tanzania's land area and are home to about 3 percent of the population. Tanzania's diverse ecology supports cultivation of maize, rice, wheat, cassava, cashew nuts, coffee, cotton, pyrethrum, sisal, tea, and tobacco, which account for about 60 percent of Tanzania's GDP. The manufacturing and mining sectors produce a range of products, including textiles, processed foods, chemicals, and gemstones. Tourism is one of Tanzania's more dynamic sectors. About a fourth of Tanzania has been set aside as wildlife or forest reserves. These and other attractions helped boost tourism receipts by 65 percent from 1985 to 1991.




Tanzania's currency is the Tanzania shilling. As of end-January 1993, the official exchange rate was T Sh 350 = US$1.

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WORLD BANK NEWS

March 4, 1993

# Debt Reduction Will Aid Uganda's Economy

## Uganda Cuts Debt And Paves Way For Improved Economic Growth

Uganda's economic development has benefited from a new debt arrangement supported by the International Development Association's Debt Reduction Facility.

Under the plan, which was concluded on February 26, Uganda has bought back $153 million of eligible commercial debt out of its total $2.6 billion debt at 12 cents on the dollar. The deal cuts 6 percent of the country's total debt, almost one-third of total arrears and three-quarters of its commercial debt.

Although Uganda still faces a serious debt problem, the new debt deal helps the government ease its cash flow situation and find support for its debt and economic restructuring strategies, says Kapil Kapoor, the World Bank's task manager for the Uganda debt buy-back operation.

"Given Uganda's debt profile, with a preponderance of multilateral debt which is not reschedulable, every million dollars worth of debt relief helps considerably. It makes life much easier for the government," he says.

The plan removes a crucial portion of

See UGANDA, page 2

UGANDA, from page 1

Uganda's debt; money which is owed to suppliers who sell vital imports to the country. By buying back the debt, Uganda sends an "important signal" that it is serious about restoring its creditworthiness and that it is in a position to do business again, Kapoor adds.

"This debt agreement enables Uganda to start off with a clean slate with its trade suppliers and will facilitate trade because it writes off a large part of the commercial debt from the country's books. If I am a supplier in Europe or elsewhere, I now know that I can sell goods to Uganda and the government will make every effort to honor its commitments to its creditors," says Kapoor.

The IDA Facility is supporting the deal with a $13.4 million grant. Of that amount, $10 million comes directly from the Facility itself and the remaining $3.4 million is contributed by the governments of the Netherlands and Switzerland. The operation is also supported by the government of Germany and the European Economic Community.

The Uganda agreement marks the fourth time the IDA Facility has helped severely-indebted developing countries ease their debt burden. The Facility, set up in 1990, has previously supported debt reduction schemes in Niger, Mozambique and Guyana.

The new plan is part of Uganda's three-year strategy of tackling its external debt which is draining government finances. Currently, the government owes $371 million in arrears and spends far more to pay off its debt every year than it earns in exports of goods and services. But if the overall strategy succeeds, Uganda could cut its debt service payments to less than one-half the revenue it earns from exports. External arrears would fall to $80 million.

The overall strategy calls for year-by-year rescheduling of eligible Paris Club debt, maximum annual debt deferral and write-off or long-term rescheduling of arrears and debt owed to bilateral creditors outside of the Organization of Economic Cooperation and Development. It also includes buyback of uninsured commercial debt and obtaining bilateral donor assistance for servicing multilateral debt.

### Debt Strangling Economy

Tackling external debt is crucial for economic recovery in this East African country of 17 million people. Uganda's debt has discouraged many trade suppliers from selling the country vital imports like agricultural equipment, raw materials and petroleum.

Despite the shortages, Uganda's economy has grown on average by more than 5 percent a year since the current government assumed power in 1986, fueled largely by the government's program of policy reform and rehabilitation investments.

**"This debt agreement enables Uganda to start off with a clean slate with its trade suppliers."**

**—Kapil Kapoor**

Under the program, the government has placed its exchange and trade system on a market-based footing, liberalized import and export procedures and introduced competition into the marketing of coffee and other crops. Price controls have been eliminated, tax collection has been targeted for improvement and investment has been promoted through a new investment code. The program has also helped rehabilitate infrastructure, reduced the number of ministries and improved controls on public spending.

Still, Uganda needs to do more, Kapoor says. To keep growing, it needs to continue to improve macroeconomic management, introduce market incentives for production and further improve its private investment climate. Uganda also needs to strengthen the financial sector to help businesses, farms and households, improve management of public revenue and spending, improve infrastructure and make the civil service more efficient. Environmental issues also need attention.

### Heavy Borrowing in the 1980s

Today, Uganda ranks among the poorest countries in the world with a per capita income of $160. But Uganda was not always that poor. Its poverty reflects several years of despotic rule, which wreaked havoc on the country, and the collapse of coffee revenues.

When it achieved independence in 1962, Uganda had one of the most vigorous and promising economies in sub-Saharan Africa. Favored with a good climate and fertile soil, the country was self-sufficient in food. Both agriculture and industry earned large foreign exchange revenues and resulted in a current account surplus.

But the regime of former leader Idi Amin radically reversed the economic and social progress attained since independence, and the ensuing civil strife cost thousands of lives. Between 1970 and 1980, Uganda's output fell by 25 percent, exports by 60 percent and imports by one-half. Large defense expenditures made the government budget unmanageable which prompted borrowing.

Much of the debt also traces back to the collapse of the International Coffee Agreement in 1989 which sent coffee export earnings plummeting. Before 1989, coffee revenue totaled $365 million and paid for 70 percent of the country's imports. Now, it brings in $117 million and covers 28 percent. To make up for the lost revenue, Uganda resorted to heavy foreign borrowing.

Since 1987, the government has been implementing a comprehensive recovery and adjustment program, which promises over the medium term to restore the country's economic health.



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**OPINION**

*The US may be unwittingly slowing the pace of reforms in Kenya by suspending much of its military and economic assistance to that country*

# Kenya Seeks to Please US

**By Stephen D. Hayes**

DURING his presidential campaign, Bill Clinton emphasized that a linchpin of his foreign policy would be strong support for strengthening democratic institutions around the world.

President Clinton now has a golden opportunity to put some money where his promises have been: Kenya. The new foreign-policy team in Washington – and the media – are heavily focused, as they should be, on such hot spots as Bosnia, Somalia, and Russia. But it is in nations like Kenya, where the struggle for genuine democratic and economic reforms is now joined, that the United States has an opportunity to consolidate some solid advancement.

Unfortunately, that opportunity is not being seized. The State Department is watching and waiting for "signals." The US may now be unwittingly slowing the pace of reforms in Kenya. In a 24-month period, Washington suspended much of its foreign military and economic assistance to Kenya and changed the "rules of the game."

In November 1990, President Bush signed legislation that established four criteria Kenya needed to meet before economic and security assistance could be resumed. In March 1991 the administration, in response to congressional concerns, expanded the foreign aid suspension to include "prior year" security assistance appropriations. In November of 1991, the US – in concert with other donor nations and multilateral organizations – suspended close to $350 million in economic assistance pending a series of additional economic and "good governance" reforms on the part of Kenya.

One month later Congress passed legislation expanding the original four criteria to five. Assistant Secretary of State Herman Cohen, testifying in June 1992 before the House Foreign Affairs Committee, added yet another dimension by explicitly linking the resumption of aid to the holding of elections and the acceptance of international election monitors.

Finally, last October Congress passed yet another piece of legislation further changing the steps Kenya must take before security assistance can be resumed.

As seen from Nairobi, the challenge of trying to "satisfy" Uncle Sam is like playing football with the goal line moved farther back after each series of downs.

Kenya is by no means an open, pluralistic society when measured against the American yardstick. But it certainly is when measured against most of its African neighbors. Most important, Kenya is moving in the right direction. The government has released its political prisoners (condition one). It has made significant strides in improving the treatment of prisoners (condition two), and taken significant steps to restore the independence of the judiciary (condition three) and restore freedom of expression and ease freedom of movement (conditions four and five).

**To understand how far Kenya has come, it is instructive to remember that opposition political parties were illegal only 15 months ago.**

To understand just how far Kenya has come, it is instructive to remember that opposition political parties were illegal in Kenya only 15 months ago. Yet on Dec. 29 the nation held multiparty elections.

Incumbent President Daniel arap Moi retained power with a plurality of 36 percent. The three major opposition candidates received a combined total of 63 percent.

Was the election totally free from corruption and administrative problems? It was not. Was it a major first step on the road to genuine democracy? Without a doubt. President Moi was returned to power, not because of any ballot rigging but because the opposition was so splintered. That same election saw the defeat of 15 members of Moi's cabinet; opposition parties captured 44 percent of the seats in Kenya's parliament – the highest opposition representation of any legislative body in Africa.

Yet weeks have passed while the State Department "analyzes the situation" and continues to withhold important economic and security assistance from Kenya.

In addition to fostering democracy and economic growth, there is now another US interest in Kenya: Somalia. There are more than 300,000 Somali refugees in northern Kenya, and Moi's government is struggling at great cost to care for that tide of humanity.

Kenya provided the port facilities and airfields from which the US launched its military airlift of food into Somalia last summer. Looking to the future, Mr. Cohen said: "Following the departure of the US military and various short-term relief organizations, it will be the responsibility of the Kenyan government to be the first to respond to any future crises.... Now is the time to encourage and prepare the Kenyans to fully embrace that responsibility."

Clinton and Secretary of State Warren Christopher have an opportunity to send a signal quickly and clearly. Releasing already-appropriated but long-impounded aid to Kenya will signal continuing strong American interest in and support of multi-party democracy in Kenya. That process only begins with an election, and the US needs to promote further gains by shifting its approach from the "stick" to the "carrot."

Continuing US assistance will help Kenya play a stabilizing role in the Horn of Africa. Finally, such a decision will demonstrate that the Clinton administration is really serious about building democracy around the world.

■ *Stephen D. Hayes served as director of external affairs at the Agency for International Development in the Bush administration and was in Kenya and Somalia in August during the initial US military airlift of food into Somalia.*

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*William T. Close*

# Mobutu's Bloody Grip

The two armies in Zaire plunder and kill differently. The soldiers of the "regular" army have little or no ammunition. They loot in Kinshasa's sprawling slums and are as hungry and alienated from President Mobutu Sese Seko as the people they beat with rifle butts. They carry away their booty on their heads. In contrast, Mobutu's well-armed Special Presidential Division uses tanks and trucks to haul away the contents of the wealthier homes belonging to foreigners or members of the opposition. Then, during the night, Mobutu's elite seal off the city and go on a killing orgy against the rest of the army and their families. Thus does Mobutu "restore order," leaving hundreds of dead and wounded in a city where there is no medical care and now no food.

In response to the killing of the French ambassador and the continued threat of murder and mayhem, French and Belgian troops were once more briefly dispatched to protect their citizens in Kinshasa. Prime Minister Tshisekedi has called for the intervention of foreign troops. The High Council of the Republic, the democratic transitional parliament headed by Archbishop Monsengwo, has been forbidden by Mobutu to meet. Mobutu, ally of the United States during the Cold War and friend of George Bush, has once more successfully hammered to a standstill the process of democratization in his starving and bleeding country.

How does Mobutu stay in power?

(1) He uses his Special Presidential Division to enforce his will against the rest of the army and the population, and he controls the National Bank, thus effectively hamstringing Prime Minister Tshisekedi's democratically chosen government.

(2) He exploits the persistent split and antagonisms existing in the opposition political parties hostile to his dictatorship.

(3) He takes advantage of the fact that the U.S. government is still reluctant to take forthright action to assist the democratic forces in ousting him.

No one, not Tshisekedi or any other opposition leader, will be able to function as head of a transition government so long as Mobutu controls the SPD and the bank.

The army's discontent and violence are a well-planned maneuver by Mobutu to frighten away the Europeans so that, whatever brutal methods he uses after their exodus, he can act at will behind closed doors or closed frontiers to eliminate with systematic ruthlessness all those who oppose him. It is wholly in character for Mobutu to blame Tshisekedi for the army's killing and looting over the past few days. He will then have an excuse to fire him and take over the country with his elite troops to "restore order." Today, assemblies of more than five people are forbidden, effectively muzzling the High Council of the Republic, and press censorship guarantees that no articles against Mobutu will be printed.

George Bush steadfastly refused to play an open and forthright role in opposing Mobutu's tyranny. He may have had his personal reasons for this, or he may have followed Gen. Brent Scowcroft's advice that Mobutu was needed in Zaire to "control the army." This "control" has now been seen to condone killing and pillaging by the "regular" army, and to encourage systematic looting under cover of darkness by his Special Presidential Division. President Clinton has stated that his administration will not coddle dictators. Surely the new administration can declare in the strongest terms that Washington's pussyfooting around Mobutu is at an end. Freezing the financial assets—wherever they may be—of Mobutu and his enforcers, and imposing a fuel embargo on his country, are measures that need to be taken.

*The writer is a doctor who spent 16 years in Zaire. He was personal physician to Mobutu Sese Seko and chief doctor for the Congolese army.*

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**OPINION**

*President Mobutu grasps Zairian purse strings, stashing funds abroad and managing to outmaneuver those who desperately seek to depose him*

# Zaire's Tyrant Hangs On

**By Steve Askin**

CAN sanctions influence a despot who doesn't care if his people suffer? That's the question facing the United States, France, and Belgium as they belatedly try to help the central African nation of Zaire escape the grip of one of the world's most successful embezzlers, President Mobutu Sese Seko.

Diplomats from these three traditional Mobutu allies are already discussing ways to leverage a transfer of power to Zaire's transitional parliament. Regrettably, the tactics receiving most serious consideration – such as a freeze on Mr. Mobutu's vast foreign financial holdings – won't do the trick.

To act effectively, the West needs sophisticated understanding of Mobutu's system of "kleptocracy," government by theft. Throughout his 28-year reign, Mobutu has treated the Zairian state as if it were his personal business.

A former accounting clerk for the Belgian colonial army, Mobutu became army chief soon after independence in 1960. He soon made himself a millionaire by diverting funds donated by the US and United Nations to pay his army. My own research, which draws on confidential World Bank studies and other highly credible information sources, suggests that Mobutu has diverted several hundred million dollars a year from Zaire's treasury, foreign-aid receipts, and mineral-export revenues.

Past attempts to restrain Mobutu ended in utter failure. The last serious fiscal crackdown came in the late 1970s, during the human rights-minded Carter era. The International Monetary Fund (IMF) sent a strict German banker, Erwin Blumenthal, to oversee the Zairian Central Bank. Mr. Blumenthal could not stop Mobutu's illegal diversions of Central Bank funds to overseas personal bank accounts. He left in frustration, declaring that "the corruptive system in Zaire, with all its wicked and ugly manifestations, its mismanagement and fraud, will destroy all endeavors" for change.

The most likely future gambit was spelled out in late February by US Rep. Lee Hamilton (D) of Indiana, chairman of the House Foreign Affairs Committee. He urged a US freeze on Mobutu's personal bank accounts, Zaire's suspension from the IMF, an arms embargo, and an embargo on Zairian copper and cobalt. But these proposals will fail unless modified and broadened.

Freezing Mobutu's personal bank accounts will have little impact. At minimum, he has transferred tens of millions of dollars to the foreign bank accounts of his friends and family. The freeze will be useless unless these individuals also are targeted. An effective freeze must also encompass real estate holdings in more than a half-dozen countries; equity investments in banks, resorts and other business ventures; the suspected safe deposit boxes full of diamonds; and a host of other assets.

Moreover, an ill-conceived freeze might keep Mobutu in power by denying him an exit route. Mobutu confidantes say he is haunted by the prospect of a Marcos-like unhappy exile, hounded to the grave and beyond by a new government bent on suing him and his family to recapture ill-gotten wealth.

A FREEZE on bank accounts is thus both too weak and too strong. To speed Mobutu's departure from Zaire, Belgium, France, Portugal, and other nations where Mobutu holds property should begin legal proceedings to seize his ill-gotten holdings. To that stick, however, they should tie a carrot: limited immunity from prosecution if Mobutu relinquishes power and accepts permanent exile.

Suspending Zaire from the IMF could be a very slow process. Far swifter action is needed to stop the cash flows that sustain Mobutu's day-to-day grip on power.

The world banking community must awaken to the fact that Zaire's Central Bank, illegally occupied by a Mobutu appointee in defiance of the transitional parliament, is a rogue institution that currently serves largely to launder diamond-smuggling proceeds. Instead of waiting for formal IMF suspension, all international funds transfer systems should immediately sever all links to the Central Bank. In addition, a global embargo should be imposed on delivery to Zaire of the currency notes, printed abroad, which Mobutu uses to pay his army. These two simple financial maneuvers could instantly cut Mobutu's control over Zairian state purse strings.

An arms embargo is useful but insufficient, because Mobutu's power rests on weapons already in Zaire. Mobutu controls the soldiers, defying parliament's assertion of military primacy, only to the extent that he pays their salaries. If some Western nation gave Zaire's parliament enough funds to meet the army payroll, most soldiers would speedily switch their allegiance.

Because Mobutu's destructive regime has already brought the copper and cobalt mines to a virtual standstill, diamonds are the commodity to embargo. This won't be easy, since any smuggler can carry several hundred thousand dollars worth in his or her pocket. Nonetheless, authorities in Antwerp, Tel Aviv, New York, and other major diamond cutting centers should have relatively little difficulty pinpointing the major buyers and sellers of Zairian precious stones. If an embargo were coupled with close observation of Mobutu's customers and harsh prosecution when violators are caught, they will quickly turn to other diamond sources.

These proposals lack precedent in the history of international economic sanctions. Yet nothing less will succeed if the world really wants to help the Zairian people escape Mobutu's grip. Nothing less can save Zaire from the murderous civil war that will soon begin if Mobutu cannot be removed by peaceful means.

■ *Steve Askin is co-author, with his wife, Carole Collins, of a forthcoming book titled "Zaire: The Theft of a Nation."*

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BY MELINDA HAM

# ONE YEAR ON

More than a year after democracy came to Zambia, living standards have fallen, health and education programs have deteriorated—but economic reform is on track and Zambians have easily embraced a new democratic culture. While the government of Frederick Chiluba (below) pledges to try to mitigate the effects of structural adjustment, even critics admit that the building of a democratic society takes time.

Sarah Jane Poole

Just over one year has elapsed since trade union leader Frederick Chiluba stood on the steps of the Lusaka supreme court, beside white-wigged judges swathed in black and red robes, and was sworn in as Zambia's second president since independence from Britain in 1964.

In that one year, Chiluba's Movement for Multi-party Democracy (MMD) government has made major economic strides in the midst of the worst regional drought this century and initiated a new democratic culture promoting freedom of speech and expression for every citizen.

But few of Zambia's 8 million people have benefited materially from the new government. Most people's living standards have rapidly deteriorated and literally millions have been impoverished. Few improvements have been made in health and education, which remain in a state of decay.

As Finance Minister Emmanuel Kasonde admits, "Our government has not been sufficiently sensitive to the social effects of the structural adjustment program. We have been trying to lay the foundation for economic

*Melinda Ham is a Canadian freelance journalist based in Lusaka, Zambia.*



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growth, but our success has been at the cost of human suffering."

Kasonde also points out that his government started from a severe disadvantage: "The MMD inherited a dismal economic scenario. Zambia had a bad name, few international friends, and an uncertain future."

Just weeks before the October 31, 1991 election, the World Bank had frozen aid to former President Kenneth Kaunda's government and other donors followed suit, while the country's international debt stood at $7.5 billion. The treasury was empty, social services were collapsing, and giant state companies controlled 80 percent of the economy.

Melinda Ham

Melinda Ham

But Chiluba's government wasted no time and within a month in office, it had begun restoring relations with donors, the World Bank, and the International Monetary Fund. At the March Consultative Group meeting in Paris, Zambia received pledges worth a staggering $1.2 billion and is currently the largest recipient of British and Japanese aid on the continent. Then at the Paris Club meeting in July, bilateral donors cancelled $950 million of Zambia's international debt.

"Zambia held democratic elections just at the time when most donors were rating 'good governance' high as a condition for aid. It was Zambia's lucky coincidence," says one European diplomat.

The government has bravely implemented its structural adjustment program agreed upon with the World Bank and IMF. All subsidies, even on the staple food, maize meal, have been cut—a move which caused riots under Kaunda—as the government turns the economy over to free market forces.

Industries and factories now can easily obtain foreign exchange to import spare parts, machinery, and raw materials, and shops are filled with imported goods, from cassette players to Italian olives.

The government has also taken initial steps toward privatizing the 152 state companies by passing a Privatization Act and opening bids for the first 17 companies, which include a jeweler and an agricultural equipment dealer. The response—more than 320 pre-tender applications—was unexpected. All state companies eventually will go, including Zambia Consolidated Copper Mines, which earns 95 percent of the country's foreign exchange annually. Foreign investors have flocked into the country, bringing with them more than $200 million of new investment.

"Our single biggest achievement is to have continued to implement our structural adjustment program at the same time as administering drought relief, without one program tampering with the other," claims Vernon Mwaanga, minister of foreign affairs.

Tony Mornement, the Lusaka-based representative of the World Food Program, says that Zambia has "the most successful drought relief program in southern Africa." Chiluba declared a national emergency weeks before any other affected country and Agriculture Minister Guy Scott began ordering the 1 million tons of maize needed to feed the people.

Much of the imported maize is being sold commercially. The 1.7 million people who had total crop failure are not receiving free hand-outs as they would have under Kaunda's government. Instead, 26 committees of the program to prevent malnutrition (PPM) have been set up by church groups and non-governmental organizations in the worst affected areas to administer the aid through "food-for-work."

These programs are organized from the grassroots upwards. Village headmen discuss with their villagers which projects are the priority in their area, such as repairing roads, digging boreholes, building clinics and schools, or fixing dams. Then the villagers work five days a week and get paid with a ration of food to feed five people.

Although at first glance these programs may seem like chain-gang labor, the people who participate are very enthusiastic and they have contributed to the MMD's popularity in the rural areas.

"Our community will have something lasting to show for our effort as well as us all receiving food equally. Under Kaunda, you only got food if the village headman liked you," says Nelson Mulongo, a farmer whose total peanut, sunflower, and maize crops failed and 16 of his 20 cattle died in the drought.

Scott attributes much of the program's success to the democratic environment. "If people in some areas are not receiving enough food or if there is corruption, they go to the media and shout about it. So far, not a single person has died of starvation. But on the flip side, some issues have also been blown out of proportion."

But the response to the MMD in the urban areas, where more than half the population lives, is not as favorable. The government has failed to control inflation which has spiralled to over 120 percent—double the target—and the kwacha has been devalued to one-fifth of its previous



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worth in the last year. Wages have not kept pace, so most people struggle to buy even the most basic goods.

Margaret Nkunka is a cleaner in a downtown Lusaka office and a widowed mother of three. She earns about $44 a month and spends about two-thirds on food—mealie meal, vegetables, and the occasional piece of meat—and the remaining third on rent. "I have nothing left to save and if I have to buy a school uniform or something else I'm in trouble," she says.

In line with the structural adjustment program, the government is rationalizing the over-bloated civil service and the Zambia Consolidated Copper Mines, which will involve the retrenchment of more than 25,000 workers. This, combined with the inevitable redundancies when state companies are sold—which could run as high as 45,000 workers—will cause untold suffering for thousands of Zambian families.

Health services and education have not received the attention that the MMD promised in the election campaign. Some hospitals have more drugs and schools more desks, but despite these negligible physical improvements, the crumbling infrastructure remains unchanged and more emphasis needs to be placed on training teachers and on increasing the motivation of medical personnel and improving conditions of service.

In November, the country was hit by a national disaster when over 500 people died of cholera in the copperbelt town of Kitwe over two weeks that could have far-reaching political implications. It was Zambia's worst cholera outbreak in one area in such a short period of time.

The health minister, Dr. Boniface Kawimbe, blamed the epidemic on broken-down equipment at the sewage and water treatment plants and a lack of chlorine. But fingers also were pointed at Minister of Local Government Michael Sata for failing to nip the epidemic in the bud by repairing the water system before the onslaught of the rainy season exacerbated the crisis.

ZCCM took over the water works to do emergency repairs and chlorinate the water, while army trucks carried the dead from the congested mortuaries to burial in mass graves in Kitwe cemetery.

In an open letter to President Chiluba in the state-run *Zambia Daily Mail*, Lusaka resident Rosemary Nsofwa said: "If health is not a priority in Zambia today and if you, Mr. President, cannot mourn for all the human suffering we are facing, you are not fit to be our leader. Resign."

Finance Minister Kasonde promises that the 1993 budget will give "a larger slice of the national cake" to both education and health, and that Zambians will be given a "peace dividend" as defense spending—for a country which has never fought a war—will be drastically cut.

The official opposition, Kaunda's United National Independence Party (UNIP), which has 25 of the 150 parliamentary seats, claims that politically the MMD has made little progress toward democracy. UNIP spokesman Rabbison Chongo says, "Zambia can be credited as a model of democratic and peaceful transition in Africa, but we are not a model of democracy in action."

And to some extent, some Western donors agree. "The MMD has achieved economic wonders in very adverse circumstances in the last 12 months, but all the ingredients of a democracy are not in place," says one.

Fred M'membe, the managing editor of the only privately owned newspaper, *The Weekly Post*, argues: "The MMD has achieved a lot. It has created a new democratic culture where any Zambian is free to say what he wants, but the government is also free to challenge him back." The cost of this freedom is the dozens of libel writs which have piled up against *The Weekly Post*, but M'membe says smiling: "We haven't lost a libel case yet."

One problem is that there is little credible opposition to the government in any form. The only two daily papers and the sole television and radio station remain in government hands, although there are plans to privatize them soon. The church-owned *National Mirror* and *The Weekly Post* represent the only independent press and their circulation, like those of all newspapers, is decreasing because of the decline in readers' purchasing power.

Although there are more than 30 small opposition parties, none of them have a substantial following or offer alternative policies to the government. UNIP is the only one with any national structure and it was so heavily discredited and defeated in last year's general election, it is unlikely to make a comeback for some years. Lobby groups are few and ineffectual on major policy issues. Trade unions—formerly the only opposition in Kaunda's one-party state—have lost a lot of steam now that their charismatic leader, Chiluba, is the national president.

The police are another area of concern, as they still retain wide-reaching powers under the Preservation of Public Security Act to ban demonstrations, which the MMD promised to repeal. At least 30 criminal suspects have also been shot dead since January, which demonstrates blatant disregard for basic rights.

One diplomat said: "We are concerned about Zambia's slip-ups on human rights. But in comparison to some other African countries, Zambia's abuses are nothing to lose sleep over."

So the MMD has survived united through this first year of the political teething pains of democracy, even though many critics thought the disparate movement of church leaders, trade unionists, and businessmen would fall apart after it ousted Kaunda.

Only two out of 27 cabinet ministers have resigned and both on unsubstantiated claims of corruption. The former minister of works and supply, Ephraim Chibwe, also was sacked for accepting kickbacks on contracts, while the former minister of information, Stan Kristofar, was fired for making racist remarks.

As M'membe says: "Because of donor pressure, the MMD had few options to choose from, but the route they have taken seems to be the best. The government must battle to look after those impoverished by economic reforms, and respond to public opinion. There is no other way in a democracy." ○



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*Civil war and famine in the Sudan have driven 100,000 members of the Dinka tribe from their homes in the south of the country. These Dinka (top, left and below, pausing in a friendly village) crossed the Nile en route to a site where, with help from a German aid organization, they carved a camp out of the bush. Most of the area is controlled by the rebel Sudan People's Liberation Army, which is fighting the Islamic fundamentalist military regime in Khartoum.*

# Disaster ir The Sudar

By Lori Grinker

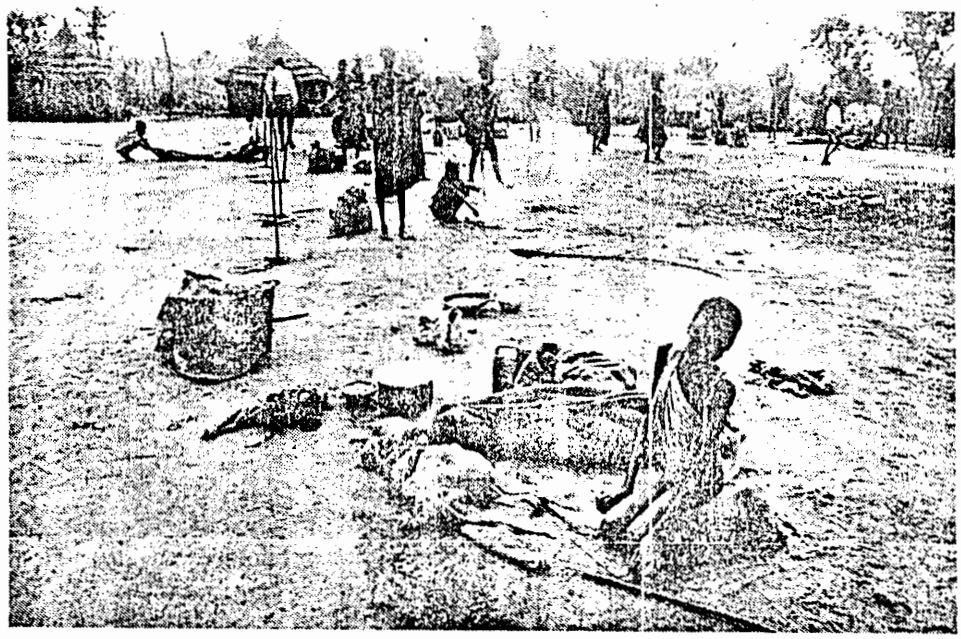
Pope John Paul II, in a visit t Sudan on Wednesday, drew a tion to what had been virt invisible: the 10-year civil w the Christian and animist that far outstrips even slaughter in the former Yugoslavia. Th data are hard to come by, specialists esti that the violence, aggrav by famine, has taken as r as 600,000 lives and upr at least 6.75 million peopl

"The world was late in r ing the Somalia disaster," Africa Watch, a human r organization. "Meanwhil comparable disaster has unfolding in the Sudan."

I visited the southern S in October and saw migr members of the Dinka displaced by the fighting trying to escape hunger, s a month on foot seeking sa The famine has resulted natural conditions, the war failed Government agricu al policies. In most villag the south, there is no run water, no electricity an currency.

The tragedy of families ing to flee the war zone is plicated by the intense e fighting among rival groups and tribes in the s

The Dinka who were i viewed said they were fle massacres inflicted by



Photographs by Lori Grinker

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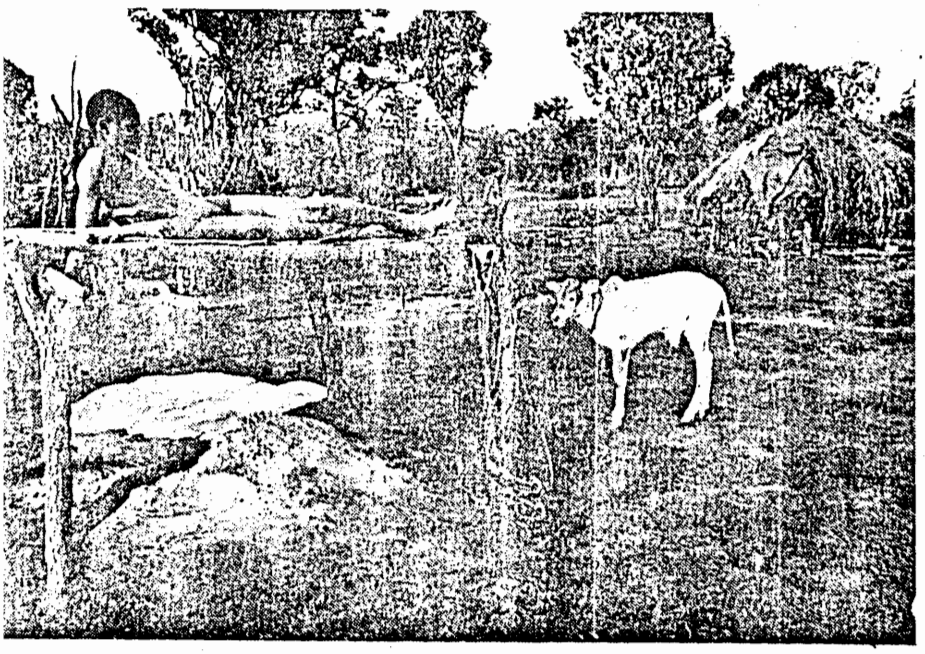
# War, famine and six million uprooted.



*To keep malarial mosquitoes away, a Dinka tribesman burns cow dung (above); many Dinka lost family members and cattle in raids by another tribe, the Nuer. Some children, too weak from malnutrition to walk, are carried by others (lower left). With no tools, a Dinka (lower right) bites off sorghum, which a farmer gave him in exchange for weeding.*

Nuer tribe because of tribal and political differences. They told of the Nuer throwing grenades in huts, disemboweling victims and smashing children's heads before throwing them down wells.

Most of the Dinka were dressed in rags and many were naked. I saw one woman clothed in a circlet of leaves. They said they felt ashamed to be seen this way.

The plight of the Dinka and other Sudanese exemplifies what the French organization Médecins Sans Frontières (Doctors Without Borders) had in mind in its recent book "Populations in Danger."

It said the Sudan "has become smothered by a curtain of silence: the faint echoes which reach us have become almost inaudible. Nevertheless all evoke massacres, famine and forced displacement of population." It continued: "The indifference of the international community to the tragedy can only encourage the 'final solution' to the Sudanese problem."

The Sudan declared itself an Islamic nation in 1991, two years after the military regime of Gen. Omar Hassan al-Bashir came to power in a coup. The regime in Khartoum in the Arab north has fought the Sudan People's Liberation Army in the African south since 1983, when Islamic law was first imposed on the country. The country of 26 million people is primarily Muslim; the Vatican says it has two million Roman Catholics.

*Lori Grinker, a photographer with Contact Press Images, has visited Africa five times.*

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OPINION/ESSAYS

# Ivory Coast's Sad Story

By Stephen D. Hayes

THE Agency for International Development is an agency that has, almost literally, been studied to death. Last month Clifton Wharton, the new deputy secretary of state, announced yet another "special" 90-day study of the United States foreign aid program.

Before concluding their review, Mr. Wharton and his colleagues would do well to look closely at the case of the Republic of the Ivory Coast. The economic saga of that country forcefully illustrates what has happened in much of the third world in the last decade, and where the West should – and should not – look for solutions.

The story starts in the 1960s. With strong encouragement from the World Bank, the International Monetary Fund, and other Western institutions, Ivory Coast set out on an ambitious course to grow and export coffee and cocoa. The program worked, and Ivory Coast became a "country that worked."

By the mid 1970s, the country's gross domestic product was growing at nearly 8 percent annually; Abidjan, the nation's capital, was becoming a modern, regional commercial center, and Ivory Coast had the best road system in all of sub-Saharan Africa. By 1978, Ivory Coast was the world leader in cocoa production and was third in the world in coffee production.

Foreign exchange earnings supported infrastructure and economic development and the "Ivorian Miracle" was recognized throughout the world.

But something happened on the way to prosperity. The bottom fell out of world coffee and cocoa prices. By 1982, the price of Ivory Coast's exported coffee stood at $1.20 a pound, compared with $3.40 in the mid-1970s. Except for a brief upswing in prices in 1985-1986, both coffee and cocoa sales continued at low levels.

WHEN I met with Charles Gomis, Ivory Coast's ambassador in Washington, he had just been on the telephone with his consul general in New York, who reported that coffee prices on the New York exchange had fallen to 80 cents a pound – less than 25 percent of the market price 15 years ago.

The result of all this was predictable: Ivory Coast's public external debt is a staggering $14 billion. The country has experienced six consecutive years of declining gross domestic product. Per capita income has dropped from $1,150 in 1981 to around $700 today. In short, this once-shining example of market vitality has plummeted from a nation on the move to a nation in crisis.

What, if anything, should the US and World Bank do about Ivory Coast and the other Ivory Coasts of the world? A more flexible and creative approach to "providing assistance" is needed.

Ivory Coast is currently losing about $2 billion a year because of depressed export earnings. Mr. Gomis points out that if world market coffee and cocoa prices would rise only halfway back to their earlier levels, his nation could fund all the US economic assistance to the African continent and still have some $220 million for internal development.

At the moment, the World Bank is withholding important loans to Ivory Coast while bank official are pressing Abidjan to devalue its currency.

Everyone knows the currency is over-valued, but Ivory Coast participates in a currency regime with 12 other West African countries. Their franc is pegged to the French franc at 50 to 1, and Ivory Coast does not have the power to unilaterally devalue its currency, even if it wanted to. In the meantime it waits for World Bank financial support.

No one can wave a magic wand and instantly produce what Ivory Coast really needs: higher commodity prices. But the new US administration should understand that if it is to provide meaningful help, it will not be with the standard package of development "projects."

Real help will come in the form of creative financial approaches and debt relief through the willingness to at least sit down and talk about a possible US-Ivory Coast commodity purchasing arrangement.

In the short term, the Clinton state department would also do well to strongly suggest that the World Bank unlink currency devaluation demands from pending loans. Everyone is in favor of long-term structural adjustment. But without short-term relief, the governing institutions that can focus on the long term will themselves be under siege.

■ *Stephen D. Hayes served as director of external affairs at the Agency for International Development in the Bush administration.*

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# AID Requests PVO Input on Zimbabwe and Ethiopia

Before leaving on a three-week study mission to Zimbabwe and Ethiopia, an AID team of development planners and policy makers recently met with a large group of InterAction members that have programs in these African countries. The InterAction Africa Liaison Project staff arranged the gathering in response to a request from Margaret Bonner, director of the Office of Development Planning in AID's Africa Bureau. The purpose of the meeting was to provide a forum in which US-based PVOs could have input into AID's strategic planning process for Zimbabwe and Ethiopia.

Bonner explained that AID missions, in keeping with AID's focus and concentration policy, have been asked to identify two to four specific objectives that will limit the scope of their mandate and the programs they support. Since PVOs looking for AID mission funding will have to submit proposals which are consistent with the mission's objectives, Bonner encouraged the representatives to identify which issues AID should address in Zimbabwe and Ethiopia as well as any recommended changes in direction and priorities. Bonner indicated that AID planning staff are especially interested in PVOs' experience working at the grassroots level because it complements AID's work at the policy level. In addition, the AID missions in Ethiopia and Zimbabwe have been advised to establish a dialogue with local NGOs to solicit their suggestions for the missions' future plans and objectives.

The participants at the meeting then outlined the challenges their organizations have encountered working in Zimbabwe. Kevin Lowther of Africare stated that when they first implemented water, sanitation and agricultural projects four years ago, restrictions imposed by Zimbabwe's government made it impossible for PVOs working there to receive funding from bilateral agencies such as AID. All program funding had to be obtained from private, non-governmental sources. Later, during the time of the drought, the Zimbabwean government became more flexible about allowing PVOs to accept AID funds.

When asked about NGO counterparts in Zimbabwe, several PVO representatives agreed that there are some strong NGOs with whom the PVOs have had a positive working relationship, especially with regard to drought relief programs. Particular mention was made of the National Association of NGOs (NANGO), an NGO consortium in Zimbabwe, and the Organization of Rural Associations for Progress (ORAP). A number of the meeting participants also characterized the relationship between foreign PVOs and Zimbabwe's regional and district government offices as being cooperative.

While the PVO representatives described successful partnerships with Zimbabwe's NGOs and local government, they also emphasized the need for improved communication in Zimbabwe between PVOs, NGOs and bilateral agencies. Suggestions regarding the type of information to be collected by, and disseminated to, all these organizations included: US government policy and programs in Zimbabwe; resources available to PVOs and NGOs; and AID's goals and objectives in Zimbabwe. Additionally, it was recommended that AID, or an agency funded by AID, in Zimbabwe should assume the leadership role in bringing together PVOs and NGOs with representatives of the donor community.

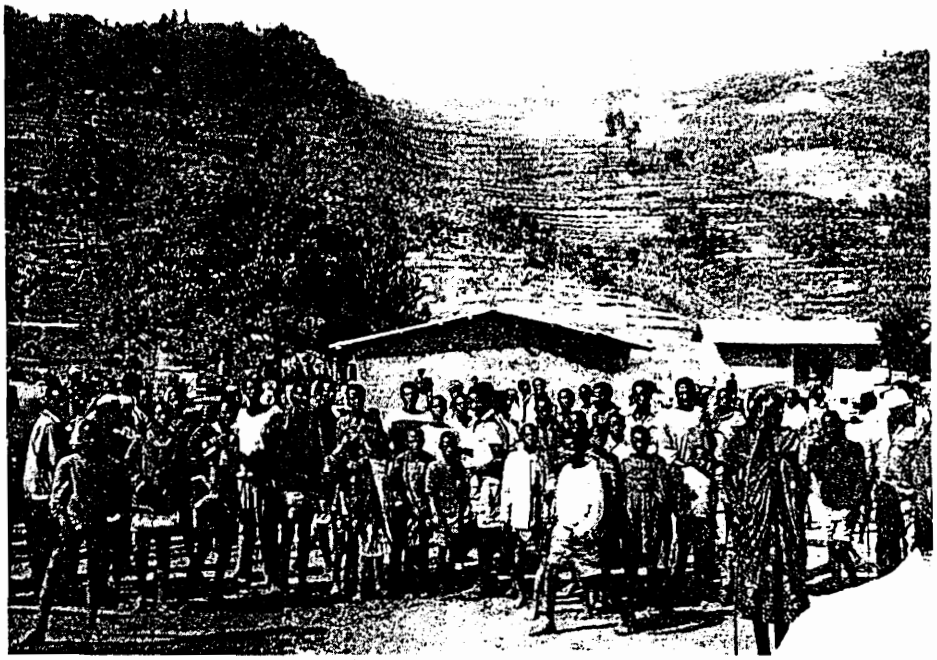
When the discussion turned to the situation in Ethiopia, there was a consensus among the meeting participants, including the AID personnel, that attention has now shifted from emergency relief to development. AID and PVO programs and funding are now being targeted to respond to this transition. Bonner gave the example of how the AID Ethiopia mission is now relying less on food for relief programs in favor of food for work programs. She also said that with respect to Ethiopia, which represents AID's largest program in Africa, AID has two simultaneous planning processes currently underway. One is focused on Ethiopia and the other on Eritrea, where AID has a staff member. According to Amdetsion Kidane of the Eritrean Relief Committee, there are still an estimated 200,000 internally displaced people in Eritrea in need of resettlement assistance.

Other PVO representatives then offered ideas regarding the ways in which AID's programs and policies in Ethiopia could be most beneficial to the PVOs and NGOs during the transition from relief to development. Several participants highlighted the importance of AID drawing upon their experience in other countries — Malawi was mentioned as one success story — as well as their record of close cooperation with the NGO community in Ethiopia, to provide guidance in the area of institution building. It was suggested that technical assistance and funding be used to strengthen the infrastructure of municipal institutions and local NGOs in Ethiopia, and that AID personnel conduct more field visits to best facilitate these activities.

A follow-up meeting will be scheduled in the coming weeks. For more information, contact Lisa Freund Rosenblatt at InterAction, 202/667-8227.

# A Quiet Emergency is Brewing in Rwanda

At a recent InterAction meeting, Levonne Harrell, an operations officer at the Office of US Foreign Disaster Assistance, briefed InterAction members on the current emergency in the central African nation of Rwanda. In just the past few weeks, a renewed wave of fighting in Rwanda has resulted in a tripling of the displaced population within this small central African nation. One million people — a fifth of the population of this most densely populated country in Africa — are currently living in crowded displaced persons camps.



**Displaced Rwandans are crowded into camps with little food or other supplies. A recent State Department cable warned the situation is "building to a catastrophe."** *Photo by Levonne Harrell*

A US State Department cable dated February 24 reports that "the food situation among the displaced is untenable and is building to a catastrophe. We need strong intervention now." It is estimated that less than 25 percent of the food requirements are being met.

In the turmoil during 1959-62 leading to independence, representatives of the majority Hutu — now 87 percent of the population — took control of the government from the Tutsi, who had been politically dominant despite their minority status. More than 20,000 Tutsi were butchered in the power struggle, and several hundred thousand persons fled as refugees to all surrounding countries. In October 1990, a force of exiles composed mostly, but not exclusively, of Tutsi invaded Rwanda from neighboring Uganda. This precipitated a vicious war which has left the rebels in control of much of northern Rwanda.

Despite human rights abuses against civilians, a cease fire between government and rebel armies had remained in effect since last July, and multi-party talks on power sharing reached an accord last month. The pact would likely have led to multi-party elections, were it not for violence in Rwanda's capital of Kigali initiated by supporters of the ruling party. In the wake of this rampage, renewed fighting and violence against civilians erupted, and the peace process was scuttled.

Non-governmental organizations are the backbone of the distribution system, delivering food, blankets, shelter material, and other supplies. NGOs currently working in Rwanda include CARE, Africare, Doctors without Borders, the Red Cross and others. The US government has donated non-food supplies such as plastic sheeting for shelter and blankets. Other donors, such as Canada, France, Belgium, and the EC have also contributed food and other supplies. Several UN organizations are involved, including the World Food Programme and UNICEF.

### Mozambique Foreign Minister to Meet PVOs

Dr. Pascoal Manuel Mocumbi, Minister for Foreign Affairs of the Republic of Mozambique, will be in Washington, DC the week of April 5 and has requested a meeting with PVOs. For further information, call Gerry Dyer at InterAction.



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WASHINGTON
ECONOMIC
WATCH

*A Digest of Development Policy Information*

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**SPRING 1993**
**ASIA**

Dear Readers:

Marking our fourth year in production, The Overseas Development Council is pleased to bring you the twelfth issue of the Washington Economic Watch: A Digest of Development Policy Information, a compilation of the recent U.S. policy debate concerning the developing world. ODC wishes to thank the World Bank, the U.S. Agency for International Development, and the Morgan Guaranty Trust Company of New York for their continued interest in this project.

This issue reflects the first 100 days of the new administration, including the debate over President Clinton's economic recovery plan for the United States, testimonies for and against the North American Free Trade Agreement, discussion of Western Aid to the Former Soviet Union, and analysis and commentary on privatization in developing countries and former centrally planned economies, among other issues.

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In the coming weeks you will receive a questionnaire to assess your institution's participation in the reciprocal publications agreement. ODC appreciates your institution's cooperation in this matter. We look forward to your correspondence and hope that you find this edition of the Washington Economic Watch to be a valuable resource for your institution.

Sincerely,

Christine E. Contee

Christine E. Contee
Director of Public Affairs
& Fellow

O | D | C

*Project of the Overseas Development Council*

John W. Sewell, President

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# ASIA

## ASIA

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NATIONAL ECONOMIES

# China's Open Economic Zones Are Speeding Its Transformation to a Market Economy

*One of the key aspects of China's reform efforts, initiated in 1978, has been the opening of its economy to promote modernization by using foreign capital and technology and by stimulating exports. A critical element of the Government's strategy to achieve these goals has been to designate a number of clearly defined areas as "open economic zones" in which outward-oriented activity will be promoted through foreign direct investment and trade.*

*In the following article, Michael Bell and Simon N'guiamba of the IMF Central Asia Department describe the various forms of open economic zones in China, their performance, and their impact on the Chinese economy in recent years.*

The policy to open up China's economy has been implemented in four stages. The first stage involved the establishment of four Special Economic Zones (SEZs) in 1979–80. The SEZs were to be more ambitious in terms of policies, activities, and geographical coverage than traditional export-processing zones. They were to promote production for export and facilitate imports of advanced technology. In due course they came to serve as "laboratories" for experimenting with market-oriented reforms. Enterprises operating in the SEZs were offered preferential treatment in terms of taxation, import licensing, and tariffs.

During the second stage, which began in 1984, these policies were extended to other areas: 14 coastal cities were authorized to establish "open zones" within their jurisdictions. The third stage involved the establishment of Hainan island as an SEZ in 1988 and the opening of the most ambitious of the economic development zones — Pudong New Area (in Shanghai)—in 1990. In the last stage, which followed senior leader Deng Xiaoping's initiative in early 1992 to accelerate economic reforms, preferential policies were extended to cities in inland provinces—particularly those along the Yangtze River valley—and a number of cities mainly on China's northeastern borders.

**A view of Shenzhen, the site of one of the four original Special Economic Zones.**

### Special Economic Zones

*The Original SEZs.* Ease of access to foreign markets was the basis for choosing the locations for the four original SEZs, which remained the only open economic zones in China through 1984. Three of the four are in Guangdong province: Shenzhen (near Hong Kong); Zhuhai (near Macao); and Shantou in the southeastern coastal area of the province. The fourth is located in Xiamen in the southeastern part of Fujian province.

An important difference between the SEZs and other areas of China is that investment decisions taken in the SEZs are largely outside the State Plan. Local authorities in SEZs are allowed to offer preferential policies to foreign investors, to develop their own infrastructure, and to undertake other investments, provided they can raise the funds. Enterprises in the zones may also make their own investment, production, and marketing decisions. This relative autonomy has been an important factor in attracting investment into the SEZs—both from other areas of China and from abroad.

Enterprises operating in the zones comprise:

- state enterprises, including those owned by local authorities or by authorities of other provinces; and
- foreign-funded enterprises (FFEs), including wholly owned enterprises.



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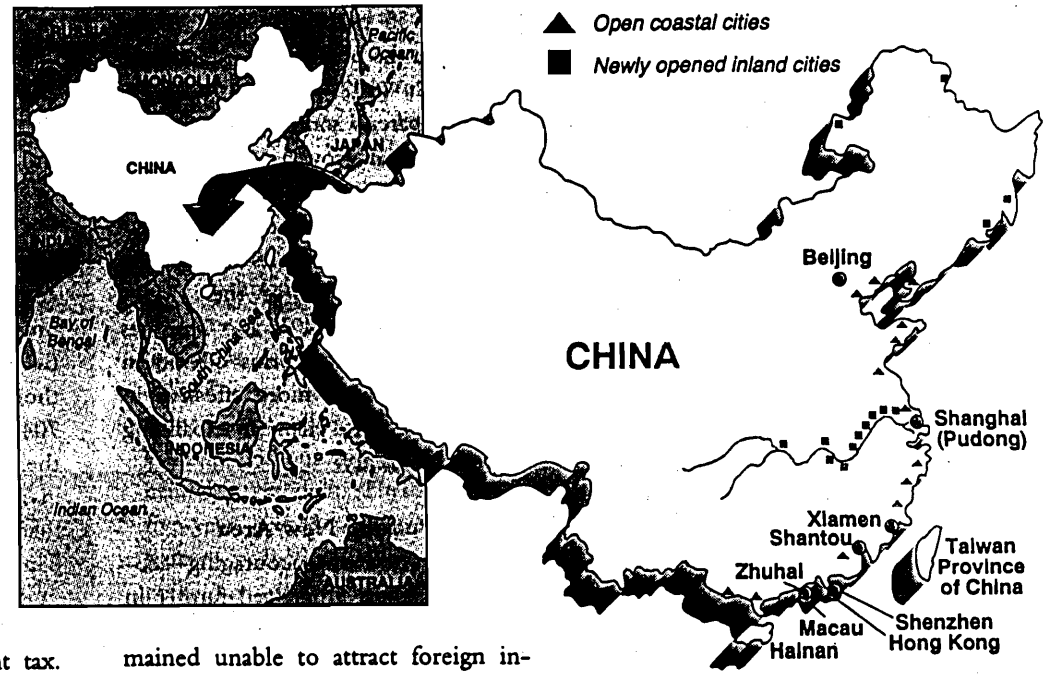
equity joint ventures, and contractual joint ventures (enterprises managed by foreign partners under contract).

FFEs operating in the zones generally make their own decisions with respect to their organizational and personnel structures, wage systems, and the hiring and firing of employees. With the authorities' approval, they may sell part of their output in the domestic market.

*FFEs enjoy* a tax holiday for the first two years. During the next three years, they pay 7.5 percent tax on their profits. Subsequently, they (as well as domestic enterprises in the SEZs) are subject to 15 percent tax. The tax rate outside the SEZs is 33 percent for FFEs and 55 percent for domestic enterprises.




During 1980–85, starting from a very low base, the four original SEZs attracted substantial foreign direct investment to develop their basic infrastructure and to initiate industrial production. In 1985, for instance, they accounted for more than one-third of all actual and planned equity joint ventures in China. Their performance was also impressive in subsequent years in terms of exports, foreign direct investment inflows, and industrial output: between 1987 and 1991, the value of their exports more than doubled to $9.6 billion (about 13 percent of China's total); their contracted foreign investment increased eightfold; and their industrial production rose by more than 35 percent in 1991 alone. Provisional data for 1992 indicate substantial further increases in activity.

*Hainan.* Hainan island, which was one of the poorest regions of China through the mid-1980s, was designated a "special area open to foreign investment" in 1983. However, it remained unable to attract foreign investment mainly because of poor infrastructure. But as labor costs rose in Guangdong, Hainan—with its abundant cheap labor—developed into an attractive site for foreign investment in labor-intensive activities.

In 1988, Hainan was designated China's largest SEZ and began to focus more on export promotion and on attracting foreign investment. Its preferential policies are more generous than those of the other SEZs. For example, it is one of the few areas where foreign exchange earned through merchandise exports and other business transactions can be retained in cash, regardless of ownership. Among its other advantages are low land prices and policies that permit free movement of goods and capital.

Hainan is experimenting with a market-oriented system of economic management. One aspect is that trading in land-use rights is permitted: the authorities can lease land owned by the state for up to 70 years, and domestic and foreign investors are allowed to engage in land development. Its authorities are empowered to approve projects whose total investment is less than $30 million. They may also issue bonds with the approval of the State Council.

During 1988–91, Hainan's economic development accelerated. It attracted substantial financial inflows from other provinces and from abroad, its exports more than doubled, and its per capita income caught up with the rest of China. By the end of 1991, it had approved the establishment of more than two thousand foreign-funded enterprises with a total value of contracted foreign investment amounting to $394 million.

### Open Coastal Cities

Encouraged by the success of the original four SEZs, the Chinese Government decided, in April 1984, to open 14 larger, established coastal cities to foreign trade and investment. At the time they were chosen, these cities were relatively well developed in terms of industry, infrastructure, and technical and managerial expertise.



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The authorities of the 14 coastal cities can approve construction and industrial projects involving foreign investment that does not exceed $5 million ($10 million for Dalian and $30 million for Tianjin and Shanghai). Nonmanufacturing projects involving foreign investment are not subject to upper limits but must be financed mainly by foreign resources.

The coastal cities offer foreign investors most of the preferential policies prevailing in the SEZs. The main difference relates to the corporate income tax, which is generally 24 percent in the cities, although some types of projects are eligible for lower rates.

Certain areas within most of the 14 open coastal cities have been designated Economic and Technical Development Zones (ETDZs). These zones are often located near the harbor and are designed to provide basic infrastructure for the establishment of new enterprises. The ETDZs enjoy the same tax concessions as those offered in Special Economic Zones; these concessions are limited in other parts of the coastal cities.

The economic performance of the 14 coastal cities has varied. Although industrial growth in 8 of them was higher than the national average during 1984–90, that in all the cities taken as a group was well below the national average. The dollar value of the cities' exports (excluding exports from ETDZs) rose by 10 percent in 1991 and by about 15 percent in 1992—close to the national average. The value of foreign direct investment contracted by the 14 cities increased by nearly 35 percent in 1991 (compared with the previous year) and then threefold in 1992.

The apparent contrast between the slow industrial growth and the rapid export expansion in the 14 open coastal cities reflects their initial relatively low level of exports and the obsolescence of many of their long-established industries. It also indicates that the preferential terms offered in ETDZs have been more effective in increasing exports than in expanding industrial capacity.

**Photo Credits:** Denio Zara and Padraic Hughes for IMF; pages 113, 123, and 125. Shenzhen Investment Guide, page 114; Pudong Development Office of Shanghai, page 117.

### Pudong New Area

China's policy of encouraging economic openness progressed further in April 1990, when the Pudong New Area of Shanghai was selected to become an open economic zone that would enjoy policies more flexible than those already in force in the four original SEZs. The Pudong New Area was expected to lead the opening up of the Yangtze River valley and to be the focal point of China's development during the 1990s. The authorities envisaged that, in the process, Shanghai would become a major economic, trading, and financial center for China—and indeed, for all of Asia.

Pudong's development aims at establishing a finance and trade zone, an export-processing zone, a free trade zone, and a high-technology park. Pudong differs from the original SEZs in that its preferential policies are broader in scope. Notably,

- foreign business is allowed to engage in retail sales;
- foreign-owned enterprises can trade their foreign exchange freely;
- foreign insurance companies may be established;
- foreign enterprises can build and operate port facilities;
- approved enterprises can engage in foreign trade without restrictions within a certain subzone; and
- foreigners can trade on a recently established securities market.

Pudong has enjoyed early success. Its output growth, led by manufacturing and services, was about 14 percent in 1991 (compared with 7.7 percent for China as a whole). Moreover, despite its infancy as an open economic zone, Pudong has attracted substantial investment, both foreign and domestic. Between 1990 and 1992, its authorities approved the establishment of 704 foreign-funded projects—most of them in high-technology activities—involving investment totaling more than $3 billion. In addition, 11 foreign banks have already opened branches in Pudong, and more than thirty others have applied to do so.

Domestic investment is also on the rise. By the end of 1992, China's central, provincial, and municipal governments had set up more than one thousand enterprises in Pudong, involving investment commitments of about $1.5 billion. Capital market activity also expanded dramatically in 1990–92. For example, the value of securities traded in Shanghai soared from about $500 million in 1990 to about $12.3 billion in 1992.

### Inland Provinces

The level of foreign investment in inland provinces was relatively low from 1978 through 1991. Concentrated, for the most past, on resource-based ventures, it was confined largely to a few areas—mainly around Beijing and a number of cities in the provinces of Shaanxi and Sichuan.

Although the foreign trade of inland provinces developed faster than foreign direct investment, it still lagged far behind that of the coastal provinces. In 1990, exports from the inland provinces represented about 28 percent of the national total and their imports only 10 percent. The



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*The Pudong World Plaza (Shanghai) was constructed with foreign investment capital.*

total trade of the inland provinces was 12 percent of GNP in 1990, compared with close to 40 percent for the coastal provinces.

An important reason for the relatively low level of foreign direct investment in inland provinces was the absence of preferential policies. Foreign investment was further discouraged by the limited power of local governments to approve investment projects, poor infrastructure, and the lack of technical and managerial expertise and skilled labor.

In 1992, the central authorities decided to apply preferential policies to 23 major cities in inland provinces, including 18 provincial capitals and 5 cities along the Yangtze River valley. In addition, 6 "development zones" were set up in the same region. The Government also permitted cities bordering neighboring countries to open their economies to the outside world. Meanwhile, many provinces have been trying to open up more cities.

Most of the tax incentives offered in the original SEZs, Hainan, and Pudong are to be applied in the newly opened cities of inland provinces. In addition, many provinces have transferred powers to local authorities to approve foreign investment projects in their respective areas. Some areas have, in fact, offered even more generous terms than those applied in the SEZs and Pudong without approval from the central govenment. These include a five-year tax exemption and a 50 percent reduction of corporate income tax over the subsequent five years.

### Conclusions

China's moves to open its economy to the rest of the world over the past 13 years have helped increase its access to foreign capital, trade, and advanced technology, thus contributing significantly to the country's rapid economic development. The acceleration of the "opening-up" policy in 1992 has paid further dividends. In that year, the value of China's exports increased by over 18 percent to $85 billion, with manufactured goods accounting for 80 percent of the total. The exports of FFEs grew by about 44 percent to $17.4 billion, and their share in total exports rose to about 20 percent in 1992 (from 17 percent in 1991). China attracted commitments of foreign direct investment valued at $57.5 billion, and the amount of foreign direct investment that actually came in was $11.2 billion—an increase of 160 percent over 1991. Reflecting these developments, the number of FFEs operating in China rose to about eighty-four thousand at the end of 1992, from about thirty-seven thousand a year earlier.

Despite their positive impact, China's open economic zones raise questions. On the domestic front, the intense competition among the various provinces—with each trying to offer more generous policies to investors than the others—could have an adverse impact on government revenue. Moreover, the proliferation of development zones could divert land away from agricultural use, a critical issue given the scarcity of arable land. Partly in response to such concerns, the Government has announced that the opening of development zones will be slowed.

On the external front, China's ongoing negotiations on resuming its participation in the General Agreement on Tariffs and Trade may make it necessary for the authorities to review the policy of offering preferential terms to new investors in open economic zones.

Whatever the future of China's open economic zones, there can be little doubt that they have played an important role in the country's transformation to a market economy. They have achieved far more than their initial aims of attracting foreign investment and technology and of earning foreign exchange to pay for imports to modernize the economy. Their use as laboratories for experimenting with market-oriented policies and their spread, in various forms, have established them as "nodes of development" that are affecting increasingly large areas of the country.

As the Chinese economy becomes more market oriented and open, the time will come for a careful review of the role of such zones. The key question that might then arise is whether China's long-term development might not be best served by phasing out those special arrangements that should be regarded as transitional (such as certain tax concessions), while extending others to all areas of the country.



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# JCCT Reconvenes During Mission to China

A central part of former Secretary Franklin's mission to China was the reconvening of the U.S.-China Joint Commission on Commerce and Trade (JCCT). The JCCT was established in 1983 to provide a forum for high-level consideration of bilateral trade and investment issues. It was last convened at the ministerial level in 1988. In the JCCT sessions and bilateral meetings with Chinese officials, Secretary Franklin's comments and remarks focused on advancing U.S. goals, which include:

- promoting U.S. commercial interests and confirming specific business projects;
- reaffirming the need for China to fully implement the recently signed market access and intellectual property rights agreements; and
- underscoring concerns over the U.S. trade imbalance with China which, at $17.1 billion for the first 11 months of this year, has reached record levels.

The accomplishments of the Secretary's mission included bilateral trade policy and trade promotion initiatives, and the signing, as well as recognition of, contracts involving U.S. business interests.

## Initiatives

**Implementation of the Market Access and IPR Agreements.** The Secretary also pressed for full implementation of the recently concluded market access and IPR agreements. The United States and China discussed several potential problems with their implementation and found ways to work toward their solution.

**End Use Checks.** The United States and China had a constructive exchange on export controls issues and agreed to start a process to conclude an agreement on end use checks on dual use technology to ensure that such technology is being used for the purpose for which it was sold. This will be discussed in coming months and should lead to expedited processing of licenses.

**Bilateral Investment Treaty (BIT).** The United States and China agreed to explore resumption of talks on a bilateral investment treaty. Eleven rounds of talks on a U.S.-China bilateral investment treaty were held in the mid-1980s.

**Establishment of Business Development Working Group.** In order to enhance U.S. export opportunities in China's priority sectors (i.e., energy, transportation, and telecommunications), a Business Development Working Group was established under the JCCT. The introduction of the working group will reinvigorate the work of the JCCT and is intended as a follow-on to the market access agreement. China committed in Article I of the agreement to make public commercial information on major projects. This group will focus on obtaining and disseminating information on Chinese major projects and priority sectors. This Working Group also will provide a high-level venue for discussing major project decisions on which there is little or no movement. As such, the United States will have a high-level forum for discussing the status of major projects at various stages of the procurement process.

**Renewal of Trade Promotion Efforts.** Trade promotion efforts will be renewed and trade events will be developed around the priority sectors. There was mutual agreement to resume the legal and finance seminars, which are intended to aid China in its reforms and its efforts to open the services sector by clarifying and explaining the legal framework in which such sectors as banking, insurance and the legal profession operate in the United States. A similar seminar program was done in the 1980s as part of the early JCCT effort designed to promote U.S. input into the economic reform process.

**U.S.-China Business Center in Shenzhen.** An agreement was signed to establish a business center in Shenzhen to assist U.S. firms in penetrating the China market.

## Specific Business Projects

**Boeing**. China Southern Airline signed a contract with Boeing to purchase six 777s with the option of purchasing six additional 777s. This deal is valued at about $800 million.

**AT&T.** AT&T signed a contract with the Changchun City Post and Telecommunications Bureau for the purchase of 71,000 lines of five ESS digital switching equipment, valued at over $10 million.

**Northern Telecom (NT)**. NT signed a contract to sell ten mobile communications switches, valued at approximately $10 million, to the China Ministry of Posts and Telecommunications.

**Bouligny Company.** The China National Technical Import Company signed a contract to purchase chemical processing equipment, valued at over $20 million, from Bouligny Company.

**General Electric (GE).** In Shenzhen, GE signed a contract with the Shenzhen Energy Office to provide an oil-fired generator, valued at $24 million.



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# U.S.-China Trade: Trends and Prospects

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In December 1992, outgoing Secretary of Commerce Barbara Hackman Franklin led a presidential mission to China and Hong Kong to focus on trade and commercial issues. A central part of this mission was the reconvening after a four-year hiatus of the U.S.-China Joint Commission on Commerce and Trade which is an important bilateral forum established in 1983 to discuss and resolve trade and investment policy and implementation problems. While in China, the Secretary took the opportunity to advance U.S. commercial interests—including reaffirming the need for China to fully implement recent intellectual property rights and market access agreements; underscoring U.S. concerns over the U.S. trade deficit with China; and confirming specific business projects. The Secretary also forcefully urged the Chinese to loosen foreign exchange restrictions and improve business conditions for foreign firms. The mission was successful in setting a stage for further expansion of U.S.-China trade. This article reviews U.S.-China trade in the past and discusses prospects for the future.

## Trade Trends

**Total Trade.** After a 20-year hiatus, trade between the United States and the People's Republic of China resumed in 1972. Trade has developed rapidly since normalization of diplomatic relations in 1979. Two-way trade increased from $2.3 billion in 1979 to $25.3 billion in 1991, a ten-fold expansion. As a result, China became the United States' ninth largest trading partner, up from 35th in 1979. In the first 11 months of 1992, two-way trade reached $30.3 billion, an increase of 31 percent over the same period in 1991.

**U.S. Exports.** U.S. exports to China have developed unevenly since 1979. The annual volume fluctuated widely throughout the 1980s, and ranged between $2 billion to $4 billion during 1980-87. The export volume rose to $5 billion in 1988 and $5.8 billion in 1989, declined to $4.8 billion in 1990, and then recovered to $6.3 billion in 1991. In the first 11 months of 1992, U.S. sales to China totaled $6.6 billion, up 16 percent over January-November 1991 levels.

In 1991, China was the 16th largest foreign market for U.S. products and took a 1.5 percent share of U.S. total exports. Chinese statistics indicate that U.S. products made up 12.6 percent of China's imports in 1991, making the United States China's third largest supplier after Hong Kong and Japan.

Fluctuations in American agricultural sales to China and China's economic policy changes were largely responsible for the unstable trends in U.S. export trade with China. Economic readjustment policies in 1982 and 1983 resulted in cutbacks in equipment and machinery imports during that

*Outgoing Commerce Secretary Franklin leads U.S. mission members through the Beijing Jeep Corporation, a Chrysler joint venture. (Photo by Ron Bell, U.S. Department of Commerce.)*



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period. Import control measures adopted in 1985 and again in the retrenchment period starting from late 1988 were a major factor in the reduction of U.S. exports to China in 1986 and in 1989.

Agricultural commodities had dominated U.S. exports to China until 1983, when agricultural exports dropped to 25 percent of the total from 58 percent in 1979. The share continued to decline sharply to only 2 percent in 1986, largely because of the vastly improved performance of China's own agricultural sector as well as the Chinese government's desire to diversify the sources of foreign grain supplies. U.S. sales have recovered somewhat since 1987, as Chinese purchases have been facilitated by the U.S. Export Enhancement Program. In recent years, the share of agricultural commodities, consisting primarily of wheat and cotton, in U.S. exports to China have fluctuated between 10 to 25 percent.

Among U.S. non-agricultural exports to China, machinery and transport equipment shipments have risen most dramatically. These shipments totaled only $229 million in 1979, or 13 percent of U.S. total exports to China, but expanded rapidly in the first half of the 1980s to reach $1.94 billion in 1985, or 50 percent of the total. This rapid growth was caused by China's demand for these products to support its modernization program, and by the liberalization of U.S. export control policy toward China. Decentralization of China's foreign trade administration was also a contributing factor.

U.S. exports of machinery and transport equipment to China declined in 1986-88 due to tighter central control over foreign exchange spending, then recovered to 1985 levels in 1989-90 despite China's retrenchment policies. U.S. exports topped $2.5 billion in 1991, or 30 percent larger than in 1990. The ending of a three-year economic retrenchment and improvements in the country's balance of payments position contributed to the increase. Constituting about 40 percent of U.S. total sales to China in 1991-92, machinery and equipment remained the number one export category. The leading exports in this category were aircraft and parts, power generating equipment, specialized industrial machinery, electrical machinery, and automatic data processing machines.

Chemical products have been another major export category. The share of chemicals in U.S. exports to China has risen steadily since 1981, from 11 percent in that year to 21 percent in 1984, to 23 percent in 1987, and to 27 percent in 1991. The leading export items in this product category were fertilizers, plastic resins, and organic chemicals. Other important U.S. export categories included professional and scientific instruments, logs and lumber, pulp and paper, synthetic fibers, and cotton yarn and fabric.

**U.S. Imports.** Unlike the fluctuations in exports, U.S. imports from China have grown almost without interruption, from $592 million in 1979 to $19 billion in 1991, an increase of 31-fold during the 12-year period. Imports are continuing to grow rapidly, reaching $23.7 billion in the first 11 months of 1992, up 36 percent over January–November 1991 levels.

In 1991 China was the sixth largest exporter to the United States, supplying 3.9 percent of U.S. total imports. Chinese statistics show that the United States ranked third among buyers of Chinese products in 1991, after Japan and Hong Kong. But these statistics do not include many China-origin products shipped to the United States via Hong Kong. When these products are taken into account, the United States actually became the largest market for Chinese goods.

The commodity composition of U.S. imports from China has changed significantly in recent years. In the early 1980s, U.S. imports from China were dominated by textile and petroleum products. Sales of China's top three categories—clothing, petroleum and textiles—accounted for 50 percent of China's exports to the United States in 1981, and 61 percent in 1984. Despite the continuing strength of these sales, China's exports have steadily diversified since the mid-1980s. The dollar volume of the same three categories as a share of China's exports to the United States declined to 49 percent in 1987 and to 22 percent in 1991.

Meanwhile, China's exports of light manufactured goods have grown most rapidly. The greatest increases in U.S. imports of Chinese goods have been registered in toys and games, telecommunications and electrical machinery, footwear and leather travel goods. These four categories made up 32 percent of the value of U.S. imports from China in 1987, and 47 percent in 1991. The increased diversification of China's exports reflects its competitive strength, which has been bolstered in recent years by the relocation of large numbers of export-oriented processing and assembly plants from Hong Kong and Taiwan to the Chinese mainland.

**Trade Imbalance.** A rapid rise in U.S. imports from China, coupled with slow growth in U.S. exports to China, has led to a large and growing U.S. trade imbalance with China. The United States has had a trade deficit with China for ten successive years, and the size of the deficit has increased from $71 million in 1983 to $12.7 billion in 1991. The imbalance is continuing to grow, and the deficit already reached $17.1 billion in the first 11 months of 1992, second only to the U.S.-Japan trade deficit.

## Prospects

In recent years, China has been one of the fastest growing economies in the world, and its gross national product is projected to grow at 8-9 percent annually in the remainder of the 1990s. Certain regions in China are booming, and many people are becoming affluent. Guangdong province, with a population of 65 million, has been sparked by neighboring Hong Kong's free-wheeling capitalist economy and the movement of Hong Kong's manufacturing sector into the province to become the fastest growing economy in the world.

This dynamic growth can be attributed partly to China's policy of reforming its economy and opening up to the outside world. Recently, the 14th Party Congress convened in October 1992 has decided to further liberalize the economic system, with the aim of developing China into a so-called "socialist market economy" where market forces will play a greater role in the allocation of resources. Moreover, to further its application to join the GATT, China has implemented certain measures to liberalize its import market.

All these developments point to a great market potential in China. This potential is backed by a record level of foreign exchange reserves, which reached $45.2 billion as of September 1992, approximately ten months of import cover. Moreover, China's export earnings are continuing to grow rapidly, further augmenting its capability to increase imports



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needed for the modernization program and to satisfy rising consumer demand.

The Chinese have a high regard for American products, and want to see more American companies in the China market. Potential for U.S. exports to China has been enhanced greatly by the recent U.S.-China agreements on the protection of intellectual property rights (IPR) and access to the Chinese market. Under the IPR agreement signed on Jan. 17, 1992, the Chinese government pledged to significantly upgrade China's intellectual property regime. The market access agreement signed on Oct. 10, 1992 called for the Chinese government to substantially reduce import barriers, especially in the product categories of great interest to U.S. firms.

Best prospects for U.S. exports to China are concentrated in the manufactured goods category. High-technology products, capital goods, and industrial materials will continue to find markets in China, particularly in the priority sectors of energy, telecommunications, electronics, and transportation. The United States will continue to be one of China's primary suppliers of raw materials, chemicals, and agricultural products. These are products that China needs to make up for domestic shortfalls and to meet industrial and agricultural production targets. Moreover, certain U.S. consumer goods are in high demand, especially by the more affluent consumers in south China due to their greatly expanded disposable incomes. (China's sectors with best market prospects for U.S. companies are described in greater detail elsewhere in this issue.)

U.S. imports from China will likely continue to increase in the years ahead. China has expanded its export capabilities rapidly, especially in the non-state sector, including foreign-funded enterprises. Rapid growth in Hong Kong's outward processing trade in China has led to substantial increases in exports of China-origin goods. Many Taiwan plants relocated in China have been mostly engaged in export-oriented production. Meanwhile, China faces import restrictions in many markets. It will, therefore, focus much of its export efforts on the United States—its most lucrative and accessible market for sales of manufactured goods.

The future of U.S.-China trade will face a number of constraints. While the market access and IPR agreements reduce or eliminate some of the most serious barriers to U.S. exports, many obstacles remain. China's economy is still basically controlled by the state, and its trade regime continues to be highly restrictive. Many trading practices are still regulated by the government, and a number of import controls remain in place. China's status as a Most-Favored-Nation trading partner of the United States must be renewed annually.

A number of trade sanctions taken by the United States since June 1989 remain in force. Human rights concerns and illegal textile transshipments also influence the bilateral trade environment.

Thus, China needs to take prompt action to speed up its economic liberalization process, eliminate all existing trade barriers, and resolve the main issues of concern to the United States. These steps are essential to the creation of a favorable economic and commercial environment that will be conducive to a smooth and further expansion of U.S.-China trade.

## FCS China—Key to Cathay

The U.S. Department of Commerce's Foreign Commercial Service (FCS) has maintained offices in the PRC since 1983. At present, FCS has a presence in the four most vibrant regions of the country: Beijing, Guangzhou, Shanghai, and Shenyang.

In the past, China's market for imported goods was determined by a central plan. Thus, FCS China was not able to offer standard trade promotion products to American exporters. Rather, FCS offices focused on assistance to resolve commercial disputes and the protection of American investment in China.

Recently, however, the Chinese commercial environment has changed. The government now encourages competition and has reduced the scope of central planning. The economy is booming and China's imports are also growing rapidly. Thus, it is now possible for U.S. companies to establish a normal commercial presence in China.

The present focus of FCS is squarely on export promotion with special attention given to new-to-market companies. China's four FCS posts are now fully on-line offering a full menu of US&FCS export assistance services. Below is a short synopsis of FCS's export promotion programs in the PRC.

**Agent Distributor Search (ADS)**—FCS China helps American exporters find agents and distributors.

**World Traders Data Report (WTDR)**—FCS China offers this service through the district offices of the Department of Commerce. A WTDR provides American clients with an overview of an individual Chinese firm, based on review of public records and liaison with the company.

**Gold Key**—The Gold Key is FCS China's most popular service, provided by each constituent post. For a small fee, FCS will set up a whole series of meetings for a visiting U.S. business person. Translators, transportation, and office services can also be provided.

**Trade Promotion Schedule**—FCS China has a whole series of trade promotion events scheduled in many industry sectors, from food processing to aerospace. As in other capitals of Asia, FCS China also cooperates with counterparts in individual U.S. states to assist in the promotion of U.S. exports.

**Reporting**—Reporting on commercial developments and opportunities in China is a top priority of FCS. These reports take numerous forms, including: Trade Opportunities Program (TOPS), Industry Sector Analysis (ISA), and International Market Information (IMI). All of these reports are available to interested U.S. firms through the National Trade Data Base or the *Journal of Commerce*. FCS can also perform custom marketing surveys for individual clients.

***Commercial News USA***—All four posts in China actively promote and distribute *Commercial News USA*. Chinese multipliers publish excerpts of this Commerce Department publication to a very wide audience throughout all of China.

In short, FCS China is the American exporter's key to opening the China market. Firms interested in China should contact their district office of the Department of Commerce to inquire into the above mentioned services. FCS China also welcomes direct contacts with potential U.S. exporters.



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# China: Breaking the Mold

by I. J. Singh

*China's impressive economic growth has occurred in defiance of conventional industrial policy wisdom. Caution and a diversity of approaches are the hallmarks.*

China is a formerly centrally planned economy under one-party rule that is trying to introduce markets and market-based incentives gradually and incrementally while retaining elements of its socialist inheritance. Its income per capita in terms of its purchasing power is now close to $2000, making it a middle income country and a rapidly industrializing one.

Since the introduction of reforms by Deng Xiaoping in the late 1970s and early 1980s, real GDP growth has averaged around 8 percent and real industrial growth 13 percent. This makes China one of the fastest growing economies in the world and will make it an emerging industrial giant at the turn of the century. The share of investment to GDP has been among the highest in the world at 25-40 percent, (depending upon which figures are accepted) and concentrated on industrial manufacturing, mining and energy.

The most notable feature of the China's reforms has been the willingness to allow a variety of cautious, often provincially initiated, experiments to proceed. Those that seemed to bear fruit are allowed to spread and encouraged in other provinces, those that fail are allowed to wither and die. Since China is regionally a very diverse economy this approach has suited its circumstances.

Decision making has been decentralized to the provincial and local levels, allowing competitive forces to take hold in industry, giving managers and local authorities incentives to enforce fiscal discipline and improve performance. Most industrial prices have been liberalized over the last decade. Some prices, notably those for energy, remain subsidized but they too are being freed to bring them into line with world prices.

The right to fire a worker remains limited and though workers are now allowed to move between regions and industries, their actual ability to move is strictly limited by their dependence on employers for housing, child-care, health centers and recreational facilities.

Local authorities have been allowed to develop the non-state sector, which is not bound by all the rules and obligations faced by state enterprises. Local and private enterprises produced 45 percent of industrial output in 1990, up from 25 percent in 1978. The non-state sector has used retained earnings to develop labor-intensive exports and their competition has forced state enterprises to adapt in order to survive.

State owned enterprises have not been privatized, but gradually their leash has been loosened; they now account for a diminishing share of industrial output and investment.

As a centrally planned, though less centrally managed economy, China has always had an active industrial policy. While adopting market reforms it retains many elements of central planning with concurrent one- and five-year plans. These central plans have significant industrial policy implications, since they specify which industries will get government budgeted investments and subsidized credits. Recently, these investments have been concentrated in industry and especially in processing industries rather than energy and raw materials.

*Courtesy of the Freer Gallery of Art, Smithsonian Institution*

Specific industries continue to be targeted for investment. Central lists of *priority* sectors for industrial investments exist which are very long and detailed. Each provincial and local government has its own list of *priorities*. At one time or another, light industry, basic materials, infrastructure projects, machine building, high technology, export industries, energy-saving projects and others have all been listed. These lists do not seem to have had any positive impact. By contrast, lists of *restricted*, *discouraged* and *banned* industries, some with investments restricted to central government approval status, have had a strong negative impact by reducing credits, often arbitrarily, to certain industries. (When faced by inflationary pressures in 1989-90 the restriction of bank credits to industries on such *restricted* lists were used to deflate the economy.)

Taxes are complex and uncertain and their administration has been farmed out by the center, leaving enterprises to negotiate rates locally, providing incentives for collusion and cheating. As a result, the central government's share of the industrial tax take has declined dramatically, reducing its ability to influence industrial investment. Investment funds used to be allocated from the central budget: now enterprises get most of their funds from retained earnings and bank borrowing.

Subsidized credits from the nascent and yet not fully independent banking system have been directed to support specific regions and industries, but there is no great strategic blueprint to determine the allocation of these funds. Each level of government has its own priorities and differences are resolved through negotiation and personal influence connections (the Chinese word for this web of connections is *guanxi*). Special budgetary allocations and exemptions from credit ceilings are reinforced by bank funds which are provided to priority enterprises, often at low rates.

Underlying these investment funds is an industrial technology policy which, while aiming to protect and develop China's key industries, also encourages foreign investments, technology transfers and foreign market access through tie-ups, joint ventures and turn-key projects in high-tech sectors. Reverse engineering is encouraged by purchasing key technologies and developing and adapting them indigenously, often for exports. This is particularly so in the arms industry.

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in which China has succeeded in becoming a major exporter.

The development of labor intensive exports, with the assistance of foreign investment mainly in the coastal provinces, is a central thrust of industrial policy. Trade has been partially liberalized and although the currency remains non-convertible, the exchange rate is market driven. Import duties have been cut, but some quantitative restrictions remain.

*The most notable feature . . . has been the willingness to allow a variety of cautious, reform experiments to proceed.*

Export incentives and subsidies have been introduced and firms can use their retained export earnings to trade on the foreign exchange markets and to purchase imported inputs. Special zones and *open* cities along the coasts of Guangdong, Jiangsu, Fujian and Zhejiang where the investment rules are more transparent, duties and regulations are waived and tax breaks on offer, have been set up to entice foreign investors. Foreign capital has come mainly from overseas Chinese in Hong Kong, Taiwan and Singapore - the little dragons - who have been assiduously cultivated and who have also provided much in terms of new technology, marketing and management skills. In the period 1979-91 these cross-border investments totaled over $36 billion.

As a consequence, China's exports and foreign investments have boomed. During the 1980s China's exports grew at a compound rate of nearly 15 percent per year. Small township and village enterprises (TVEs) have been a part of this boom. Their exports increased five fold between 1985-90 and now account for around 25 percent of all of China's exports.

Big, vertically integrated and collusive organizations continue, both as a hangover from central planning and as a conscious policy. They are seen as essential for scale economies, research, marketing and foreign penetration. China actively encourages large holding groups and foreign trading organizations. These are seen as essential if China is to become a player in global markets where large corporations are seen to dominate world trade.

China's industrial growth and its appearance as a major exporter in world markets is a testament to the effectiveness of its reforms and the industrial policies pursued: a partially open door, gradual price liberalization, decentralized industrial management, the development of a quasi-private sector and the encouragement of foreign investments for labor intensive export development in the coastal regions via special incentives. However, the system of social obligations borne by the state sector remains a significant obstacle to the development of a free labor market. Investment is inefficiently allocated, the banking sector is underdeveloped, loss makers still receive subsidies and there is fear of social chaos if workers were to be made redundant.

China has defied conventional wisdom on both what industrial policy ought to be and how it ought to be implemented. It has proceeded gradually, it has been experimental, bottom-up, partial and with vague and negotiated rules. Each region has taken its own path and the different tiers of government have had different aims. Nevertheless, the rate of economic and export growth has been impressive. ■

*The development of labor intensive exports, with the assistance of foreign investment . . . is a central thrust of industrial policy.*

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*The views expressed are his own and do not represent those of the World Bank.*

# Kung-Fu Con Job

*by Steven Schlossstein*

## *Ten Reasons Why China's Economic Potential is Grossly Exaggerated*

As a Far East specialist, I am constantly amazed at how visitors to China come away with exaggerated expectations of that country's economic potential. These exaggerated expectations in business lead to commercial projections of mythical proportions, based on promises of a "vast" market of latent consumers. In foreign relations, they create false hopes for Chinese cooperation on such delicate issues as human rights, military weapons exports, and market access. These perceptions are all based on an old nemesis — conventional wisdom.

The conventional wisdom holds that China will be this century's next economic miracle, or that Beijing's political "reforms" will succeed where Moscow's failed, or that China will be Asia's next Japan. It also suggests that China is too large a country to ignore, and that Beijing's leaders can't be pressured too hard for fear of losing face, and that China is about to be engulfed by a tidal wave of entrepreneurial energy. But the conventional wisdom is dead wrong. Here are ten reasons why.

### Media Hype vs. Reality

A casual reading of the Western press suggests that China's economic boom is well underway, that China will be Asia's next economic giant, and that China represents a "huge" market of potential consumers for Western goods. This has always been a romantic notion, particularly with Americans, dating from John D. Rockefeller's intention to sell "oil for the lamps of China" half a century ago. But the tone of recent articles tends to put a distinct spin on current news. The *New York Times* trumpets so-called "free market gains" with headlines like "China Leaders Stress Both Market and Orthodoxy" or "The New China and its State Secret: Communism Aiming for Capitalism." And *The Economist*, in its recent major survey, forecasts a Chinese economy the size of Japan by the turn of the century, suggesting that "if China's GNP grows as fast for the next 20 years as it has for the past 14, it will be the biggest economy on earth."

But reality is very different: try to persuade the multitudes of political prisoners in China's labor reform camps [*laogai*], about Beijing's tilt toward capitalism; try to convince the millions of rural, illiterate peasants that capitalism will bring them greater benefits; try to reassure the hordes of cramped urban residents that capitalism will soon improve their lifestyles. China today is where Korea was perhaps forty years ago, or Japan at the end of the last century, but with one critical difference: the Chinese have a totalitarian government. One need only read Jim Mann's excellent account of the enormous difficulties Western businesses have faced in China [*Beijing Jeep*, 1990] to realize the huge gap between myth and reality. What the Chinese say and what they do have always been very different.

### Contemporary Schizophrenia

There is clearly the sense that China's coastal provinces (viz. Guangdong and Fujian) together with the SEZs in Shenzhen and Xiamen and the huge city of Shanghai are the driving forces of China's new economic growth. But that growth is being propelled not by mainland Chinese but by private entrepreneurs from Hong Kong, Singapore, and Taiwan who use their connections in China [*guanxi*] to get things done. The so-called "free markets" that exist in major cities are little more than what any suburban American would call a glorified garage sale: large quantities of low-quality merchandise attracting lots of lookers but few buyers. And those who do buy tend to be the less educated, lower-income rural workers who

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have no commercial outlets in their villages to begin with.

So the private sector accounts for a very small portion of China's total economy — perhaps 10 percent — with the bulk still dominated by central planning, state price controls (on agricultural goods), and heavy industries, such as oil, coal, and petrochemicals. China's current schizophrenic condition stems from this incompatible dualism: it will be impossible to create a free market for manufactured goods as long as the raw materials (commodities, energy, steel) remain controlled by the state. In the rural areas, where illiteracy remains high (about a third of China's total population cannot read or write), manual labor is still the tool of choice; productivity is low, and while farmers can sell surplus vegetables and other foodstuffs in the so-called "free markets," the state still controls prices on rice, corn, pork, and other mainstays. Living conditions remain crude and extremely primitive, especially in the people-intensive farming sectors that dominate China's national economy.

### THE IMPORTANCE OF STRATEGIC PARTNERS

*Beijing Jeep*, a very perceptive, analytical account of foreign investment in China through the experience of AMC's (now Chrysler's) Jeep division, shows the infinite number of bureaucratic, legal, ideological, cultural, and linguistic obstacles Western firms continuously have to surmount, rarely successfully and never profitably. For smaller foreign investors, it is critically important to have another corporate partner to front for you in China, ideally a Chinese firm from Hong Kong, Singapore, or Taiwan, whose principals have family connections there. Through 1991, about 75 percent of all foreign investment in China was from Hong Kong and Taiwan, another 15 percent from other overseas Chinese elsewhere in Asia, and the remaining 10 percent from the U.S., Europe, and Japan *combined*. Japanese firms, in particular, have shied away from direct investment, due not just to historical and cultural problems relating to the Pacific War, but also for reasons relating to profitability.

In one recent study conducted by JETRO, fewer than 10 percent of Japanese firms with direct investments in China said their subsidiaries earned a profit there. Over and above the cultural hurdles and the obvious regulatory barriers, there is the very serious (and growing) problem of corruption, bribes, and payoffs: without a reliable partner, Western firms never know where corruption begins and "fees" end, so the formidable Chinese bureaucracy plays them off from one agency to another. And not just at the national level in Beijing, through the Communist party, the state agencies, or tax officials and regulators: the provincial and municipal governments want their cuts, too. Some estimates suggest that foreign investment commitments to China during 1992 were more than the cumulative total since 1979, but there has always been a gap between "commitments" and actual sums invested, by a large margin.

### WHY TRUST THE FOREIGN DEVILS?

Mistrust of foreigners is the flip side of the strategic partnership coin. There is an old Chinese saying that goes, "If we can't trust each other, why should we trust you?" It is critical to understand this attitude, which stems from China's history as the Central Kingdom. Because of the Opium Wars in the 1850s, the unequal treaties and the carving up of China by the Western powers in the late 19th century, and Japan's invasion and occupation in the 1930s and 1940s, China has kept foreigners at arm's length since Liberation (1949). As a result, there tends to be a kind of cultural arrogance in official China, a strong feeling of prejudice against Westerners, a sense that we are clearly second-class citizens. The feeling of mistrust at the national, or ideological, level is still strong, and has grown stronger following the 1989 massacre at Tiananmen Square. Beijing's leaders firmly believe that America and Europe are hell-bent on Communism's destruction and will stop at nothing until the last vestige of socialist influence has been eradicated. This attitude strongly drives China's strategic thinking, and underscores the real importance of Western firms not entering the market without appropriate strategic business alliances there. It is also the primary factor behind China's tougher line with Hong Kong as its new Governor, Christopher Patten, prepares the way for more representative democracy (and protects prosperity) in the Colony prior to reversion in 1997.

### A NEW DEFINITION OF "LONG TERM"

The earliest China will begin to resemble the Little Dragons (Korea, Taiwan, Hong Kong, and Singapore) in any meaningful way is about the year 2020. It will take at least 30 years for China to lay the groundwork for durable economic growth. The political structure must shift from being totalitarian to being "merely" authoritarian, a fine line to some but actually a critical difference. In a totalitarian regime, even with limited "free" markets, there are no incentives for personal gain. Besides, economic improvement is only half the bargain; political and personal betterment is the other half — freedom of expression, freedom of assembly, a freer press, a voice in government, a reliable system of laws and justice. Western investors and traders justify their meager returns (or outright losses) by saying that in China, "things take time." The point is, that time never arrives when profits are large enough to justify the enormous commitment of time and



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energy (let alone money) to an undeveloped market like China. The road to Beijing is littered with countless corpses of unsuccessful Western merchants who were once drooling over the lure of a "huge Chinese market." If Japan represented the graveyard of merchants' hopes a century ago, à la Basil Hall Chamberlain, China may well be the graveyard of Western commercial hopes today.

### A New Oxymoron: Socialism With Two Faces

This may be another way of saying that China is schizophrenic. China's leaders say they want Western capital and technology (in fact, they know they can't modernize and improve Chinese lifestyles without them). But they don't want Western ideas — freedom, liberty, justice, representative democracy — infecting the body politic. Deng Xiaoping used to say he didn't care what color the cat was as long as it caught mice, but – General Secretary Zhao Ziyang achieved some notable successes in deregulating the economy (fuelling popular expectations), and students took to the square in Tiananmen in

## Shattered China Dreams

- The so-called "free markets" that exist in major Chinese cities are little more than what any suburban American would call a glorified garage sale: large quantities of low-quality merchandise attracting lots of lookers but few buyers.
- The private sector accounts for a very small portion of China's total economy — perhaps 10 percent — with the bulk still dominated by central planning, state price controls and heavy industries.
- There are an infinite number of bureaucratic, legal, ideological, cultural, and linguistic obstacles Western firms continuously have to surmount in China, rarely successfully and never profitably.
- In one recent study, fewer than 10 percent of Japanese firms with direct investments in China said their subsidiaries earned a profit there.
- Western investors and traders justify their meager returns (or outright losses) by saying that in China, "things take time." But that time never arrives when profits are really large enough to justify the enormous commitment of time and energy (let alone money) to an undeveloped market like China.
- China's leaders say they want Western capital and technology. But they really don't want Western ideas — freedom, liberty, justice, representative democracy — infecting the body politic.
- Trying to link capitalist economics with socialist politics may not only be oxymoronic but very dangerous in the long run. Like a match held to dry tinder, faster economic growth can only accelerate demands for more political change. There is a tremendous amount of resentment under the surface that could very well erupt in other Tiananmen-like incidents in years ahead.
- There is the sheer impossibility of transplanting Little Dragon strategies from Southeast Asia to China: all the Asian success stories are comparatively small island (or peninsular) countries with relatively small populations. To replicate these successes in a huge mainland culture of 1.2 billion stretches credibility to the limit.
- Saying one thing and doing another is classic Chinese behavior: Beijing's verbal commitment to arms control contrasts vividly with its disturbing sales of Silkworm missiles to Middle East terrorist groups and other unstable regimes.
- China today still maintains a large network of labor- and thought-reform camps. By some estimates, material production in the camps now accounts for as much as 4-5 percent of China's GNP, with many products exported to overseas markets, including the United States.
- Private overseas Chinese firms throughout Asia are famous for cooking their books: one set for their banks, another for the auditors, a third for the tax authorities, one more for customers, and the real thing for the family owners. It is hard to see how statistical data on China's economic performance has any more credibility than Mad magazine or the National Lampoon. Beijing officials live in an Alice-in-Wonderland world: their numbers mean exactly what they want them to mean, nothing more, nothing less.



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mid-1989, demanding political change. Zhao is still under house arrest, and Deng clearly does care what color the cat is.

Maintaining the bifurcation between Western technology and Western ideas would be a difficult task under any circumstances, but in an expanding information economy, it is virtually impossible. The underground fax network, cellular phones, cable television, and digital hookups are impacting China's political ideology. Educated, literate Chinese *know* what is going on in Japan and Asia's Little Dragons — they are aware of both the authoritarian capitalism and the political flexibility that have fuelled these success stories. After Tiananmen, after the collapse of the Berlin Wall, and after Mikhail Gorbachev's demise, they also know it is only a matter of time until China, too, will be forced to restructure its political economy. Trying to link capitalist economics with socialist politics may not only be oxymoronic but very dangerous in the long run, too. Like a match held to dry tinder, faster economic growth can only accelerate demands for more political change. There is a tremendous (and growing) amount of resentment under the surface that, in my view, could very well erupt in other Tiananmen-like incidents in years ahead. And it will come from the younger Chinese, whose dreams are both bolder and less fulfilled than those of their parents.

### MICROCOSM TO MACROCOSM DOESN'T COMPUTE

One scenario that has gained popular currency in China in recent years is an economic growth strategy predicated on the successes of the Little Dragons themselves. But there are (at least) three things wrong with this approach. First, there is the intractable problem, described above, of trying to incubate high-speed economic growth in a totalitarian political system. The transition from totalitarian to authoritarian control must be made before economic growth and prosperity can follow, and economic prosperity is a precondition for stable political restructuring. Second, it is the height of folly to expect that a vibrant, dynamic, entrepreneurial capitalism based on the hardcore experience of overseas Chinese *immigrants* will ever take root and flourish in a culturally sluggish mainland environment. The weight of China's traditional bureaucracy is too great, and I question whether conditions at home will ever be conducive to entrepreneurial takeoff, excepting perhaps the coastal provinces, the SEZs, or the cities of Canton and Shanghai. Third, there is the sheer impossibility of transplanting Little Dragon strategies from Southeast Asia to China, expecting a successful transition from microcosm to macrocosm. As I have written at length elsewhere, all the Asian success stories are comparatively small island (or peninsular) countries with relatively small populations: Hong Kong, 5.5 million; Singapore, 2.5 million; Taiwan, 20 million; Korea, 40 million. To replicate these successes in a huge mainland culture of 1.2 *billion* stretches credibility to the limit.

### MORE UNPREDICTABILITY AND CHAOS

We also have to discount much of what we read about Party Congresses or new faces joining the Politburo or Beijing's stated policies of "one market, two systems" and "socialism with two faces." Just last fall, in the most recent Party Congress, the Communists retired some of their octogenarian hardliners in the Politburo and replaced them with younger colleagues. Even so, the average age of the leadership is still somewhat higher now than it was before. [The *New York Times* chronicled these changes with its typically rosy optimism followed by a non sequitur: "Chinese Shake Up Top Party Group; Free Market Gains."] China's leaders would like nothing more than to continue to lead the country from communism to capitalism on a plane of buffered stability, but if history is any guide, reality would suggest that the next thirty years may see only saw-toothed progress — two steps forward, one step back. They say they want to maintain political control, but at the same time, permit economic freedom. It just won't work. Saying one thing and doing another is also classic Chinese behavior: Beijing's verbal commitment to arms control contrasts vividly with its disturbing sales of Silkworm missiles to Middle East terrorist groups and other unstable regimes.

Chaos and unpredictability are China's watchwords, and the clues to its future are in its past. The Manchu dynasty clung to power after the opium wars with Britain, then was stung by the Tai P'ing rebellion and suffered a humiliating dismemberment at the hands of Western powers, who carved up the defenseless Central Kingdom mercilessly. In 1895, China was defeated by an aggressive, expansionist Japan and lost Taiwan. In 1901, the Boxer rebellion occurred, ushering in more instability, and in 1911, the Manchu dynasty collapsed, having long since lost the mandate of heaven. Sun Yat-sen then emerged and fought with Chiang Kai-shek for control of the Nationalists, all while Mao Zedong was organizing the Communists. China was weakened by civil war, and then collapsed under the force of the Japanese invasion and the hardships caused by World War II.

Since Liberation in 1949, China has lurched through the Great Leap Forward, the Hundred Flowers campaign, the Five Antis, the Cultural Revolution, Mao's death, the Four Modernizations, the Tiananmen Massacre, One Market/Two Systems, and now Socialism with Two Faces. Compared to Asia's Little Dragons, China's



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record more nearly resembles a random scattergram than a rising curve of steadily improving accomplishments. The Central Kingdom's claim to fame, simply put, is Confucius and gunpowder; everything else is hidden in small print, buried in footnotes, or lost in the bowels of its bureaucracy.

The late essayist, Bo Yang, once imprisoned in Taipei, has been even more blunt: "Generations of despots and tyrannical officials have rubbed their hands in glee at the thought of the Chinese masses acting wisely and playing it safe," he wrote. "[But] modern Chinese have become increasingly narrow-minded and closed off, through a habitual inability to admit mistakes and a predilection for bragging, lying, and slander. Due to their inveterate arrogance, even the slightest success is overwhelming. It is all right if a few people behave in this manner, but if a majority behaves this way, it spells disaster for the nation."

### A Miserable Record on Human Rights

China today still maintains a large network of labor- and thought-reform camps. In his new book, *Laogai: The Chinese Gulag*, former political prisoner Hongda Wu chronicles the activities of China's prisons in sobering detail. By some estimates, material production in the camps now accounts for as much as 4-5 percent of China's GNP, with many products (notably lower value-added textiles) being exported to overseas markets, including the United States. This has become a sticky point for U.S. trade negotiators who want to continue Most Favored Nation (MFN) status for China but bump up against human rights abuses in the process. Following the Tiananmen incident, thousands of faculty, students, and other demonstrators were arrested by China's feared Public Security Bureau and packed off to the camps; more than three years later, many of them are still there, though the most prominent have been released in response to pressure from Washington.

The U.S. has fought successfully for the release of noted dissidents, like physicist Fang Lizhi, who sought refuge in the U.S. Embassy in Beijing in 1989 and was permitted to leave the country a while later after some tough bargaining by Washington officials. While I would not like to see a return to foreign policy driven solely by human rights concerns, à la Jimmy Carter, the Chinese probably can and should be pressed more firmly on rights issues, especially regarding the labor camps. Trade fraud is also a growing problem which we have been right to prosecute. Ever larger quantities of Chinese textiles and yard goods are either purposely mislabelled (e.g., "Made in Panama"), or transshipped via Taiwan and Hong Kong, illegally bypassing the international quotas negotiated as part of the Multi-Fiber Agreements. The absence of a Commercial Code in China — or any basic legal system, for that matter — is just one more reminder of how far the Chinese have to go in their efforts to modernize.

### The Idiocy of Socialist Statistics

If you believe what you read in the press, China's exports have increased by 22 percent a year since 1980, its GNP has expanded by 10 percent per annum since 1977, and the growth of its huge population has slowed dramatically, to well under 2 percent a year (1.6 children per woman of child-bearing age, according to one set of statistics I saw recently). But the revelations now coming out of Moscow show just how bogus Communist statistics really were, and China is no better (if not worse) than the old Soviet Union. Forced abortions, in the eighth and ninth months of pregnancy, are still the rule in China, especially in the rural sectors, and independent surveys suggest a much higher population growth rate than 2 percent. Private overseas Chinese firms throughout Asia are famous for cooking their books, too: one set for their banks, another for the auditors, a third for the tax authorities, one more for customers, and the real thing for the family owners. It is hard to see how Chinese statistical data has any more credibility than Mad magazine or the National Lampoon. Beijing officials live in an Alice-in-Wonderland world: their numbers mean exactly what they want them to mean, nothing more, nothing less.

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Does all this mean that we ought to ignore China, or disbelieve everything they say or do? Clearly not. For one thing, China's sheer size means it cannot be ignored, and one way to ensure Beijing's cooperation on sticky foreign policy issues is by expanding trade and investment. (America's second largest trade deficit, after Japan, is with China.) But Western firms need to pay more attention to the kinds of strategies they devise for penetrating the Chinese market: what works for a big blue-chip firm is obviously not going to succeed for a small, entrepreneurial concern. Indeed, after nearly half a century, many Western companies still have problems finding the right strategies to compete successfully in Japan.

Second, Western governments have a lot more leverage they can bring to bear on Beijing, short of forcing China either to become isolationist (which benefits no one, least of all the Chinese people) or to grow belligerent, which could put much of Asia's recent economic and political gains at risk. And third, we could do worse than take the daily media with a grain of salt. China is not going to overtake Japan by the end of this century, and we unwillingly suspend disbelief if we think it's going to have the world's biggest economy anytime soon. ◆



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THE WALL STREET JOURNAL WEDNESDAY, MARCH 3, 1993

# China's Growth Area, the Service Sector

By PETER F. DRUCKER

Coastal China, home to 400 million people of mercantile and urban culture, has been the world's fastest growing economy over the past decade. But now it, and the rest of the country, face formidable problems.

To prevent runaway inflation, thousands of unproductive and unprofitable state enterprises that employ millions of workers and are a key power base for the Communist Party must be dismantled. Social tensions are mounting as peasants stream into overcrowded cities where there is no housing, no health care and far too few jobs. And a nationwide power struggle has begun in anticipation of the octogenarian leadership's passing. Their successors may not be democrats.

Yet where the internal effects of China's growth are unsettling, the external effects are potentially destabilizing. It is hardly a harbinger of peace that the Chinese military—with no foreign enemy in sight—eagerly snaps up whatever high-tech weapons a cash-hungry Russia offers for sale. And the world is confounded by a Chinese trade dragon that exports like a capitalist but imports like a communist. The world must find new ways to meet the challenge of this emerging power.

Trade is a good example. U.S. trade policy toward China should be based on the assumption that by the early years of the next century coastal China might become one of the largest economic powers in terms of total gross national product, industrial output and industrial exports.

### An Unconventional Approach

Yet a conventional approach to bilateral trade problems may fail to target the fundamentally different kind of commercial relationship a modern China will need to have with the world. This is because China is likely to be the first country where the balance of payments rather than the balance of trade is the key to economic relations. Indeed, China may be the first country to be integrated into the world economy through services rather than through trade in goods.

To be sure, the Chinese market has to open to foreign goods. In many ways it is far more tightly locked than Japan has ever been. But even if China's doors are fully opened, it is doubtful whether the country would become a major market for foreign-made goods. Despite the enormousness of its marketplace—more than a billion people with rapidly rising incomes—and an insatiable appetite for foreign brands, China will not import Coca-Cola and Levis. Instead, such products will be manufactured in China—by joint ventures, by franchises such as soft-drink bottlers, by licensees and by alliances of all kinds. (Just last week Coca-Cola signed an agreement with the government in Beijing to invest $150 million in 10 bottling plants in China over the next five years.)

The reason for this is compelling social necessity: Manufacturing will be the primary vehicle to accommodate the Chinese peasant's transition from the feudal countryside to the modern era. Within the next 10 years, as much as half of China's population might be employed in factories. Whatever can be made in China will be made there—and that means most manufactured products.

Bringing down barriers to the importation of goods into China has to be worked on, and hard. But far more important is creating a legal and administrative framework to enable a foreigner to do business in China as a partner. Laws today are often unenforced, sometimes even unpublished. There is nearly no protection for a licensor or minority partner and often little respect for intellectual property rights. A trade policy with China must establish and safeguard access to partnership.

All that said, the biggest market opportunities for foreigners in a fast-growing China are not in manufacturing but in services.

Consider, for instance, education. Despite a literacy rate of 73%, China's university system is one of the world's most backward, and unable to support sustained economic growth. There are barely 1.5 million college students in China, a proportion to population smaller than America's a hundred years ago. Even India, with a literacy rate about half that of China, has proportionately nearly four times as many university students. Worse still, most Chinese university educations prepare students for bureaucratic careers that prove more useful for preventing others from doing than for getting things done.

Unless this changes, and changes fast, China's growth will be aborted by a shortage of engineers and chemists, statisticians and accountants, physicians and nurses, managers and teachers. In a similar fix 40 years ago, South Korea sent thousands of its young people to U.S. colleges for training; they then created the "Korean miracle," which transformed a war-ravaged, rural country of profound poverty into one of the Four Tigers in less than 30 years.

But China's education problem will not be alleviated by dispatching 40,000 students abroad every year, as it does now. What is needed is a massive and immediate overhaul of the country's educational system—a job that can be done only by large-scale outside service contractors who design, plan and set up the needed educational institutions. Qualified suppliers of such services do exist—the English polytechnics, for instance, are well trained in such endeavors, as are many American universities and colleges that generally provide educational contract services as a charitable activity.

## *Drucker on Management*

*It is not inconceivable that higher education will one day become America's biggest "export" to China and the source of major export earnings.*

Such generosity, however, ignores a potential market. If such ventures are organized and professionally run, there is money to be made. A number of American colleges already have branches in Japan, and it is not inconceivable that higher education will one day become America's biggest "export" to China and the source of major export earnings.

Health care offers similar opportunities. Mao's flawed vision of a China cared for by "barefoot doctors" is as much a travesty today as it was 30 years ago. What is needed are experienced (and that means foreign) contractors who plan, design, build and manage health-care facilities and train medical staff. The needed hospitals could be built quite fast; the American military's field hospitals, developed over the past 30 years and tested in the Iraq war, provide a prototype.

Financial services, the circulatory system of a modern society, provide yet another major market opportunity. Chinese financial services are in worse shape than either higher education or health care. Simply put, China has a very high savings rate but no way to put the money to productive use. It lacks the legal structures for a financial industry; its financial institutions are primitive and its personnel poorly trained. An infusion of foreign commercial and investment banks, thrifts, insurance companies, mutual funds, and the reliable economic and business data they provide would help develop a system that the Chinese could not possibly develop by themselves, at least not to the extent they need to in the time they have.

What else does China need? It needs telecommunications and information services on a massive scale. The need is so great and China is so far behind that it will have to bypass a century of Western technology and leap directly into the more modern wireless forms of telecommunications—shortwave telephone transmission beamed directly into urban homes, microwave and satellite transmission to span the enormous distances in the countryside.

The same applies to China's last major development need: transportation. China is blessed with excellent natural harbors. But few are well enough developed to handle much traffic or cargo. And the few that are lack roads and railways to move goods to the interior. Almost seven decades have passed since new railway lines were built, and many of those are narrow-gauge and single-track, have obsolete switching yards and still run on steam.

### Yesterday's Argument

The measure of success in trade relations with China is thus selling services rather than selling goods. This is surely not "free" trade. But no matter how desirable it might be, free trade is not a possible policy for China—at least not until the enormous surplus population from the farms has been absorbed into urban society and urban jobs.

A service-focused trade policy with China will be criticized, especially by trade unionists, for "not creating jobs." But this is yesterday's argument. In all developed countries the majority of jobs, especially of well-paid jobs, are precisely in those industries that would benefit the most from a successful service-focused trade policy: engineering, design, health care, education, management, training and so on. What really matters is that these service areas are the ones where the emergence of China as a major economic power creates opportunities. They are where the markets are.

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# Making a Difference in China

## ASIA VIEW

By MARY CHILD

HONG KONG — About this time last year, an American businessman involved in China trade told me he thought American attempts to influence human rights, child and prison labor practices in China were misguided and futile.

He rankled at the accepted notion that a proposed U.S. boycott on toys made in China (over alleged child labor practices) would force him and others like him to pressure their Chinese suppliers on this issue.

"What am I supposed to do about it?" he said, exasperated. "This is business. Why are Americans always the only ones to think they have a right to stick their nose into other countries' domestic matters? I mean, who do we think we are?"

That particular boycott was indeed misguided, both because of the lack of strong evidence of widespread, institutionalized child labor abuse and because of the blunt, unspecified nature of the proposed trade punishment. But the issue raises the question of what role a businessman can play in trying to improve human rights in a country where he has a vested interest.

The U.S. China trade community has effectively argued that continued economic cooperation and trade with China will do more to promote human rights and individual freedoms than sweeping trade sanctions.

This policy of constructive engagement with China on the diplomatic and economic fronts makes good sense. But individual business contacts are pieces of the larger picture. While one person can't do much to change China's repressive domestic policies, Americans in business here can and should represent their views — and their government's views — on human rights.

The gentleman I spoke with made two false assumptions: first, that he, as an individual, could not bring about even small changes in China; and, second, that any attempts to do so would affect his bottom line. Still, there are steps individuals can take to help China understand why it is important to adhere to the United Nations declaration on human rights, to which it is signatory.

Joint ventures and other business contacts give Americans a unique opportunity to exchange views with their Chinese counterparts on domestic matters that affect China's international reputation and bilateral trade. This exchange need not affect a healthy business relationship and, in a few cases, has achieved remarkable, if small-scale results.

This is possible because China is not an impenetrable monolith when it comes to human rights policies. The treatment of prisoners on conscience, for example, is not always directed by Beijing, although most of the celebrated cases are. Many human rights violations take place on the provincial level and some provincial governments are far more severe than others. Gansu province in western China, for example, has a worse-than-average reputation for repressing freedoms supposedly guaranteed by the Chinese constitution. Guangdong, with its relatively permissive economic policies, has the best reputation for protecting constitutional freedoms.

"If you're looking to invest in a province and you go there to talk business, I think it makes a lot of sense to know what the human rights record of that province is," says U.S. businessman and China human rights lobbyist John Kamm. When opportunities present themselves, he adds, it makes sense "to talk about (human rights) in nonthreatening ways with senior leaders of the province."

Mr. Kamm is living proof that one person can make a difference. When he brought the case of the Li brothers, the little-known pro-democracy dissidents arrested and detained in Hunan province, to high-level attention in Beijing in 1991, Beijing stepped in to commute their sentence to a little more than five months (they were released last August). Mr. Kamm also has helped to win the release from prison of 11 elderly Catholic bishops.

Mr. Kamm is under no illusion that China has made fundamental changes in human rights over the past few years, but he finds senior leaders at least willing to listen and discuss certain cases.

Does that mean all businessmen should become diplomats at large, boycotting certain provinces with bad human rights records or allow their consciences to dictate business decisions? Not at all. As Mr. Kamm says, it's wrong to bring up human rights concerns at a first business meeting, especially before a working relationship has been established. Far better to wait until closer ties have been formed with local officials and the opportunity for frank discussions presents itself — perhaps at a banquet where an "old friends" atmosphere prevails. That's the time to carefully seize the opportunity.

"When a Chinese official asks an American business person 'Why are we having such a tough time on most-favored nation rights,'" says Mr. Kamm, "tell him, 'Well, to be honest, you have a terrible human rights record.'

"If the guy says 'Well, we've released some people and we're doing the best we can,' *that* is the time to mention, if you can, just one prisoner in that guy's province, a 75-year old priest maybe, and say, 'This looks terrible. Is there something you can do to help him?'

"He might say, 'What's his name?' and write it down. That's your chance to help that old priest."

*Mary Child writes a biweekly feature on Asian trade and economic affairs.*

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# Greater China: Economic Power

By MURRAY WEIDENBAUM

Preoccupied with political challenges in Europe and the Middle East and with economic competition from Japan, most Americans are ignoring a powerful longer-term trend in Southeast Asia: The rise of the greater China economy.

Paced by a rapid rate of investment and given the abundance of trained human capital, the Asian rim has become the fastest growing part of the world, averaging more than 5% a year in real economic growth. That trend is generally expected to continue at least for the rest of this decade and perhaps well into the 21st century.

Without underestimating the strategic role of the Japanese economy in the Asian rim, there is another way of looking at economic developments in this key region. Over the years, scholars in the United States have referred to the Chinas as a multiple — two Chinas, three Chinas and more. They have in mind the fact that several of the major economies of this region have a predominantly Chinese population and an unusual degree of interaction.

In addition to mainland China, the overall Chinese economy includes such other rapidly growing areas as Taiwan, Hong Kong, Macao and Singapore. Beyond that, Chinese companies in Malaysia, Thailand, Indonesia and the Philippines make up about 70% of the private sector in those countries, according to some estimates.

The Chinese-based economy has resisted the global recession, which recently has plagued virtually every advanced nation. This informal economy is currently the world leader in terms of economic growth, industrial expansion and exports. It contains an array of potential consumers that far exceeds the European and North American markets.

The Chinese-based economy contains substantial amounts of technology and manufacturing capability (Taiwan), outstanding entrepreneurial, marketing and services acumen (Hong Kong), a fine communications network (Singapore), a tremendous pool of financial capital (all three) and very large endowments of land, resources and labor (mainland China). A talking doll, for example, may be designed in Hong Kong, contain a computer chip made in Taiwan and be assembled in China.

The informal Chinese economy differs from the more official economies, which are dominated by large multinational firms. Of the world's 500 leading industrial companies, only Taiwan's Chinese Petroleum was part of the greater China economy.

The Chinese-based economy consists in large measure of mid-size, family-run firms. Transnational networks seem to be the natural accompaniment of the Chinese trading tradition. These channels for the movement of information, goods and capital help to explain the flexibility and efficiency of the numerous informal agreements that bind together the various parts of the Chinese-based trading area.

To be sure, government is often heavily involved in the ownership of many specific enterprises. In Taiwan, the Nationalist Party is the largest property owner, with widespread business interests. In mainland China, government owns a great variety of enterprises.

The close connection between public and private sectors and the greater China economy is illustrated by the operations of the Shanghai Far East Container Co. This joint venture between Shanghai, Hong Kong and Taiwan involves enterprises in all three areas to produce steel containers in Shanghai.

Several economic indicators illustrate the close connection among the Chinas. Eight years ago, the special economic zone of Xiamen in mainland China booked 10 telephone calls a month to Taiwan. Currently, such calls are averaging 60,000 a month and the number is rising.

In 1987, fewer than 7,000 Taiwanese visited the mainland. The current rate is approximately 1 million a year. Bilateral trade, which legally can be conducted only through third countries, was about $1.5 billion in 1987. The current figure is about $6 billion. Moreover, about 4,000 Taiwanese enterprises have set up factories in China. In the aggregate, more than 5,000 Taiwanese companies have invested about $5 billion in the China mainland.

China's new economic flag

The current interdependence between mainland China and Hong Kong is even more striking. Each is the other's largest trading partner and largest source of external investment. Three-fifths of all foreign investment in China has come from Hong Kong's Chinese entrepreneurs. Conversely, the People's Republic of China has reportedly invested about $11 billion in Hong Kong real estate, transport and financial enterprises.

At the macroeconomic level, some private analysts believe the foreign exchange reserves of the various Chinas total some $200 billion. That amount is far in excess of the foreign exchange holdings of any other economic power.

Former World Bank President Robert McNamara has provided an upbeat, long-term appraisal of the economic prospects of mainland China. He believes that if China achieves its economic goals for the year 2,000 and then moves forward at satisfactory but not spectacular growth rates, its per capita income in 2050 may be roughly equal to that of the United Kingdom in 1965. The total size of its economy would approximate that of the United States or Western Europe. Economist Charles Wolf of the Rand National Defense Research Institute estimates that the economy of mainland China alone may exceed that of Japan by the year 2,000, if not sooner.

Trends, of course, rarely move in a straight line for long periods. In the recent past, setbacks have occurred in the economic and political development of Southeast Asia and future detours are likely. China's economic future is uncertain, and the notion of political integration among the various Chinas does not seem likely any time soon. What does seem likely is continuing, informal integration, perhaps leading to a de facto Chinese common market.

Looking ahead to the 21st century, the Chinese economic and trading area might well reach across the Pacific. Such a development would form a major part of the economic and Pacific equivalent of the North Atlantic Treaty Organization. Barring a major political setback in the intervening period, the Chinese economic area has the potential of providing a principal engine of world growth in the early 21st century.

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*Vladimir I. Ivanov,*
*Raj Mohan*
*And Thomas Robinson*

# China's Power Plays

Beijing is emerging as the victor of the Cold War in Asia. In the 1980s, it gained access to Western markets, capital and technology, all critical elements of China's successful economic reforms. In the midst of the Tiananmen demonstrations in 1989, Soviet President Mikhail Gorbachev visited Beijing and signed historic documents ending a long period of political tensions and occasional military clashes between the two countries. While China's image in the West was severely tarnished by the violent repression visited upon the students in Tiananmen Square, by August 1991—when Communism fell in Moscow—China had nonetheless survived a period of skittishness on the part of investors unsure of the future, and was well on its way to regaining international respectability. Recently, Russian Federation President Boris Yeltsin made his own pilgrimage to Beijing to sign a nonaggression agreement. While a full-fledged alliance, the agreement is an ironic confirmation of the flip-flop in central roles these two play in Asian security.

By any measure, compared with 1991 or even 1989, China is much stronger politically and more active diplomatically than Russia throughout Asia. Beijing is determined to exploit turmoil in Russia to replace Moscow as the dominant land-based military power in Asia. The Yeltsin government, desperate for hard currency to save its fledgling democracy and market economy, appears resigned to boosting Chinese military might. Russian arms are far superior to those available to China from the Third World and less costly than Western military products. If purchased in sufficient quantity, they will enable China to leapfrog into the modern era. By buying Russia's modern military hardware and advanced technologies, China also helps Moscow repay its hard currency debts. Under discussion are not only the sale of high-tech weapons similar to the more than 60 SU-27 fighter-bomber aircraft already committed, but also modernization of more than 20 1950s-era Soviet-built military production facilities.

By these means, Beijing is attempting to play a "Russia card," thus making itself economically essential to Moscow and strategically relevant again for Washington. The more than 20 Russo-Chinese agreements signed in December also raise the question of how Yeltsin, himself the intended victim of governance by tank, can deal with a government that used tanks against its own people. The simple truth is that practical economic and security considerations, not sentiment, are driving these two together again. In the process, China obtains a modicum of leverage against the world's remaining superpower, while Russia capitalizes on its only easily convertible asset, military hardware and technology. But expanded Sino-Russian military cooperation adds to the new world disorder and to the security concerns of Asia and America.

The Clinton administration will have to live with the consequences of the Bush administration's too-hesitant approach to Russian reforms and its lack of interest in building a strong economic and security partnership with Russia in the Asia-Pacific region—the result of which is a window of opportunity for China. A more conservative, post-Yeltsin Moscow can also easily deal with democratic reformers, who even now have been politically weakened. Some of these have already converted themselves into cynical pragmatists, no longer willing to wait for a glimmer of hope from Washington. As a result, Yeltsin's domestic economic and political desperation and Washington's lack of strategic vision have driven him toward the China option. The result is policies that could spoil Russia's budding relationship with the West.

This China option is also evident in Russia's growing trade with Beijing, in contrast with the gloomy economic prospects Moscow faces elsewhere. China has decided to take advantage of Russia's rocky transition to capitalism and is now ready to spend the fruits of its own renascent market economy to gain wide access to Russia's conventional weapons systems. Even more significantly, long-range delivery systems and sophisticated targeting technology are also on the auction block. These are trained against America's allies in Asia and the United States itself.

Thus, by aiding the quantitative and qualitative improvement of China's nuclear ballistic missile force, which is not limited by treaty, Russian military technology could undermine the fragile Asian security balance. At the same time, America's expanding economic stake in China is blinding Washington to the consequences of Chinese military hegemony in Asia. Japan, Korea and the Association of Southeast Asian Nations states are already nervous about growing Chinese power and influence. While still linked to the United States in their security and foreign policies, these American partners find it prudent to expend cooperation with Beijing rather than risk confrontation. That, of course, is appeasement. Thus, having helped build China as a counterweight to the Soviet Union, the United States is now confronted with an emerging Chinese military dominance in Asia.

Japan and Korea, facing a militarily stronger China, are justified in questioning the value of American security guarantees and the theory of extended nuclear deterrence. The anti-Soviet security umbrella cannot evolve into some kind of post-Cold War "foul-weather poncho." The emerging Chinese strategic profile poses a grave challenge to Japan, which feels isolated after Yeltsin's visits to Seoul and Beijing and his abruptly canceled trip to Tokyo. With increasing uncertainties in its relations with Washington, Tokyo may have no option but to expand its own military. Facing a nuclear-armed China, Japan and India may rethink their nuclear abstinence, triggering an Asian nuclear arms race.

The United States must lead in building a comprehensive regional security structure, not just to counter the Chinese military buildup but also to engage and balance Beijing's future territorial ambitions. Washington and Moscow have a direct responsibility to bring China into the Asian and global arms control processes and to constrain its conventional and nuclear potential. Initiating such a process now is crucial to eliminating nuclear fears in India and Japan. A global nuclear freeze and a convention on no-first-use of nuclear weapons are possible agreements that China could join. Without Chinese participation in arms control and nuclear disarmament, prospects for controlling the proliferation of weapons of mass destruction in Asia are dim.

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# Stumbling Toward the GATT

## ASIA VIEW

By MARY CHILD

HONG KONG — The Yangtze Optical Fibre Cable Company, a Sino-Dutch joint venture in Wuhan, has a worry. Right now it is the number one producer of fiber optic cable for China's rapidly growing telecommunications market. Its high-tech cable is beginning to replace the more cumbersome, less diverse standby, copper cable.

But Xu Tongmao, the company's general manager, says that unless the company increases its output and diversifies its product line, it could be unseated when China becomes a member of the General Agreement on Tariffs and Trade and is opened to foreign competition.

Indeed, Beijing has been fueling expectations that GATT membership will be conferred on China by the end of this year. The idea of "foreign wolves at the door" has provided an excellent impetus for Chinese companies to become competitive fast. The Yangtze cable company plans to meet the challenge by expanding its annual output more than fourfold by 1995 and by acquiring the technology to produce a fiber optic cable suitable for dedicated leased lines.

But while there's no doubt of the need for Chinese companies to plan ahead to compete with imports, particularly in those areas covered by the Sino-U.S. trade agreement on market access, chances for GATT membership this year are remote. Companies like Yangtze may have more time to ready themselves for full-fledged foreign competition. And Beijing may be buying them time — by design, some would say — with foot-dragging on GATT-related reforms.

Though the United States had pledged to "staunchly support" China's application for membership in the GATT, U.S. patronage is not unconditional. It is tied to two factors: China's adherence to the October 1992 bilateral agreement on market access, and the acceptability of the terms under which China would be admitted to the GATT.

There are some serious, legitimate stumbling blocks in each of these areas at the moment.

Nearly four months have passed since China agreed to reduce tariffs and lift most import quotas and non-tariff barriers on a wide array of U.S. products and to make its trade regulations transparent.

While the deadlines for some of these reforms are still some distance down the road — tariff reductions by the end of this year, gradual lifting of import quotas and licensing restrictions by year-end 1997 — China has not yet begun to seriously implement this program. If, as promised, China is to remove 75% of its non-tariff barriers by the end of 1994, it had better get a move on.

Among other things, China has not, as promised, effectively lifted import licensing restrictions on Sino-U.S. auto manufacturing ventures that need to import U.S. auto parts.

Washington is finding this delay so troublesome that a delegation from the office of the United States Trade Representative, including Assistant U.S. Trade Representative for Japan and China Ira Wolf, will head to China late this month to press Beijing to live up to its market access commitments.

If China does not begin some interim action, expect a blowup of major proportions. With China's $2 billion-plus trade surplus with the United States and access for U.S. imports stymied, rumors of action under America's "Super 301" trade retaliation law already are swirling.

Moreover, Beijing cannot expect strong U.S. support on GATT membership while it is violating the spirit of the October agreement.

Meanwhile, Washington and Beijing differ on the interpretation of the U.S. pledge to "staunchly support" a "good protocol" for China's entry into the GATT.

As Rich Brecher, director of business advisory services at the U.S.-China Business Council, put it, "China is emphasizing the phrase 'staunch support' and the United States is stressing 'good protocol.'"

From Washington's perspective, a "good protocol" would allow the member countries to reserve the right to "invoke non-application" of some GATT privileges for certain new GATT entrants. That would allow the United States to continue its current annual Most Favored Nation review process, rather than offer permanent, unconditional MFN status to China.

China, naturally, opposes membership under those terms. But Beijing and the United States may have no choice but to settle on these terms. Under the Jackson-Vanik amendment, Washington is required to go through the annual MFN review circus. It's unlikely this anachronistic law will be repealed any time soon.

Ultimately, whether China's protocol is acceptable will be a matter for the GATT Council to decide. But U.S. opposition would seriously impede the process.

If all these trouble spots are smoothed out, China could be admitted to the GATT by 1994.

But even if China does not become a full GATT member any time soon, if Beijing lives up to its bilateral market access commitment, a company like Yangtze Optical Fibre Cable should face some foreign competition at home from U.S. suppliers.

That's because, as part of its Section 301 agreement with the United States, China agreed to phase out its import substitution practice, which discourages Chinese companies from importing products that already are being made at home.

Still, it may take quite a long time before U.S. producers can compete on an even playing field in China's telecommunications market. The Yangtze company, for example, has a distinct advantage: One of its investment partners is a section of the Ministry of Posts and Telecommunications in Beijing.

But once non-tariff barriers — such as state directives to buy Chinese — are removed, this infant industry will have to grow up fast.

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# Business Outlook Abroad

## Current Reports From The Foreign Service

## INDIA

### The Reform Movement Hits Some Snags, But is Producing a More Hospitable Environment for Business Relationships

*While a good monsoon and strong industrial output have pushed economic growth up to an annual rate of about 4 percent, the pace of economic reform in the second year of India's structural adjustment program appears to have slowed. Sustaining the pace of economic stabilization and reform over the next several years may prove difficult as fiscal austerity and labor-productivity measures begin to hit influential interest groups. Nonetheless, India is evolving into a substantially more hospitable environment for bilateral business relationships. The U.S. Embassy in New Delhi filed this report on economic trends in India.*

Despite a largely successful macroeconomic stabilization program and vastly improved balance of payments, there is widespread concern over the pace of reform in the second year of India's structural adjustment. The billion-dollar securities trading scam is cited for ongoing delays, and the Dec. 6 destruction of a mosque in Ayodhya by Hindu nationalists raises additional concerns. Nevertheless, India's trade and industrial reforms since July 1991, which substantially improve its investment climate, remain intact. The Rao government has reiterated its commitment to continuing reforms, and is expected to codify foreign investment regulations issued earlier by decree. The FY 1993-94 budget (the Indian fiscal year is April 1-March 31) is expected to include significant further reductions in tariff rates as well as in personal and corporate tax rates. Further reductions in trade controls are expected, as long as export growth improves. Proponents (and opponents) of a convertible rupee for the trade account continue a vigorous debate, though the government remains cautious.

A major result of the new industrial policy has been a shift toward financing new investments through capital markets instead of traditional banking channels. In September, the government opened the Indian capital market to portfolio investment from well-established foreign institutional investors.

The generally good 1992 monsoon will help propel real GDP growth during FY 1992-93 to about 4 percent, compared to less than 2 percent the previous year. The government is confident it will reduce its fiscal deficit to 5 percent of GDP, though large operating-budget deficits and widespread tax evasion persist. Money supply expansion, high inflation, and sluggish industrial/export growth are major concerns for policy planners as well as a focus of criticism from opposition political parties. There is also concern that increasing debt-service obligations could outstrip growth in exports and invisibles receipts, posing a serious threat to the balance of payments over the medium term. Non-gold foreign exchange reserves stand at $5.0 billion, equivalent to about 2½ months' imports, though a substantial further inflow under international agreements should return them to the $6 billion level. In addition to an International Monetary Fund standby credit of $2.2 billion, India began discussions in October 1992 for access to about $7.0 billion in long-term IMF credits.

### What This Means for U.S.

India's trade and industrial reforms are making it a substantially more hospitable environment for bilateral business relationships. There is now a single window for approval of foreign investment of up to 51 percent equity in 34 broadly defined industries. Greater foreign ownership and/or projects in other industries are reviewed by the Foreign Investment Promotion Board and its specially-empowered committee, which are overseen by a Cabinet Committee on foreign investment.

Limits on expansion and other activities of large firms, under the Monopolies and Restrictive Trade Practices Act, have been eased. Local-content and export-performance requirements have been dropped for most foreign investments and technology transfer rules have been simplified. The energy industry has been opened to foreign investment; U.S. firms are looking into power production as well as petroleum exploration, refining, and distribution. In May 1992, India also opened its coal industry to foreign investment in some limited areas such as methane extraction. Imports of most consumer goods remain banned or restricted, though earlier restrictions on personal computer imports have been relaxed. Further reductions in trade controls, including tariff levels of up to 110 percent, are expected, as long as export growth remains steady.

The U.S. Export-Import Bank has doubled its lending in India to over $500 million and expects this country to be its fastest-growing portfolio.

Bilateral trade disputes remain, however; for the second straight year, the United States listed India as a priority country under Special 301 for investigation of inadequate intellectual property rights protection. The United States also withdrew GSP duty benefits for $60 million worth of Indian pharmaceutical products. The main issues are strengthening Indian copyright enforcement and the lack of product patent protection for chemicals, drugs, and food products.

The United States remains India's largest trading partner. U.S. exports to India reached a record $2.5 billion in 1990, but fell to $2.0 billion in 1991, largely due to Indian government import-restraint efforts. Trade data through the third quarter of calendar 1992 show U.S. exports to India down 6 percent, to $1.4 billion, because of a decline in non-crude oil sales. U.S. imports from India were up 19 percent during the same period, on the strength of booming garment sales. The main U.S. exports to India are sophisticated machinery and high-tech products, aviation parts and avionics, fertilizers, steel scrap, and chemicals. The United States also sold one million tons of wheat to India in 1992.

The United States and India have a double-taxation treaty which went into effect in 1991.

U.S. firms are the largest cumulative foreign investors in India since its independence, with over $750 million invested as of December 1991. In response to the Rao government's economic reforms, annual U.S. investment shot up from $19 million in 1990 to an estimated $150 million in 1992. Approvals currently are running at a higher level, though not all projects are likely to be realized.

Prospects for U.S. exports and investment seem promising for aircraft and parts; oil- and gas-field machinery and services; electronic and scientific equipment; telecommunications equipment and services; medical equipment; chemical production machinery; machine tools and metalworking equipment; computer software and services; mining equipment; computers, peripherals, and specialized CAD, CAM, and CAE systems; biotechnology; port and shipbuilding equipment; printing and graphic arts equipment; hotel and restaurant equipment; textile machinery; railroad equipment; industrial process controls; environmental technologies; and general industrial equipment.

Many firms considering the Indian market find participation in events sponsored by the U.S. Department of Commerce or Commerce's U.S. and Foreign Commercial Service (US&FCS) in India to be excellent vehicles for promoting business in India. For details, U.S. firms should contact the U.S. Department of Commerce, International Trade Administration, Washington, D.C. 20230, tel. (202) 482-2954; one of the district offices of the International Trade Administration located in major U.S. cities (listed on page 32); or the US&FCS offices at the Embassy in New Delhi and the Consulates in Bombay, Madras, and Calcutta.

ASIAN DEVELOPMENT REVIEW

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# The State and the Market in Industrial Development: Perspectives from the 1980s

George Rosen*

The relationship between the state and the market has been a continuous theme for those economists seeking to understand the process of economic growth and to advise on policies to affect that process. The classical economists from Adam Smith through Marx devoted much of their work to that task, and a central theme was the relationship of those two institutions in facilitating or hampering the growth process. With the rise of neoclassical economics, attention shifted from the study of growth to the study of the market per se. Simultaneously, the question of appropriate government policies, whether in relation to the market or to economic growth, became a marginal issue in mainstream economics, although not among institutional economists in the United States or historical economists in Germany. The world depression of the 1930s, the rise of Keynesian economics and World War II revived such issues within developed economies.[1] The aftermath of that war, which saw the breakdown of the colonial system and the rise of a large number of independent states with a major goal of economic growth, recreated the field of economic development within the economics discipline. This was true in the developed countries, whose leaders sought to develop economic policies toward the former colonies, and in the developing countries, where appropriate government policies to stimulate growth became a major task for the new rulers.

The development economists of that period presented a theory of economic development which argued for the state playing a major role in fostering economic, primarily industrial, growth. This was relatively unchallenged until the 1970s. However, the growing criticism of Keynesian analysis among economists in developed countries, the varied results of the development policies of the developing countries, the coming to power of Ronald Reagan in the United States and of Margaret Thatcher in Great Britain with their programs for a reduced role for government in their own

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1. See R.M. Collins, "The Emergence of Economic Growthmanship in the United States", in *The State and Economic Knowledge*, ed. M.O. Furner and B. Supple (Cambridge: Cambridge University Press, 1990), Chapter 5.

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countries, and the economic difficulties and collapse of the centrally planned Eastern European economies in the 1980s induced a major rethinking of this issue among development economists, the policymakers in developing countries and the policymakers in aid-giving agencies. The governments of the People's Republic of China and India, the two largest of the developing countries, each introduced economic reform programs to reduce state controls of their economies and to strengthen the role of market forces in economic decision-making; other countries have done the same.

In this article, I propose first to briefly review the issue of the relative roles of the state and market among the mainstream development economists of the 1950s and the critics of that early position. I will then briefly examine the market-oriented economic reforms introduced in the People's Republic of China and India in the 1980s, as well as the policies of the very successful East Asian developing economies. I will conclude by pointing out the changing, but still important, areas in which state action is vital on the basis of the experiences of the People's Republic of China and India and the East Asian economies.[2]

## State and Market: Mainstream and Critique

In his introduction to *Pioneers in Development*, Meier summarized the "mainstream development economics of the 1950s as being structural, shaped by trade pessimism, emphasizing planned investment in new physical capital, utilizing reserves of surplus labor, adopting import substitution industrialization policies, embracing central planning of change, and relying on foreign aid. But there were crosscurrents, and....vigorous debate over some leading issues. [One of those controversial issues was]... planning versus reliance on the market system".[3]

The dominant thinking of the 1940s and 1950s was also reflective of its times: the key role of the government in dealing with the depression of the 1930s and in mobilizing the economies of the capitalist countries for and in World War II. The development of Keynesian economics, and of a separate macroeconomic framework of analysis, provided an underlying theoretical basis for a major role for growth-oriented government policy. But in addition, in the area of microeconomics, policies toward growth brought up major issues of the relevance of conventional equilibrium theory in the face of a disequilibrating growth process, in the absence of innovating

2. Lewis presents another treatment of this theme within a broader political economy framework. See J.P. Lewis, "Government and National Economic Development", *Daedalus*, vol. 18, no. 1 (Winter 1989), pp. 69–83.

3. G.M. Meier, "The Formative Period", in *Pioneers in Development*, ed. G.M. Meier and D. Seers (New York: World Bank and Oxford University Press, 1984), p. 22.

entrepreneurs, in the face of the importance of economies of scale and of externalities of benefits, all of which were felt to constrain reliance upon private economic behavior in pursuit of national development. Essentially, the role of the state in development was to overcome "market failure" in an underdeveloped economy, quite apart from the structural characteristics of a society that sought to begin the process of development. In addition, there was the apparent success of the Soviet Union's centrally planned socialist system, of which in fact little was known, in rapidly industrializing so that it was able to resist successfully the attack by Germany's more economically advanced society. Thus, the emphasis given to the state in development in part reflects the failures of capitalism in the Great Depression, and the assumed success of state action, including central planning, in dealing with those market failures on both a macro and micro level.

By the late 1960s the actual experiences of the developing countries and of development economists working in those countries, together with the resurgence of neoclassical thinking among mainstream economists in developed countries, led to serious questioning of the initial analytical and policy framework of development economics.[4] Little's pioneering work on industrial policy and trade in developing countries and on economic pricing in project evaluation was a major element in this reconsideration in the area of industrial development. Schultz's earlier interpretation of the optimizing economic behavior of peasants in response to incentives played a path-breaking role in the reinterpretation of the role of the agricultural sector in the development process. Viner's work on trade and development was rediscovered, and Bauer's criticism of state-centered policy came to the fore again. In the 1970s and 1980s the rapid economic progress of the "Four Little Tigers" of East Asia confirmed the importance of foreign trade in the development process. Among developed countries, the move to the market and deregulation under Margaret Thatcher and Ronald Reagan, the collapse of rigid central planning in the Soviet Union and Eastern Europe and the economic reforms in the People's Republic of China and India, as well as in the smaller developing countries of the world, have led to a resurgence of free market economics and a denigration of the role of the state in

4. I will not list all the relevant books and articles by the four economists named below, but I will list their major works written before 1970, or their own summary articles in which they present their positions. In alphabetical order, they are Peter Bauer's own summary of his research and criticisms of the mainstream in "Remembrance of Studies Past: Retracing First Steps", in Meier and Seers, *op. cit.*, pp. 25-43. This also lists all of his earlier books and articles going back to 1948, many of the later ones written with B.S. Yamey. The works of Ian Little referred to are I. Little, T. Scitovsky and M. Scott, *Industry and Trade in Some Developing Countries: A Comparative Study* (London: Oxford University Press, 1970); and I. Little and J.A. Mirrlees, *Manual of Industrial Product Analysis in Developing Countries* (Paris: Organisation for Economic Co-operation and Development, 1969). T.W. Schultz's path-breaking book was his *Transforming Traditional Agriculture* (New Haven: Yale University Press, 1964). Jacob Viner's long ignored book was the text of his 1950 lectures, *International Trade and Economic Development* (Glencoe, Il: The Free Press, 1952).



development economics. Too, as economists have extended the assumptions of maximizing behavior and economic tools of analysis to explaining political behavior, this has led to a change in the picture of the state. In Lal's words, the state is no longer seen as a "benevolent" institution with the goal of improved well-being for the public, but rather as a "predatory" institution, with officials seeking to maximize their economic and political gains by working with individuals or groups that seek to use the state for private ends.[5] "Government failure" has become the counterpart of "market failure" and requires the careful scrutiny of any government activity, including action to correct market failure.

## Traditional and Revised State/Market Roles

But I am skeptical of that position and I will try to support that skepticism on the basis of some of the same country experiences that supporters of a reduced government role in development use to argue their position. In some ways, the attitudes of development economists and policymakers towards the respective roles of the state and market following the apparent failure of the state in the past decade seem to parallel the opposite attitudes of a previous generation towards the roles of those institutions following the apparent collapse of the market in the depression of the 1930s and the war in the 1940s.[6] My disagreement with the current disparagement of the state is not with the argument that much of the past role of the state has led to inefficiency and slow growth. Rather, I will argue that the state still has major roles to play in the development process in developing economies, and that failure to play those roles will make it doubly difficult to extricate itself from those policy areas in which it has not been effective. Furthermore, the state in fact played a major role in those developing countries whose successes are cited as support for state abstinence, and it continues to do so but in ways that would be considered unorthodox by both earlier and contemporary neoclassical development economists.

I will identify those areas in which the government's role has been unsuccessful over time. Initially, it appeared that direct government investment in, and ownership of, industrial plants, accompanied by central planning of production and distribution, controlled prices and highly restricted foreign trade, would achieve an industrial development at a faster pace and over a wider production area than would reliance upon the market or upon greater freedom of trade. In fact, this policy framework did achieve impressive initial results, but over time it has been found to be counterproductive.

5. D. Lal, "Comment", in *Pioneers in Development: Second Series*, ed. G.M. Meier (New York: Oxford University Press, 1987), p. 194.
6. See Peter Temin, *Lessons of the Great Depression* (Cambridge, Mass.: MIT Press, 1990).

Schumpeterian entrepreneurship, defined as a willingness to take risks and the flexibility to identify and respond to new opportunities, which I consider the necessary requirement for development and growth, does not flourish in government-owned, politically or bureaucratically controlled institutions, in which risk-taking can be dangerous. Furthermore, all too often such government enterprises are monopolies facing neither internal competition, nor the experience of imported products that would exert some pressure for response and change. Thus, such industrial enterprises may succeed initially as a result of large investments and the political pressures to produce, but over time these propelling forces diminish or disappear, and with that, performance also weakens. This will be reinforced if the enterprise has a captive market and at the same time is protected against losses by subventions from the government if costs cannot be met. When such monopoly and government ownership is combined with price control to keep prices of output deliberately low and even below cost, the results have been shortages relative to demand, financial losses, and lack of funds for investment as well as a continual need for subsidy. Ironically enough, one of the rationales for such government activity has been to prevent private monopoly, but at times the result has been an oligopoly with both the private and public firms having protected shares of the market but with the private firm profitable at prices that barely cover the costs of the government enterprise.

Some of these problems may be less significant if the government owns and operates natural monopolies in such economic overhead areas as transport and electric power. These are areas in which there is a long tradition of government ownership or control because of their monopolistic character and high capital requirements. Rapid technological change has not been a major element of those industries, which might qualify for the Galbraithian term of "post-office capitalism". But all too often these are considered industries which should charge low prices, based on some idea of need, rather than on any relation to cost or appropriate rate of return on investment. Thus, they are often heavily subsidized loss-makers, unable to meet levels of demand at the prices charged, and unable to expand, thus creating bottlenecks which force closure of plants or pile-up of shipments that impose heavy costs upon the economy. Very often, too, they provide employment sinecures for politically well-connected workers, while their ability to allocate electric power and transport facilities gives political and bureaucratic figures control of a strategic factor input. Because of these elements, permitting entry of private firms into this sector might well introduce a degree of competition that would reduce state monopoly power and improve service.

The economic reforms in both the People's Republic of China and India have sought to move away from this model in terms of goals. They proposed to give enterprise managers in the public sector greater responsibility for, and control of, the performance of their establishments. To do this, they



attempted to separate political or bureaucratic agencies from enterprise management; they introduced performance contracts and rewards for enterprise performance not just in physical terms but in financial terms as well; they reduced lifetime employment for workers and introduced wage payment by results as well as for presence; they permitted easier entry of private firms into industry and/or reduced controls on existing private firms; they eased restrictions on imports and on foreign investment; and they reduced direct control of prices and permitted, within varying limits by product, a greater role for the market in setting prices for a wide range of products. While their reach has exceeded their achievements, the consequences have apparently been positive in terms of growth rates of output, varieties of goods produced, and exports of manufactured goods. Thus, this experience seems to support the position "that government which governs best governs least". But I will argue that one of the main reasons for those governments' inability to withdraw from direct goods producing areas of their economies lies precisely in their failure to perform other government functions adequately and that they will have to expand their activities in new directions to withdraw from the older activities. (This is apart from bureaucratic and narrowly political resistances to such withdrawals.)

In both countries the price and marketing reforms have been associated with periods of inflationary price rise. They have also been accompanied by continued, and even increasing, subsidization of financially failing enterprises, or in an expressive Indian term, "sick" firms. Both of these developments have limited the extent of permissible decontrol of prices and the use of the market to set prices and the governments' ability to withdraw from owning or operating industrial firms. And these experiences point to two areas in which government must play a more effective role if economic reform is to succeed.

The first such area is in macroeconomic policymaking and implementation. If an effective monetary and fiscal system is lacking, the first effect of decontrolling prices on a wide scale is likely to be a massive rise in prices of necessities and of "essential" inputs whose prices have been deliberately set low, often below cost. In the People's Republic of China there has been an effective decentralization of economic powers and resources to provincial and local authorities, combined with an absence of an effective central bank and with close political connections between local banks, governments and enterprises. This has meant first that the central government has in the past been unable to raise sufficient resources by taxes to meet its fiscal requirements and has had to create money to make up the difference. Second, the central bank has been unable to control the increase in bank credit to meet demands of local enterprises and governments. Both of these have contributed to the sharp cycles of inflation, clamp-down, relaxation followed by inflation, that have been so prominent in the People's Republic of China's economic history since the late-1970s.

India does have an effective central bank and a very competent economic officialdom, but the Reserve Bank of India's credit and interest rate policies are essentially determined by the Ministry of Finance and the fiscal and political needs of the central government. In the past decade the taxes collected by the government have been regularly well below the level of expenditures, and the government has had to resort to issuing money and borrowing from the central bank to make up the difference. The result has been an annual rate of price increase in the order of 510 per cent during the 1980s. On the one hand, this has been a stimulus to business activity, but, on the other hand, it has made it harder for the large part of the population whose incomes are not protected against rising prices to support itself.

In both countries, too, major areas of expenditures are the complex systems of subsidies to different politically potent groups in society. A major reason for the subsidies is the effort to keep prices low to those groups. The groups benefiting from the subsidies may be urban consumers, they may be producers of important industrial products, they may be exporters, and they may be fertilizer, power and water-using farmers. In any case, the government must make up the difference between the cost of the product being subsidized and the price at which it is sold. Furthermore, the government may also have to cover the losses of the enterprise producing the price-subsidized outputs and to provide resources for additional investments in those areas of production. Thus, effective price reform is necessary to reduce one set of government expenditures that are major contributors to the government deficits, but this in turn requires an effective macrocontrol system to restrain the overall level of prices.

While reduction or elimination of subsidies would reduce one major area of expenditures, the tax systems of both countries are limited in their ability to raise revenues. Fishlow, in reviewing the economic problems of Latin American countries over the past two decades, emphasizes "fiscal inadequacy [to be]... the real villain of the piece".[7] That has also been true for the People's Republic of China and India: in the former country the reforms did not include establishing an effective national tax system, while in India there are significant gaps in the tax system, especially as it affects landowning peasants. Tax reform obviously faces all sorts of political difficulties, and this is just as true for the United States as for the People's Republic of China and India. But this is an area in which improved government performance is essential for an effective macroeconomic policy framework.

At the microeconomic level, a major purpose of the economic reforms has been to increase efficiency and productivity of state enterprises, using competition from other domestic firms as well as imports, as one of the means to achieve this goal. In both countries, there has been discussion of

7. A. Fishlow, "The Latin American State", *Journal of Economic Perspectives*, vol. 4, no. 3 (Summer 1990), p. 67.



withdrawing support for loss-making firms and allowing bankrupt enterprises to fail and go out of business. However, little has in fact been done in this area. The reasons for this reluctance is understandable. In both countries, the large state-owned (and at times private) enterprises have significant non-economic tasks to play. They may provide housing, schooling and health facilities for their workers; many were set up in relatively undeveloped interior areas for reasons of defense; workers employed in them were offered promises of lifetime employment not only for the first generation but also for their children. In those countries, as well as in other developing countries with long traditions of patron-client relationships, the patron (in this case, the state or large private employer) has responsibilities of providing continued support for clients (the workers and staff), especially if they moved long distances for the work, to which they may have been assigned.

Apart from this relationship, one of the measures of the government's success has been rising industrial employment. The reverse—increasing unemployment resulting from industry failure—would be an indication of a broader development failure. (In India the number of workers in sick firms in 1987 may have been on the order of 1.5–2.0 million, or about one third of all the workers in private large-scale manufacturing.[8] In the People's Republic of China it is estimated that about one third of the state-owned enterprises are unprofitable.) In the past, this has meant that both governments provide support to failing firms by such means as direct budget subsidies, by credit supplied through the banking system, and in India until fairly recently by nationalization of previously private firms. (This also occurred more selectively in the United States in the case of enterprises whose failure would have been socially dangerous, such as Chrysler and Lockheed and various banks.) Unless there is some alternative policy framework that at minimum provides support for the worker thrown out of a job, this is likely to continue. This requires that the government introduce programs of unemployment insurance and retraining and relocation (including not only housing but also schooling and health) for the workers and their families during the period of unemployment and transition. In fact, the large amount of funds currently used to support these sick firms might well be used to develop such social security programs, which do not now exist, in the People's Republic of China and India among other Asian developing countries. Such a development would both contribute to raising the efficiency and competitiveness of the industrial systems in the countries and give workers the possibility of improving their positions in new jobs. But it is an area in which additional government effort is needed if the broader program of economic reform is

8. See G. Rosen, "The Indian Economy: Muddling Through in a Year of Turmoil", in *India Briefing, 1991*, ed. P. Oldenburg (Boulder: The Westview Press, 1991), p. 80.

to succeed. Associated too with such narrowly economic steps as closing inefficient enterprises must be a program to widen the support of such important social functions as the provision of education, health and housing facilities from the individual enterprise to society as a whole, so that these broader functions are not diminished by the closing of a firm, or by its sale to a private entrepreneur. It is clear that both the introduction of a broad program of unemployment insurance and retraining and the transfer of social functions formerly assumed by the firm to the state call not for less government, but rather for more, but in areas previously neglected or of secondary importance for the state.

Until now I have based my argument on the experiences of reform in the People's Republic of China and India in the 1980s, on which I have done my own research. But the highly successful industrialization programs of the Republic of Korea; Singapore; and Taipei, China in the 1970s and 1980s, which I will only briefly discuss, provide further rationale for an active role by government in those programs.[9] It is true that in all three economies private ownership of industrial enterprises is the dominant form of management, and is indeed an essential ingredient in their success. But in all three, the governments by deliberate policies, including tariff protection, played a key role in encouraging development and influencing the directions of growth.[10] The governments carried through extensive education programs to create an effective and responsive labor force; they provided adequate and well-administered infrastructure in the form of power and transport facilities so that shortages of these inputs have not been bottlenecks to industry; they provided stable legal frameworks for private activity in a market environment; and they established conditions for the smooth functioning of factor markets for capital and labor, in addition to product markets. The land reform programs in the Republic of Korea and Taipei, China served as stimuli to accelerated agricultural growth as well as for greater mobility of labor and capital from the land. But beyond these very important actions in creating institutions and facilities, the three governments actively intervened to influence directions of industrial growth, both by direct encouragement of selected activities and by more general macropolicies in the areas of taxation, credit availability, foreign exchange allocation and investment by foreign enterprises. One of the governments, Singapore, is socialist, but with a type of socialism far removed from the Stalinist model; Taipei, China has been strongly influenced by Sun Yat-sen's ideology in which the state plays a major

9. References to Taipei, China are to the island of Taiwan.
10. For what follows on Singapore, see Goh Keng Swee, *The Practice of Economic Growth* (Singapore: Federal Publications, 1977), especially Chapter 9, "A Socialist Economy that Works"; on the Republic of Korea and Taipei, China, see L.J. Lau, ed., *Models of Development: A Comparative Study of Economic Growth in South Korea and Taiwan* (San Francisco: ICS Press, 1990); also on the Republic of Korea, see L.E. Westphal, "Industrial Policy in an Export-Propelled Economy: Lessons from South Korea's Experience", *Journal of Economic Perspectives*, vol. 4, no. 3 (Summer 1990), pp. 41–59.



economic role; and the Republic of Korea's policy mechanisms bear strong resemblances to those of Japan, inasmuch as the government works closely with private entrepreneurs to identify future growth sectors, and supports investment and specialization in the identified sectors by specific micropolicies. Both the Republic of Korea and Taipei, China, like the United States and Germany in the nineteenth century, began their industrialization with tariff protection and import-substitution, but moved away from those protective policies at a stage in their development when a more external orientation became economically more appropriate. In all three economies, too, the gains of industrial development were spread widely among their populations as a result of deliberate policy, and this created wide political support for the economic programs.

## Conclusions

What then are the conclusions of this brief review of the changing roles of the state and market in the industrial development of the two Asian giants and three of the "Four Little Tigers" in the past two decades? First, government management and control of manufacturing enterprises, in which entrepreneurial, risk-taking behavior is essential for rapid and flexible growth, is unlikely to be successful beyond the initiating phase. However, there are major areas of infrastructure activity in which technology is not rapidly changing, which call for very large investments, and which tend to be natural monopolies, where government investment and control may be very desirable—but in those areas it is important that government adhere to economic pricing policies, and private entry may be desirable to curb excesses of government monopoly.

The government too has major tasks in the provision of adequate social infrastructure in the areas where external benefits are high. These include education at all levels, but especially at the pre-college level as well as at university and research institutions. Health facilities, including urban water supplies and sewage facilities, are other such areas in which there are high external benefits while investment costs are high. In the more narrow area of shorter term industrial related policy per se, the government, by establishing appropriate macroeconomic institutions and policies, sets the framework within which microeconomic policy changes and reforms to establish a smoothly working market and price system can be successfully pursued. In addition, the government can, by establishing an effective system of social security, including unemployment insurance and retraining, create a public environment in which rapid flexibility of response to industrial change becomes acceptable. In such an environment, business failure and resulting unemployment and loss will be acceptable, since the hardship of transition to new employment will be alleviated.

Apart from such specific programs to reduce the shocks of change, it is essential that the government adopt broader equity programs to ensure that the bulk of the population benefits by economic and industrial development. Without such efforts and results, public support for longer run programs of economic reform and development may be lost, and with that as well the political ability of the government to pursue those programs.

Socialism has many faces. While the detailed central planning and tight control regimes of Eastern Europe and parts of Asia appear to face major problems today, the socialism of Singapore and of Sweden that combines individual economic freedom with social support have apparently succeeded in achieving the economic flexibility that is necessary for rapid growth and improved social well-being for their peoples. In both Singapore and Sweden, there have been major roles for government in the economy, roles that are far less direct and hands-on than in the highly centrally planned socialist economies. But it is not an easy role, as the recent experience of both countries testify, and requires for its success both suitable and different public institutions than under traditional socialism, together with well-trained and effective officials who are able to develop and implement the necessary but very different government policies.

WORLD BANK NEWS

January 22, 19

PUBLICATIONS

# Immediate Action Needed To Prevent Destruction of Asian Environment

The Asia-Pacific region abounds with an astounding diversity of plants, animals and microorganisms. Stretching from Pakistan in the west to the Pacific Islands in the east, the vast area boasts the world's second-largest rainforest complex, more than one-half of the globe's coral reefs and the planet's highest mountain system. It also hosts tens of thousands of diverse island chains.

But the region is also home to sor the globe's poorest countries and half of the world's population, gro by 60 million people a year. This inc ing population pressure, along with nomic demands on the earth and conservation policies, is straining the natural fabric of the Asia-Pacific ar

To save their rich biodiversity, c tries in the region have to act now, s new report published by the World

"Unless immediate, decisive step taken to counter the effects of defor tion and other forms of natural resc destruction in the Asia-Pacific re much of Asia's biodiversity will be versibly lost within this generation," the report, *Conserving Biological D sity, A Strategy for Protected Areas Asia-Pacific Region.*

"Most of these losses will take pl species-rich lowland tropical rainfo few of which are expected to re undisturbed, other than those in tected areas. But losses will also be in many of the region's dry forest grasslands, as well as in freshw coastal and marine ecosystems. Ov next quarter of a century, the Asi cific region is expected to lose a h proportion of its species than any part of the world."

Every country in the region must protect its own biodiversity, say report.

But conservation efforts should n focus on those countries with the est wealth of diversity and high nu of endemic species and which have areas under immediate threat of de tion. Also, governments in the area s draft or enhance conservation p that could apply to all areas with biodiversity sites instead of targeti dividual sites.

To best protect resources, count the Asia-Pacific region must chang cies and activities that harm biodiv try new ways of protecting are volve local communities and carv

*Continued at top of n*

## Eco-Tourism – Conservation's Friend or Foe?

As the Asia-Pacific region grapples with conserving its biodiversity in the face of rapid population growth, some countries are turning to "eco-tourism" for help.

But eco-tourism, or programs which charge visitors an entry fee into protected areas, has its friends and foes.

Supporters say park fees bring in revenue that helps conserve and manage protected areas and justify setting aside large regions for conservation. The money tourists spend in and around the parks also helps pay back communities for their lost access to livelihoods in the protected areas.

Opponents of eco-tourism say it causes as many problems as benefits. Unless visits are closely managed, they say, tourists can severely degrade protected areas.

Nepal illustrates both sides of the eco-tourism debate.

On one hand, eco-tourism has helped biodiversity by channeling entry fees for a large protected area to local conservation efforts and local communities. But tourist visitation has also taken its toll in the Sagarmatha National Park around Mount Everest. Every year, tens of thousands of visitors come to trek and climb the protected area, burning large stacks of firewood and leaving behind waste and piles of garbage.

Horst Wagner

Forests being cleared in Solomon Islands. Most of the region's losses will take place in lowland tropical forests.

# Some Countries Have No Protected Wilderness Area

*Continued from bottom of page 4*

stable lifeline of conservation funding, says the report.

Reforming economic and fiscal policies can help to protect biodiversity by weeding out regulations and procedures that work directly against conservation efforts. Forestry policies that promote uncontrolled wood processing, for example, can induce wasteful and destructive practices. And agricultural policies often speed up the conversion of wetlands and rangelands and encourage overuse of pesticides and fertilizers.

Conservation efforts should include actions to get local people involved, the report says. Without help from communities, many efforts may fail because of the government's inability to enforce conservation laws.

Securing funding for the future of conservation efforts is also important. The study says countries should try to gain revenue through taxes and levies on use of natural resources. One example is eco-tourism, which charges tourists for visits to conservation areas.

The Asia-Pacific region has already set aside 3.8 percent of its land as protected areas for conserving biodiversity, an amount equal to the world average.

But many countries do not have any protected areas or have very weak protection systems. Also, the existing areas are often poorly managed and lack on-site staff, the report says. Some areas have been so degraded that "they are no longer worth designation as park report says.

The region's protected areas also because of weak environmental law enforcement and limited fundin rently, the region spends roughly $ lion a year on protected areas. I report says that the region needs to 10 times that to protect its biodivers at least $100 million a year on exp

*Conserving Biological Diversity: egy for Protected Areas in the Asia Region* is priced at $7.95. Journalis receive complimentary review co writing on company letterhead World Bank, Office of the Pub Marketing Unit, Room T-8054, Wa ton, D.C., 20433, U.S.A. Fax: (20 0579. □

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# Asia's Food Challenge: To Produce More With Less

Hunger problems loom unless governments and international development agencies act soon.

**By Truman Becker**
ADB Senior Information Officer

*Corn countries are more populous than pasture countries, and rice countries more populous than corn countries. But their happiness does not depend upon their being thinly or fully inhabited, upon their poverty or their richness, their youth or their age, but on the proportion which the population and the food bears to each other.*

***Thomas Malthus, 1798***

Is Asia's population growing disproportionately to its food supply? Will famine once again stalk millions of people?

Most agriculture experts agree that a Malthusian crisis is not likely to occur in the near term. The reason: the overall food situation in Asia has been characterized by a large increase in regional output since the famine-ravaged 1960s.

In the 1960s, the food situation was described as "desperate" in Asia. Famine had plagued India's Bihar state in the sixties, and Indonesia in the seventies. International food specialists predicted further famine because food production looked as if it would lag far behind population growth.

Instead, average crop yields per acre soared, thanks to the introduction of high-yielding varieties of rice and wheat and to expanded irrigation and chemical fertilizer use. It has been called the "green revolution."

## Double Role

According to a recent ADB report on the "Food Situation and Outlook for Asia: Preliminary Findings and Policy Implications," the keys to the higher food production have been irrigation, the adoption of high-yielding varieties (HYVs) of foodgrains and the increased use of modern inputs such as fertilizers.

"Irrigation has played a double role," the report says. "It has not only helped raise yields through synergistic interaction with HYVs and fertilizers, but has also contributed to considerable increases in harvested area by enabling higher cropping intensity."

Still, there are ominous clouds on Asia's food horizon. In light of the region's high population growth, increased urban sprawl and rampant environmental degradation, there are signs that hunger problems could loom unless action is taken by Asian nations and international development agencies.

## Shrinking Base

"The favorable food supply situation is likely to disappear within the next decade due to a shrinking resource base," Nihal Amerasinghe, Manager of the Bank's Agriculture Division I, points out. "The earlier decades had witnessed a natural resources-based growth strategy as there were adequate land and water resources for development. But this is fast disappearing due to urbanization, industrialization and ecological degradation. We should also remember that about 65 per cent of food production is from rainfed lands and a few years of drought could alter the food security which we now enjoy. The high costs of irrigation and land development, coupled with low commodity prices, are also hampering required investments and these effects will be seen in the next decade.

"By the year 2030, Asia will have to produce 60 per cent more rice with much less resources. Clearly, there will be a major challenge for scientists and policy-makers to meet the increased food demand. Asia's population is growing at between 2 to 3 per cent a year, making the challenges for regional food security a daunting task."

Amerasinghe echoed that the solution for meeting future food demand will be breakthroughs in science and technology since yield levels have reached a plateau and are even showing signs of decline. The possibilities through biotechnology and genetic engineering are exciting and can herald another "green revolution." This is the only hope for avoiding the Malthusian dilemma, he concluded.

In gauging the region's population-food squeeze, it is useful to look first at its swelling population. Asia – the world's most populous region – contains several countries with high population growth rates. The experience of the Bank's individual developing member countries (DMCs) varies considerably. While the newly industrializing economies (NIEs) have achieved stable growth rates as postwar declines in mortality rates have been matched by reduced fertility rates, population growth rates remain high in other DMCs in which fertility rates have remained high while mortality rates have fallen.

## Ironic Problem

As noted in an ADB report on "Health, Population and Development in Asia and the Pacific," rapid population growth dilutes and impedes economic development. An increase in the population base puts greater pressure on finite resources, both financial and natural, and, in the DMC context, worsening of income distribution, increased poverty incidence and environmental degradation.

Moreover, there is the ironic problem, as the report notes, that although rapid population growth increases poverty, poverty encourages larger families through its impact on access to education and decreased prospects for child survival.

In terms of absolute numbers, the report notes that the DMCs with the largest populations in the region are the

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*A Bank-assisted fertilizer research program in the Philippines: Yields have reached a plateau.*

People's Republic of China (PRC), India, Indonesia, Bangladesh and Pakistan. The PRC and India account for more than two-thirds of the region's population. While Bangladesh, Lao PDR, Nepal, Pakistan and Papua New Guinea are expected to have the highest population growth rates in the next decade, the PRC and India are still expected to contribute the largest number of additional people.

Variation in fertility status among DMCs may be attributed in part to differences in their levels of socioeconomic development. For instance, the more developed NIEs, which have started to approach replacement-level fertility (i.e. two children), have lower fertility rates than the less-developed South Asian and Pacific Island DMCs. Yet, fertility status is also influenced by the interplay of socioeconomic conditions such as education and the status of women that influence family decisions on the number of children; the general access to, and cost of, family planning services; and the degree of government commitment.

Reduced fertility tends to be correlated with advanced socioeconomic development. For instance, the NIEs, whose GNP per capita income ranged from $5,400 to $11,490 in 1990, also produced the lowest average number of children (1.5 to 2 children). In contrast, most South Asian countries, which had the lowest GNP per capita income, ranging from $190 to $470, also exhibited the highest fertility levels, with Myanmar and Sri Lanka exhibiting somewhat lower fertility levels (3.8 and 2.5 children, respectively).

In between, the Southeast Asian countries, with per capita income ranging from $200 to $2,320, have shown declining levels of fertility, with somewhat higher fertility levels for the Socialist Republic of Viet Nam and Lao PDR (4 and 6 children, respectively). However, several countries, including PRC, Malaysia and Sri Lanka, deviate from this pattern, showing fertility rates higher or lower than their level of economic development might otherwise suggest.

If population growth is uncontrolled, the report points out, the economic and social consequences are:

- ecological imbalance, with greater pressure on natural resources.
- increased urban crowding, with increases in demand for municipal services and infrastructure.
- a more unequal income distribution, particularly as labor supply outpaces job creation.
- signs of mass poverty, including high infant and child mortality rates, high levels of child malnutrition and hunger, poor school performance, unemployment and underemployment.

## Bleak Prospects

"Existing population growth rates are unsustainable, even for the relatively near future," the report notes. "Unless population growth rates are kept within manageable limits, the prospects for creating acceptable standards of living for low-income groups in the developing world will be bleak. Even assuming prompt action, the incremental increase in population in larger DMCs such as Bangladesh, India, Indonesia and Pakistan will be massive, thus posing a major development challenge."

The global population is growing more rapidly than ever before and will continue to do so for at least four decades, according to United Nations estimates.

Indeed, without major technological breakthroughs and changes in patterns of consumption, even the most optimistic population growth projections are likely to be accompanied by increases in poverty, hunger and environmental degradation.

"Whether we look at population, the environment or development, the next 10 years will be critical for our future," says Sri Pamoedjo Rahardjo, an ADB Population Specialist. "The decisions we make or don't take will widen or narrow our options for a century to come. They could decide the fate of the earth as a home for human beings."

The raw data on population growth tell a compelling story. Every day, the human family grows by a quarter of a million people. Thus, every 24 days, a new Hong Kong is added to the world. Every eight months a new Philippines. Every 10 years, nearly one billion people – or a new People's Republic of China. The pace of acceleration is breathtaking – it took thousands of years for the earth to reach the first billion in the early 1800s.

Beyond the sheer scope of population growth, the future will be profoundly influenced by its distribution:

- Population growth is occurring in regions of the world least able to respond to the demand for food, housing, education and employment opportunities that it will create. Ninety-five per cent of world population growth will occur in the developing world. Africa, where birth rates are highest, is growing 13 times faster than Europe, where population may decline in the years ahead.
- Population growth will be concentrated in the most vulnerable areas of the developing world: cities. In 1950, only one Third World city had a population of 5 million. By the year 2000, there will be 46, all taxed to, or beyond, the limit to provide services and maintain stability. According to an ADB report on "Urban Policy Issues," by the year 2010 there will be 204 Asian cities with more than one million persons, 36 of which will have more than 4 million people. Moreover, it is expected that the 16 Asian urban agglomerations will rank among the 35 largest cities in the world.

A historic turning point will be reached in 1997 when most of the world's population will live in urban areas, the report points out.

Still, the runaway population growth that began in the 1940s and peaked during the 1960s is a historical aberration. Largely the product of improvements in public health and sanitation, it will taper off during the last half of the next century. Exactly where it levels off could determine whether upward trends in economic growth and longevity will be reversed.

Demographers have been heartened by steady declines in fertility rates that have occurred since the late 1960s in response to economic development and the rapid spread of family planning programs around the world.

But lower fertility rates are not an immediate panacea. With so many people in their reproductive years – one-half will be under 25 in the year 2000 – the world's population will actually grow for the next several decades by larger numbers than ever before.

According to UN estimates, if fertility rates are reduced during the 1990s :

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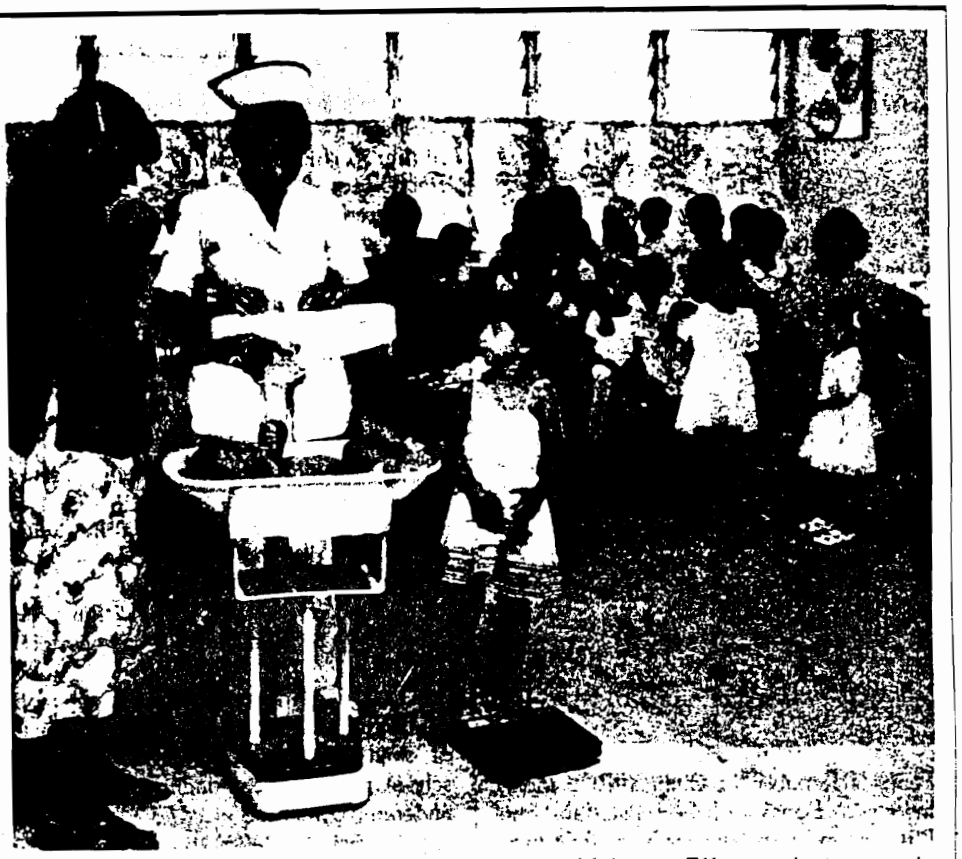
replacement level – that is, to the two children a couple need to replace themselves – there is a good chance population rates will begin to level off by mid-century at just twice today's total. If fertility rates remain high, the population could expand far beyond the earth's capacity to provide for it.

What is the ADB doing to help solve the twin problems of dwindling food supply and population growth? On the agricultural front, the Bank's DMCs are largely dependent on this sector for food, employment and foreign exchange earnings. Indeed, agriculture plays a key role in the region's economy, as Asia's rural areas contain the preponderance of the poor and produce essentially all of its food and non-mineral industrial raw materials both for export and domestic use. Moreover, poverty-induced pressures on the environment (soils, forests, water) are everywhere depleting the region's resources.

The Bank is placing an increased emphasis on resource sustainability, natural resources management and environmental protection in its agricultural lending. In line with the Bank's priorities for the 1990s, agriculture projects increasingly include components directly aimed at reducing poverty, enhancing the role of women and protecting the environment. Also included are policy reforms aimed at removing constraints on private enterprise.

As to future directions of the Bank's operations in agriculture and rural development, Richard Bradley, Director of the Agriculture Department, points out that the role of the sector will vary among DMCs, depending on the country's level of development, directions of macroeconomic policies and the performance of the Bank's agricultural portfolio in the past. Within the broad framework of the Bank's medium-term strategy, and the twin objectives of natural resource management and improvement in agricultural production and productivity, the Bank's agriculture operations will reflect a much broader awareness of the cross-cutting issues of development. Beneficiary participation and enhancement of the role of the private sector will be central themes, Bradley said.

In addition to these broad issues, there are particular agricultural subsector-specific aspects which will guide project identification, design and preparation in the medium term. According to Bradley, strategies and programs will be more narrowly focused and country-specific, drawing on the lessons of experience. Orientations in important subsectors will include:



*A Bank-supported Health and Population Project in Malaysia: Efforts to be increased.*

■ Water and land resources. Bank operations will address the problems of deteriorating and declining water resources caused by pollution, degraded watersheds, over-exploitation and inefficient water use, and increasing flood frequency and severity. The Bank will continue to provide irrigation, drainage and multipurpose flood control facilities, taking more account of water resources planning and development considerations, including river basins and surface and groundwater resources as well as physical, institutional and policy measures to enhance water use efficiency. Future projects in low-potential areas such as rainfed uplands and highlands will involve more emphasis on conserving soil and water resources and promoting non-agricultural opportunities to supplement incomes.

***The Bank's strategies will be more narrowly focused and country-specific, drawing on lessons of experience.***

■ Forests. Support for the sustainable management of forests will emphasize systematic efforts to restore forest cover and vital ecosystems through interventions that will include policy and institutional reforms as well as investments. The Bank will seek to facilitate an integrated approach to forest development taking into consideration the link between poverty, deforestation and environmental degradation. High-priority policy and institutional reforms would address the roles of government, private sector, NGOs and communities in reforestation, forest management and exploitation, rights of indigenous communities, monitoring and enforcement of forest regulations, and promotion of rural-based forest industries and services geared toward poverty reduction. The Bank would also assist DMCs to carry out inventories of forest resources and the delineation of forest areas and prepare country-specific masterplans for forestry development based on rational land use.

■ Fisheries. This sector is beset with divisions: between artisanal coastal and reef fisheries and high-technology marine fisheries; between capture fisheries and aquaculture; and between high-value export species and low-value species for domestic consumption and improved nutrition. Fisheries also has major environmental implications since poverty, which is widespread in this sector, leads to over-use or abuse of resources. Future fisheries projects will focus on poor, artisanal fishing communities. This will entail a holistic, community development approach to

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project design, looking beyond fisheries to alternative income-earning activities. Since many of the problems facing the sector are policy induced, policy-based lending will also play a major role.

■ Livestock. Investments will be adapted to the overall farming and ecological system, with sustainability the major concern. The importance of livestock is likely to increase as the Bank becomes active in countries (Afghanistan, PRC and Mongolia) where livestock plays a central role in the economy. However, future livestock projects will be taken up only after the lessons of past experience have been thoroughly assimilated. Sustainable livestock development would be supported through health maintenance and disease control, feed production and livestock farming systems adapted to the cultural and socioeconomic conditions of the rural poor. Ancillary policy adjustments will be pursued in regard to security of land tenure and incentives for private sector participation in production, processing and marketing.

■ Crop Subsector. Project objectives would include sustainable increase in production and productivity (food crops, industrial crops, horticulture) to keep pace with increased demand resulting from population and economic growth. Farming systems approaches will be emphasized. The Bank will continue to target small-scale farmers with the aim of putting them on a commercial footing.

## Community-Managed

■ Rural Infrastructure. The Bank will continue to support investments in irrigation, farm-to-market and access roads, rural water supply, etc. Participation of beneficiaries-farmer groups, water users associations – in planning, design and implementation – will be of prime consideration in undertaking such works which will also typically be small-scale and community-managed.

■ Agricultural Support Services. Adequate and efficient support services (inputs, rural credit, extension, research) are prerequisites for optimum returns on project investments. Accordingly, the Bank will support efficient and timely delivery of such services by encouraging private sector involvement and policy and institutional reforms. The Bank will assist in strengthening national capacity for agriculture research in the DMCs and support the catalytic role of international agricultural research center. The Bank will also look at creating new modalities for channelling support for agricultural research.

# A Genetic Revolution Holds the Key

**Biotechnology is a promising new technology which can contribute to the welfare of developed and developing countries. It includes any techniques that use living organisms to make or modify products, to improve plants or animals, or to develop microorganisms for specific use. Although practical applications of microorganisms are not new, there have been significant technological breakthroughs in the selection and manipulation of genetic materials.**

**Recombinant DNA technology (direct manipulation of genetic materials), monoclonal anti-body technology (preparation of complex molecules known as MAb), cell fusion (artificial joining of cells) and other techniques in bio-process engineering are expected to find applications in agriculture, plant and animal breeding and pharmaceuticals.**

**Potential applications of biotechnology in developing countries in the near future could include genetically manipulated plants for growth in tropical and sub-tropical climates, livestock and human vaccines that need no refrigeration, or small-scale conversion of biomass to ethanol and other energy sources. Furthermore, the production process in biotechnology would require relatively low capital investment compared with other new technological development. This means that biotechnology is also viable for application in small industries.**

Twenty years after the green revolution, biotechnology promises to boost food production again. But the biotech revolution will be far different from the green revolution, as it is likely to affect a wider range of agriculture than the green revolution. However, commercial products will take years to get to the marketplace, since scientists can only manipulate simple traits of plants at the moment. But, in the end, biotechnology will probably have a greater impact than the green revolution. □

In the population sector, the Bank's objective will be to help DMC governments attain rates of population growth and fertility most appropriate to their specific circumstances. Bank assistance to the sector should be expanded and should aim at developing systems for the delivery of health care and family planning programs, including the provision of support services.

While DMCs have well-defined population policies, several with continued high population growth do not. Assistance for sectoral planning and development is particularly needed in those DMCs where fertility is high, but contraceptive prevalence remains low. In those DMCs, however, where population programs enjoy strong political and financial support, as in Indonesia, Bank assistance may need to focus on program implementation support. In addition, the Bank should support promotional activities, and incorporate population activities within relevant projects.

In most DMCs, both the health and population sectors are affected by administrative and managerial weaknesses, partly because they are often handled by the same departments. In those DMCs, such as Indonesia, where the population program is well-developed and is under a separate administration, it is usual to find strong political and financial support with a positive impact on performance. However, some form of management support may be required even in these circumstances.

According to the ADB report o "Health, Population and Development Asia and the Pacific," Bank assistance for th population sector has been limited so fa Future efforts to step up support for fami planning services would depend on the d gree of political commitment by DMCs devise and implement programs. Hence little scope for Bank assistance is seen i countries (such as Malaysia) where the polic is pronatalist or, for that matter, in the cas of those DMCs (such as Thailand) where th program is already technically advanced.

## Support Needed

The greatest opportunities for Ban assistance exist in those DMCs where su stantial efforts are needed to strengthen th program (such as the Philippines), whe political commitment to fertility reductio exists but contraceptive prevalence is s low (such as Nepal and Pakistan), or whe the program is well-organized but requir support for expansion and technologic improvement (such as Indonesia).

Bank assistance to the population se tor is likely to expand. "However, the fa remains that Asia is adding about 60 milli people to the world each year," no Rahardjo. "Technology has reduced t specter of mass famine for the time bein but it may not reduce the sheer impact projected population growth if you're talk about quality of life."

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February 1, 1993

undp

# update

## *UNDP finalizes programme to encourage more foreign investment in Asia*

UNDP is in final negotiations with other organizations to launch a proposed $14 million regional programme to boost trade and investment in Asia. The ambitious programme will focus on creating the policies, institutions and promotion strategies needed to encourage further trade and investment in the region.

To ensure that regional technical cooperation is anchored in real needs, UNDP organized three consultations over the past year with Asian ministers, representatives of investment promotion agencies, and economic policy-makers.

As a result, UNDP's regional programme will be geared toward strengthening institutions concerned with the areas those consultations examined: international trade policy, export-oriented small and medium-scale enterprises, trade-related intellectual property, and direct foreign investment and trade. In addition, the programme will help governments reform their investment policies to increase the likelihood of attracting foreign capital.

UNDP will work in close cooperation with other UN agencies, the World Bank, and national and regional institutions in Asia and the Pacific. The private sector, universities, trade associations, chambers of commerce and non-governmental organizations will also be involved, both as beneficiaries and implementing agents of the five-year programme.

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# update

## UNDP to Implement New Technical Support Project for Economic Reform in Mongolia

UNDP is implementing a new $755,000 project that will help Mongolia institute crucial economic reforms. In the past, Mongolia's economy was tied to that of the former Soviet Union. In the 1980s, 95 per cent of the country's trade took place with that now-defunct state. In 1990 and 1991, Mongolia replaced its communist government with a democratic one and began to move away from state planning towards a market-oriented economy.

Mongolians have had to pay a price for economic reform. Loose monetary and fiscal policies are credited with hiking the monthly inflation rate to an average of 12 per cent in 1992. Exports and imports, measured in dollars, fell by 22 per cent and 43 per cent respectively in 1991. Unemployment is currently estimated to be as high as 16 percent.

To help the government address these problems and complete its reform process, UNDP and several multilateral and bilateral donors are providing assistance at the macroeconomic policy level. UNDP has funded long-term advisors in the areas of foreign investment policy, aid coordination systems and medium-term planning. With USAID funding, UNDP has also provided Mongolia with a team of short-term economic experts who are giving advice in a number of key areas and teaching basic courses in economic theory. The increased support will provide longer-term advisors in crucial areas, including regional development, market research and privatization.

WORLD BANK NEWS

February 11, 1993

## 1992 Floods Hamper Economic Growth in Pakistan

*Severe flooding in northern Pakistan in August and September 1992 claimed thousands of lives and destroyed a significant portion of the country's crops and homes. The Pakistani government has since launched recovery efforts with the help of many bilateral and multilateral donors, including the World Bank.*

Pedro Alba

*But the legacy of the floods is still being felt months after the waters subsided. Damage to crops like cotton, rice and sugar cane was so extensive that it may drive down Pakistan's economic growth rate for 1993, says Pedro Alba, senior economist in the World Bank's South Asia Country Operations Industry and Finance Division.*

*Alba recently spoke to* World Bank News *about the economic future of Pakistan. Excerpts follow:*

# Slower Growth for Pakistan's Economy This Year

INTERVIEW, *from page 1*

WBN: How will the 1992 flooding affect Pakistan's development and economic growth in 1993?

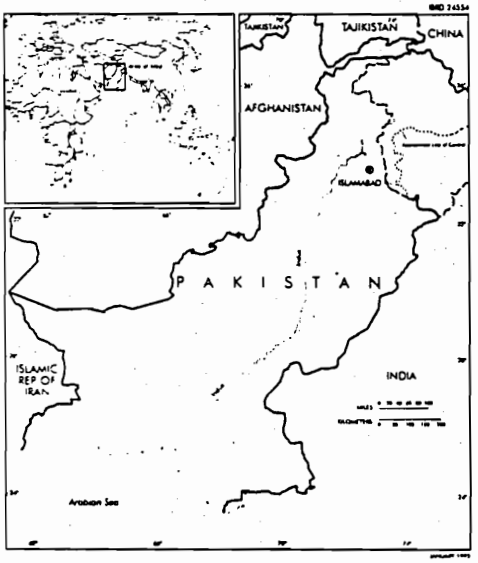
Mr. Alba: Pakistan's growth rate for 1992-1993 will be lower than anticipated because of the floods. Instead of the expected 6 to 7 percent, Pakistan will probably see only 4 to 5 percent growth.

Agriculture brings in 25 percent of the country's gross domestic product. The floods washed away thousands of farms, so the damage will have a big impact on the economy this year. Agricultural growth will fall quite significantly to 1 or 2 percent at best because of the floods. The country's budget deficit will also rise this year to higher than last year's 7.5 percent of gross domestic product because of the government's relief and repair efforts and loss of tax revenue.

WBN: Several years ago, some development experts saw Pakistan as one of the "rising stars" of Asia. Is that still true today?

Mr. Alba: In certain aspects, yes. Pakistan has done very well in terms of GDP growth and exports in the past few years. Its growth rate hit 6.8 percent last year and 5.5 percent the previous year. Exports have grown 14 percent a year by volume over the last four years.

Pakistan has been undertaking a series of far-ranging structural reforms to promote private sector investment and activity. In trade reform, it has eliminated many non-tariff barriers and reduced maximum tariffs significantly. In the financial sector, among other things, it has put in place an auction system for government debt so that interest rates better reflect market conditions. It has also liberalized investment and the foreign exchange regulations.

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| Population: 116 million | Per Capita GDP (1990): $400 |
| Annual Population Growth Rate: 3.1 percent | Life Expectancy At Birth: 56 years |
| Average Births Per Woman: 5.7 | Literacy: 35 percent |

WBN: Has Pakistan fallen short of expectations in other areas?

Mr. Alba: It's a mixed picture. Pakistan has done well in some policy areas but not as well in others.

It has not been entirely successful in improving fiscal and external account balances. Fiscal deficits remain high at 7 to 8 percent of GDP a year. Revenue mobilization has not been as strong as it could be. Tax revenue, in particular, has remained basically stagnant since fiscal 1988. The structure of expenditures needs to be looked at too. Interest payments on the country's debt and non-development expenditures account for two-thirds of the current budget.

Another area of concern is improving social conditions and reducing poverty. Social sector indicators lag behind countries with similar and even lower levels of development. Health status and poverty indicators have not improved significantly over the last 10 years.

However, Pakistan is putting together an ambitious social action program together with external donors, including the World Bank. The social action program will focus on improving the provinces' ability to deliver basic social services by tackling implementation, programming and funding constraints. The government is trying to make sure that enough funding is available for recurrent costs like teachers' salaries, more and better instructional materials and for school maintenance.

Also, among the most important reforms to be undertaken in the social action program focuses on improving women's access to basic social services. In this regard, the provinces are trying to increase the number of women working in rural health and education facilities. I think these are very important first steps in moving forward with the implementation of the social action program.

WBN: Pakistan's adjustment program for 1992-1994 aims for 6.3 percent growth. Is that realistic in view of the country's recent problems?

Mr. Alba: Economic growth rates in the future depend on whether the government continues to forcefully pursue its adjustment agenda and external environment.

With regard to the private sector agenda, Pakistan needs to continue with its privatization efforts, financial sector

*continued at top of next page*

# Privatizations in Pakistan Under Way

*continued from previous page*

reforms and trade reform program. However, the most important focus should be on reducing the fiscal deficit. Such high deficits could undermine price stability and economic growth in the long run.

However, let me end on a positive note and comment on one of the government's recent initiatives.

Since the current government took over, Pakistan has been taking big steps in implementing a privatization program. So far, the government has identified 100 industrial units for sale and about one-half of these have been privatized. The government has also begun privatizing the banking system which was nationalized in the 1970s. Two of the four banks are now in private hands. They're also expanding the privatization program to explore options on utilities like telecommunications and electricity.

These efforts are important not only because they will motivate increased private investment. They will also permit the government to concentrate scarce financial and administrative resources in priority programs like the social action programs. □

Vendor in Peshawar sells locally grown fruit

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## EDITORIAL/OPINION

# Off to a Slow Start in Manila

By JOSEPH P. QUINLAN

One can only hope that President Bill Clinton gets off to a faster start than Philippine President Fidel Ramos, whose deliberate style has earned him the nickname "Steady Eddie."

When he assumed office in June 1992, Mr. Ramos promised "remedies close to surgery" in combating the nation's economic and social ills. But if the first six months of the Ramos administration are any indication, the required medicine to cure the Philippines may be a long time in coming.

Ever cautious, President Ramos launched very few policy initiatives in the first half-year of his term. On the economic front, the government lifted foreign exchange controls in September and concluded a debt restructuring deal in early December. Both initiatives, though, did not require legislative approval and were begun by the Aquino government.

On the political front, the government made some headway in brokering peace with rebel soldiers and communist insurgents. Toward the end, the ban on the Communist Party has been lifted and an offer of amnesty has been extended to communist guerrillas.

The president has also made peace with the House of Representatives. In what many consider Mr. Ramos' most significant accomplishment to date, a rainbow coalition in the 200-member House of Representatives has been constructed, which, in effect, gives Mr. Ramos a working majority in the lower house.

Dealing with the more populist and nationalistic Senate will be more problematic for the president. Controlled by the opposition party, the Senate has already squared off with Mr. Ramos over the nation's foreign debt ceiling.

In addition, key pieces of legislation, including measures that would liberalize foreign banking regulations, are in the legislative limbo, thanks to an uncooperative Senate.

Dealing with cantankerous senators, however, pales in comparison to the two most pressing issues facing Mr. Ramos: re-establishing law and order following a wave of kidnappings-for-ransom last year and resolving the nation's crippling power shortages. Both problems have undermined the confidence of foreign investors.

Both problems have also acutely embarrassed the government. Mr. Ramos made it a point to voice his commitment to law and order in his inaugural address. Yet almost immediately afterwards, a rash of kidnappings-for-ransom, directed primarily against wealthy Chinese Filipino businessmen and their families, swept the nation. Many Chinese businessmen responded by sending badly needed capital overseas.

President Ramos reacted by creating a Presidential Anti-Crime Commission, although that "super-body" has been hamstrung by inadequate funding and alleged leaks in the operation.

Even more embarrassing for the government, some police officers and military officials are suspected of being involved in the kidnapping. To date, and not surprisingly, the majority of the cases remain unsolved.

The nation's energy problem remains unresolved as well, though to be fair to Mr. Ramos, the Philippines' energy crisis took root under the Aquino government.

Due to past neglect, brownouts in Manila and other key industrial areas now average up to six hours a day, costing companies millions in lost sales and productivity.

Mr. Ramos, at first, was slow to grasp the gravity of the energy problem, but has since created a special Energy Department and begun a fast-truck program to install new power generators. The government has even gone so far as to revamp foreign investment laws in the energy sector. The 40% equity limit on foreign investment has been scrapped, allowing foreign companies to take a 100% stake in firms dealing in petroleum, coal, electricity and gas.

"Are we in a 'no-fly' zone?"

In the long term, these measures should boost the nation's energy capabilities. But in the immediate future there is little relief in sight to the energy crunch. The government does not expect the brownouts to subside until September, when a number of new power stations come on line. Consequently, Mr. Ramos confronts a brutally hot summer in Manila.

In the meantime, the president has other problems to sweat over. Infrastructural bottlenecks threaten to choke commerce, a large foreign debt consumes one-third of budget expenditures, rapid population growth strains limited government resources and a bloated bureaucracy poses a serious obstacle to economic reform.

Against this backdrop, it's hardly surprising that the much awaited economic rebound and investment boom have yet to materialize. The economy, while showing some signs of improvement, limped along at near zero growth last year.

And prospects for this year are not any better: the National Economic Development Authority expects the economy to expand by 4% this year, though most private forecasts envision growth at half that rate.

Foreign investors, meanwhile, remain on the sidelines, weary of the many risks of doing business in the Philippines. Indeed, Vietnam, the Philippines' new regional competitor, attracted nearly four times the amount of new foreign investment last year than the Philippines. This, despite the fact that Vietnam is one of the poorest nations in the world and still under the restrictions of the U.S. trade embargo.

Vietnam's sudden attraction to international investors should serve as a warning to President Ramos. The Philippines, once one of the most advanced nations in Asia, is falling dangerously behind its dynamic neighbors. Mr. Ramos must move faster.

*Joseph Quinlan, an international economist, writes often about Asia.*

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# BANGLADESH

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|---|---|
| 1992 population: | 111,400,000 |
| 1992 natural increase in population: | 2.4%/2.7 million people |
| Change in fertility (TFR) 1979/80-91: | 6.8 to 4.2 children (-38.2%) |
| Contraceptive use (CPR): | 40% total/31% modern methods |

*1991 estimate

*Status of abortion/menstrual regulation:* Abortion technically permitted only to save the woman's life; menstrual regulation services provided as part of the government family planning program.

## Contraceptive Use Tops 40 Percent of Couples Despite Widespread Poverty and Low Women's Status

The doubling of contraceptive use in Bangladesh over the past decade—from under 20 percent of married couples in 1981 to 40 percent in 1991—is an unexpected achievement given the extreme poverty, tremendous logistical problems (floods inundate much of the country during the monsoon rains), high levels of illiteracy, and low status of women. The case of Bangladesh challenges assumptions about the necessity of broad based socioeconomic development as a precondition for fertility decline; average family size has fallen to nearly four children, down from almost seven in 1980. Most young Bangladeshi women say they only want two or three children.

With over 100 million people packed into an area no larger than the state of Wisconsin, and with the highest population density on arable land of any country in the world, the need for population stabilization is urgent. In 1976, the government identified population growth as a severe obstacle to development and made the family planning program a national priority. The level of political commitment shows. Buttressed by sustained national political leadership and generous international donor support, Bangladesh's extensive government program, complemented by the efforts of hundreds of private organizations and one of the





strongest social marketing (subsidized contraceptive retail sales) programs in the world, is an outstanding example of family planning progress.

The national program is currently working to incorporate a number of important innovations developed by the Matlab Family Planning and Health Services Project (of the International Centre for Diarrhoeal Disease Research), in particular, the emphasis on more intensive coverage by outreach workers and more comprehensive counseling as well as wider contraceptive choice. (The Matlab project is the world's largest family planning field research effort and has produced a significant body of scientific information on family planning service design and delivery.) Ongoing expansion of the community-based distribution system, including an increase in the number of female fieldworkers, accounts for a large share of the recent gains in contraceptive prevalence. In this predominantly Muslim society, the severe restrictions placed on women's mobility add to the importance of home visits by female health workers. Satellite health clinics and mobile teams back up the village outreach system to provide contraceptive sterilization services, IUD insertions, and menstrual regulation.

The social marketing of highly subsidized contraceptives has greatly broadened access to reversible and short-term family planning methods, particularly in urban areas. In 1991, a full 40 percent of condom and pill users obtained their regular supplies through commercial channels, paying the equivalent of as little as one dollar for a year's supply.

Beginning in the mid-1980s, the female family planning fieldworkers (known as family welfare assistants) were also made responsible for the child immunization campaign, which, although successful, has significantly added to their workload. A subsequent government initiative to replace the predominantly male health assistants, responsible for other health efforts with

women, could help to address tensions between family planning and health workers and produce a more successful team approach to primary health care.

Given the high rates of abortion-related maternal mortality in Bangladesh, menstrual regulation services are a crucial component of the family planning program. Although the availability of services has greatly increased because trained health personnel other than physicians may perform menstrual regulation, these services are still not universally accessible in rural areas. Slow progress in dealing with the problem of unsafe abortions is partially the result of U.S. foreign aid policies, introduced in the mid-1980s, which prohibit local family planning organizations from providing services or referrals for menstrual regulation as a condition of their U.S. government support. The family planning program is 90 percent or more dependent on foreign aid, a major part of it from the U.S. government.

The Bangladesh program continues to make important strides in expanding and improving family planning services, but it still has a long way to go. Although societal acceptance of contraception is growing, religious beliefs, gender roles, women's young age at first pregnancy, and son preference continue to pose cultural obstacles to early population stabilization. A greater focus on women's development is clearly needed to accelerate the changes in family size norms already underway. Like programs in most countries, the Bangladesh program would also benefit greatly from improvements in quality of care. Continued movement away from rigid targets for contraceptive use, especially for sterilization, and abandonment of various economic incentive schemes, will be important in building a better rapport between service providers and their clients and ensuring that couples have the information and choices they need to effectively plan their

BANGLADESH
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families over the course of their reproductive lives.

The family planning program is unfortunately becoming the victim of its very success. The large and growing costs of sustaining such a high level of contraceptive use are prompting foreign donors to push for increased efficiency and greater self-reliance. Mounting donor "fatigue," however, could be disastrous. Many experts predict a serious shortfall in contraceptive supplies in the next several years unless donors move quickly to increase donations of contraceptives. Continued generous international support for better quality reproductive health care and for related development initiatives is crucial to early population stabilization and, consequently, to Bangladesh's future.

# INDONESIA

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|---|---|
| 1992 population: | 18[illegible],500,000 |
| 1992 natural increase in population: | 1.7%/3.2 million people |
| Change in fertility (TFR) 1980-91: | 4.6 to 3.0 children (-34.8%) |
| Contraceptive use (CPR): | 50 tot. / 47% modern meth[illegible] |

*1991 estimate

*Status of abortion/menstrual regulation:* Abortion legal only for serious health reasons. Menstrual regulation, however, increasingly available through private providers.

## Five-fold Increase in Contraceptive Use in World's Fourth Most Populous Nation the Result of Strong Political and Community Support

Hailed for many years by population experts as a major success story, Indonesia's government-run family planning program has been marked by strong political support at both the national and local levels, a high degree of local community mobilization, and widespread access to several modern contraceptive methods, particularly on the main islands of Java and Bali. Although for religious reasons contraceptive sterilization and abortion are not offered by the national program, the government has condoned and at times encouraged the provision of sterilization services at reasonable cost by private clinics. Menstrual regulation is also available through private channels, but to a lesser degree and without official sanction.

In this, the fourth largest country in the world, contraceptive prevalence is now at least 50 percent of reproductive age couples, a remarkable five-fold increase in 20 years, despite a low per capita income of just $570 a year. Knowledge of family planning is almost universal, and most young couples want only two children. But today, the massive Indonesian program is taking on a whole new set of challenges. This highly successful government-run program is attempting to put itself out of business by turning





more and more responsibility for family planning services over to the private sector and by putting government services on a fee-for-service basis.

Currently, almost 80 percent of family planning users rely on government sources for modern contraceptives, which have been provided free of charge. Faced with the likelihood of reduced donor support and increased costs owing to the record number of young people entering their reproductive years, Indonesia has instituted a policy of *KB Mandiri*, or "self-reliance." Most couples will now pay for at least part of the cost of their family planning supplies and services, and many will be encouraged to rely on private sector health providers. Indonesia is also striving for self-sufficiency in contraceptive production (including condoms, IUDs, oral contraceptives and injectable contraceptives) and already has close to a dozen contraceptive factories.

An innovative social marketing program, introduced in 1988, promotes the retail sales of subsidized brands of contraceptive methods identified by a Blue Circle label. The highly visible Blue Circle advertising campaign appears to have stimulated increased use of contraception in urban areas where, in the absence of strong community support, organized family planning efforts have traditionally been less effective. Experts are confident that the new fee-for-service policy will not lower contraceptive prevalence, given the high level of motivation of many couples.

Indonesia's national family planning program was launched as part of President Suharto's New Order government in 1968. The interministerial National Family Planning Coordinating Board, known worldwide by its Indonesian acronym, BKKBN, has been the driving force behind a rapid expansion of family planning services in the 13,000 island archipelago, first in the most populous islands of Java and Bali, then by stages in the peripheral islands. Indonesian family planning efforts combine a centrally

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planned program with a high degree of local community involvement in the promotion and delivery of services. Family planning is available not only through health clinics, but through village outreach workers, Mother's Clubs (*Kelompok Ibu-Ibu*), and several Muslim organizations.

The government has worked hard to build political support for the family planning program and has carefully cultivated backing from religious and traditional village leaders. That the chair of the BKKBN reports directly to the President is another mark of the importance accorded family planning efforts in the country. The active support of local community leaders has helped to overcome traditional religious and cultural barriers to contraceptive use and has actually created considerable social pressure on couples to conform to the small family norms promoted by the government. Along with a strong public information campaign that emphasizes the benefits of small families and the expanding family planning service network, the consistency of political support has played a critical role in the more than 40 percent decline in average family size (in just two decades) from five or six children to about three.

Not surprisingly, however, the program's heavy emphasis on reaching targeted levels of contraceptive use and fertility decline has been controversial in some quarters, and critics of the program have occasionally charged it with human rights abuses, particularly—but apparently without basis—in the formerly Portuguese-controlled area of East Timor, which Indonesia occupied in 1975. Also controversial among program critics is the increased reliance in recent years on long acting methods such as the IUD and the contraceptive implant Norplant. Both methods, being controlled by service providers rather than clients, are potentially subject to abuse in the context of Indonesia's hard-driving program. So far, however, outside evaluations of the program have failed to uncover major abuses. Most knowl-

INDONESIA
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edgeable observers believe contraceptive users are making informed voluntary choices, even though many may feel under some pressure to conform. These concerns should, moreover, become less important in the future as more couples pay for their family planning services from a variety of public and private sources.

It should also be noted that the Indonesian government has pursued most other social and economic development goals with the same style of intensive community mobilization and national target-setting. Over the years the well-established family planning infrastructure has been used to successfully deliver services in child survival and community development. Government efforts to improve the status of women through educational and income generating programs, combined with a significant decline in child mortality and fairly rapid economic growth, have undoubtedly contributed to the government's success in slowing rates of population growth.

The government has taken steps in recent years to improve the quality of family planning services by increasing the range of contraceptive choices from two or three to a half dozen. As privatization efforts continue, such quality of care issues will take on added importance in response to the higher expectations of paying clients with a choice of service providers. But there will still be plenty of room for improvement in government efforts, especially in related areas of reproductive health care such as maternal mortality, where death rates remain relatively high, and with respect to the looming threat of AIDS, given its important implications for the delivery of contraceptive services.

# PAKISTAN

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|---|---|
| 1992 population: | 121,700,000 |
| 1992 natural increase in population: | 3.1%/3.8 million people |
| Change in fertility (TFR) 1976-91: | 6.3 to 5.4 children (-14.3%) |
| Contraceptive use (CPR): | 12% total/9% modern methods* |

*Status of abortion/menstrual regulation:* Abortion permitted only to save the life of the woman.

*1991 estimate

## Mounting Demand by Women for Fertility Control Largely Unsatisfied by Weak Health Services

Erratic political support from Pakistan's national leaders, mirrored by a lack of any commitment at the state and local level, bears much of the blame for Pakistan's almost total lack of progress in family planning over the past 25 years. Even former Prime Minister Benazir Bhutto, Pakistan's only female head of state, avoided open support for family planning in an effort to make herself acceptable to the country's powerful religious conservatives.

The absence of consistent political support for family planning over the years, combined with the extremely low status of women, widespread poverty and high rates of illiteracy, have made Pakistan—the eighth most populous nation—one of the world's most serious family planning failures. Average family size is still between five and six children, despite an official policy on the books since the early 1960s to reduce population growth. Pakistan is the third largest contributor to world population growth after India and China.

The biggest problem does not appear to be lack of demand for fertility control. Surveys reveal that over a third of Pakistani women want no more children, and large additional numbers want the means to space births. But with levels of modern contraceptive use at only 9 percent of couples, Pakistan lags far behind neighboring India where modern contraceptive use is now at 40 percent.



# PAKISTAN

C O N T I N U E D

A major obstacle to meeting the demand for services is the lack c adequate health infrastructure. Pakistan has never made the kind: of investments in rural health networks that India and Bangladesl have made, with the result that 70 percent of the rural populatior lack access to modern health facilities. Moreover, not all existing facilities offer family planning, in part because staff are not traine in contraceptive services. It is estimated that as few as 5 percent c couples in rural areas can obtain services. Nationwide at least on third of couples want and need family planning services, but hav virtually no access.

The limited reach and effectiveness of the government's national family planning program has left much of the responsibility for providing services to nongovernmental organizations (NGOs). The Family Planning Association of Pakistan is the largest of several major private organizations. The government and foreign donors also channel funds to many small local organizations through an NGO Coordinating Council. Funding from the United States has also helped launch an effort to market contraceptives a subsidized prices. But so far, most of these activities have operat on too small a scale to make a big impact on unmet demand.

Without more effective family planning efforts, Pakistan's population of over 120 million people could double in just 23 years, with serious implications for national development goals. In 1990, 80 percent of the population still had no sanitary facilitie and close to one third of the population—some 37 million peopl — were classified as living below the poverty line. Between 197 and 1990, adult literacy increased by only 15 percent, to just 35 percent of the adult population. For women, the situation is muc worse: 79 percent of Pakistani women have received no formal education. These conditions contribute to and are aggravated by rapid population growth. As a percent of total government expenditures, the Pakistani government's budgets for health and education are among the lowest in the South Asian region—

about half the level of neighboring countries like Sri Lanka and Bangladesh.

Since the election of Nawaz Sharif as prime minister, the Pakistani government appears more committed to meeting family planning needs. The government seems finally to have recognized that poor service delivery, rather than a lack of interest, is the country's primary family planning problem. When Prime Minister Sharif addressed the 1992 Earth Summit in Rio, he strongly supported the need for population stabilization.

The Sharif government has announced plans to double the number of government health outlets at which contraceptives will be made available over the next several years. But even this relatively modest goal may be unachievable. Pakistan has relied heavily in the past on foreign assistance, including close to $10 million a year from the United States. U.S. aid to the government was recently cut off because of disagreements over Pakistan's nuclear policies. U.S. law allows continued support of NGO programs, but these will have to be scaled up substantially to make an impact on Pakistan's galloping population growth.

WASHINGTON
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**SPRING 1993**
**EASTERN EUROPE**

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Christine E. Contee
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FOREIGN POLICY

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# RUSSIA AND ITS NEIGHBORS

*by Paul A. Goble*

The most serious and difficult question confronting Russians today is not how they will survive economic reform but rather whether they can accept the independence of the 14 other former Soviet republics as legitimate. The question is serious because its answer will profoundly affect Russia's ability to make the transition to democracy, maintain its own territorial integrity, and integrate itself into the international community. It is difficult because the question concerns more the status of the Russians themselves than that of the non-Russians. Long submerged under the czarist and then Soviet empires, the Russians have never before been forced to define precisely who is a Russian and what the proper limits of Russian territory should be; now they must find answers. Although no one can do that for them, Russia's new neighbors and the West will both have significant roles to play.

Those two existential questions—what is Russia, and who are Russians—were somewhat obscured by the traumas of the last year. But now, more than a year after the Soviet Union's demise, Russians are coming out of shock and confronting what many of them see as the key to their future. Not surprisingly, some Russians try to deny what has happened or want to recover what they perceive they have "lost." But most seem to be groping toward some modus vivendi with the new reality in which they find themselves. Unfortunately, the realization of that modus vivendi will be no easy task.

The Russians' current difficulties on that score have a long history. Following the collapse of the Mongols at the end of the fourteenth century, the rulers of the Russian lands began to absorb other peoples, most notably

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with the taking of Kazan in 1552, long before the Russian people had consolidated as a nation. The empire continued to expand until, by the mid-seventeenth century, it was the largest state in the world. Russian rulers had few concerns about the new populations except for their loyalty. As a result, the boundaries of both the people and the state were never clear, producing a psychological ambiguity that meant both czarist Russia and the USSR were empires of a pre-modern type: Instead of a clearly defined metropole and colonies, they consisted of a nebulous center and a periphery. The Russians, then, could not view with equanimity the departure of any part of the empire, no matter how different its population.

That ancient problem was compounded by the actions of the Soviet state. Not only did communist ideology mandate virtually continuous expansionism, but the Soviet state's specific approach to its multi-ethnic population further retarded and distorted Russian national development. By converting the ethnic identity of all groups into official nationalities with a clearly defined territorial dimension, Stalin institutionalized ethnic tensions, justifying his authoritarian regime and guaranteeing that the collapse of the Soviet Union would follow ethnic lines.

The ethnic territories Stalin designed were not based on simple ethnography or the popular will of those concerned. Instead, the borders were drawn to both generate and ensure continued ethnic tensions, creating dependent minorities inside each and making Moscow the power broker. While outside observers have long understood that feature of Soviet statecraft in the non-Russian parts of the USSR, they have seldom acknowledged that the Russian Soviet Federated Socialist Republic (RSFSR) was equally inauthentic. Given earlier Russian history, it could hardly be otherwise; but that may prove to be Stalin's ultimate "poison pill," left behind to confound those who would dismantle his work.

The problem is not only that almost one-fifth of the population of the Russian Federation is non-Russian. The historical homelands of millions of people who have always considered themselves Russians, and who have wanted to become citizens of the Russian Federation

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since the demise of the Soviet Union, lie beyond the federation's borders. And the tension inherent in that arrangement has been exacerbated by the fact that the Soviet state gave the Russians alone extraterritorial status as well; that is, it provided Russians with Russian-language institutions regardless of where they lived. In fact, more than 25 million Russians now live outside of the Russian Federation. As a result, and in contrast to all other nationalities of the Soviet Union, Russians never viewed their RSFSR as either a republic or their homeland but as one part of a country in which Russians were at home everywhere. That view preserved the ambiguities of their identities that had begun in czarist times.

**The Russians have never before been forced to define precisely who is a Russian and what the proper limits of Russian territory should be.**

The sense that Russia should really be more than the Russian Federation was intensified by the sudden complexity of Moscow's relationships with the 14 other new countries that emerged after the collapse of the USSR. Before Mikhail Gorbachev, Moscow and the Russians did not negotiate with the republics; the center almost always gave orders. While there was an awareness that the territories were not all the same, it did not form the primary basis for Moscow's relations with them. With independence, however, the republics posed additional challenges to Russian identity. They flowed both from the 15 republics' commonalities, which were largely the product of the Soviet system, and from their differences, which reflect geography, culture, economics, nationalism, and politics.

Not surprisingly, Russians and most outside observers focused on the commonalities shared by the 15 new countries, commonalities that many felt justified a continued political union:

•The tight economic integration of the 15 post-Soviet countries renders continued economic cooperation critical. Because Moscow's planners favored big centralized plants, many key industrial goods are only produced in one place, tying the old Soviet Union together and making its divorce more difficult.

•The relatively greater importance of nationality over citizenship in Soviet times has had consequences into independence, making the integration of all ethnic minorities more difficult and convincing many Russians now living "abroad" that they in fact remain "citizens of the USSR."

•All face the task of decommunizing both the polity and the economy, and all share the tendency to blame current problems on the post-Soviet transition rather than on the Soviet past.

•Borders are increasingly seen as artificial, leading many to conclude that repression, aggression, or migration will eventually be the only options.

•All fear instability throughout the region.

Though the commonalities of the post-Soviet region are obvious, equally obvious are the enormous diversities:

•There has been what geographer David Hooson has elegantly called "the return of geography," the renewed impact of location and resources on political decisions. No one, for example, would argue that mines in Turkmenistan are more important to Russia than ports in the Baltic countries.

•The diversity of cultures has been accentuated by the Soviet collapse. So too has the desire of all non-Russian groups to integrate directly into world culture: They do not want their participation to be mediated by the Russians, as was the case in the past.

•Economic conditions vary greatly, with some of the states having enormous resources and others virtually none, and with some groups of states fitting naturally together and others less so.

•Nationalism's nature and role in the fight for independence and democratic values have varied widely according to region. The western republics were all home to highly articulated national movements that defined national goals before independence; those of Central Asia, for whom independence came as an unwelcome surprise, were not.

•Each country has specific problems—citizenship in the formerly occupied Baltic states, stability in Central Asia, violence

in the Caucasus—that set them apart.

Even that brief listing of the similarities and differences illustrates why some Russians want to resurrect the empire while others are ready to accept the ex-Soviet republics' independence. The former group looks to the Commonwealth of Independent States (CIS) structure as a means, viewing it as the framework for an ever tighter confederation by which most, if not all, of the former republics can be integrated into a state under Russian domination. The CIS commander-in-chief Marshal Yevgeny Shaposhnikov, for example, has argued that CIS-controlled nuclear weapons in Belarus, Kazakhstan, and Ukraine can serve as a first step along that road. And Sergei Stankevich, currently Russian president Boris Yeltsin's adviser for political affairs, has supported the idea that Moscow deal with the republics not through the Foreign Ministry, as would be the case with normal countries, but with a yet-to-be-created ministry of CIS affairs that would highlight their continued integration.

At the same time, many others—including Yeltsin—have been prepared to recognize the independence of the 14 as entirely legitimate. Their arguments are three-fold. First, since no one would advocate that Moscow have the same foreign policy for both Mongolia and Poland because they are both formerly communist, why should Moscow adopt a common approach to Estonia and Tajikistan? Second, any effort to adopt a single approach to all would require the use of force beyond Russia's current capacity, further bankrupting a country already in trouble. And third, relying on force to hold such an enormous region together would have consequences for Russia itself, leaving it less liberal and more susceptible to authoritarian rule.

It is "not accidental," as the Russians say, that those who prefer resurrected empire tend to be more authoritarian in disposition than those who prefer independent countries. And given developments within Russia since the December 1992 meeting of the Congress of People's Deputies, as well as those in the "near abroad" and elsewhere, it is no accident that those backing the former approach have picked up additional support.



*Securing Russia*

Beneath the former republics' commonalities and diversity are some very real Russian interests in what happens with the newly independent states. Russia has economic interests in ports, access to raw materials, transportation, communication, and plants where production is not yet duplicated by firms in the Russian Federation. It has political interests in cooperation with the new states lest there be an explosion of ethnic violence, in protecting its citizens and even co-ethnics abroad, and in coordinating policies on a variety of regional issues such as the environment. And it has security interests in preventing instability that might bring massive refugee flows into Russia or a spillover of violence into Russia proper, in denying outside powers access to regions that might be used to threaten Russia itself, and in certain specific military sites—like the Skrunda radar site in Latvia—even in the face of general Russian military withdrawal.

Although those interests are both obvious and generally recognized, it is not clear how they are to be pursued. Russia faces a difficult security situation. If it attempts to use force to achieve its ends—such as projecting military units into Moldova or employing economic sanctions against its new neighbors—it will find itself generating countervailing forces in the successor states as well as in the West more generally. Here, too, there are three main areas in which an attempt to impose a common solution on the region could backfire: It could rebound into Russia itself by prompting other states to play the ethnic card against the Russian Federation or by encouraging the numerous non-Russian communities within Russia itself to rebel. It could also drive the new states to seek weapon systems and allies in unconventional areas or it could prompt a more general war.

Whenever Russians speak of protecting Russians in Ukraine with military force, Ukrainians like to respond by quoting Vladimir Nabokov's *Pnin*: "He who lives in a glass house should not try to kill two birds with one stone." That saying is especially appropriate. It highlights the fact that the non-Russian states could also make

use of nationality politics within the multinational Russian Federation. It also underscores the extent to which Moscow would change in an authoritarian direction if it pursued aggressive policies toward its neighbors.

An aggressive Russian policy toward the new states would, moreover, encourage them to militarize, to seek control over nuclear weapons, and to acquire outside allies, thus undermining Russia's own policy. While Western states are reluctant to extend specific security guarantees to most of the new states, a Russian move against any of the larger ones might prompt revision of that policy and, at a minimum, isolate Russia internationally by undercutting Moscow's efforts to portray itself as a reformed and responsible member of the international community. And, in an extreme situation, such maneuvers could ignite a more general war, possibly extending well beyond the Eurasian landmass.

Indeed, the actions and attitudes of Moscow's new neighbors will critically condition Russian policy. The new states can do five key things to encourage an enlightened Russian approach.

First, all 14 must acknowledge that Russia faces a unique set of problems, that the Russians see themselves as having "lost" while others have gained, and that such a sense of loss necessarily leads to rhetorical excesses that, given a responsible policy by others, will not lead to action.

Second, they must recognize that the Russian Federation is inherently different from the Soviet Union and that Russians abroad are not necessarily "imperial agents." Indeed, the rapid acceptance of those people by the governments of the new states, either as citizens or as Russian citizens with the rights of permanent residency, will remove one of the greatest threats to regional stability.

Third, they must acknowledge that Russia has real geopolitical interests and, by virtue of its size and history, that it will continue to occupy a central place in shaping the foreign policies of the new countries for many years to come. At the same time, instead of expanding multilateral arrangements, the new countries should strengthen bilateral ties, both because of the extraordinary diversity of their relations and because of their own needs for national self-determination. Virtually all of the non-Russian states would view total reliance on multilateral arrangements as a diminution of their sovereignty.

Fourth, they should understand that the West is unlikely to take any military actions to protect them in the face of Russian aggression. Consequently, they should act prudently regarding Russian claims—even if those claims represent a violation of international law.

Fifth, they should recognize that they, too, face a security dilemma, one that is even more serious than Russia's. Any defense expenditures beyond minimal requirements will not enhance their security but rather undermine it by generating countervailing pressures in Russia and other neighboring states. And even if they believe that the Russian state is going to disintegrate—a not unlikely prospect for the next year—they should not make the mistake of thinking that they will be able to simply wait and take advantage of such a cataclysm.

**It is "not accidental," as the Russians say, that those who prefer resurrected empire tend to be more authoritarian in disposition than those who prefer independent countries.**

None of those steps will be easy: All run counter to the newly released energies of national assertiveness. But each of them will facilitate Russia's movement toward becoming a more normal country—a movement that will benefit all involved.

The West's stake in a democratic answer to the Russian question is enormous, but its ability to affect that answer is remarkably limited. Unfortunately, the West has neglected its most effective tool: the consistent restatement of principles of human rights, democracy, and acceptable international behavior. Beyond that, though, the West can do five things to help.

First, it can recognize Russia's trauma and its legitimate interests and work diplomatically and by means of aid with Russia and its neighbors to allow those interests to be pursued in a

peaceful way. The West can underscore that any resort to violence against either minorities or neighboring countries will mean both international opprobrium and the end of aid.

Second, Western countries must also recognize the new diversity of the Eurasian landmass. They cannot allow Russians to believe that the West views the post-Soviet configuration as "Russia plus branch offices." Instead, it must back the legitimacy of the independence of the new countries and recognize that most multilateral arrangements in the region, such as the CIS, have outlived their original utility. Many conservatives in Moscow want to exploit those multilateral arrangements to reestablish Russian control over the periphery, as Russian foreign minister Andrei Kozyrev highlighted at Stockholm in December 1992, when he sketched out what some future right-wing nationalist government might insist upon.

Third, the West must face the fact that its support for the stability of borders regardless of how they were created in that region has enormous consequences, some of which may undercut the West's other goals and values. Given the continuing consequences of Stalin's approach and the politicization of ethnicity into nationality, the West's current tack could lead some regimes either to become more repressive at home or to try to change borders by force. To avoid those twin dangers, the West needs to explore the possibility of negotiated border changes as Conference on Security and Cooperation in Europe (CSCE) rules allow. In addition, it needs to examine whether the international community can develop any mechanisms for intrusive protection of human rights in all 15 countries.

Fourth, the West must adopt a policy of "tough love" toward Russians and non-Russians alike on human rights and other general issues. Using international forums like CSCE and the U.N., moral suasion, and the leverage of aid, the outside world must insist simultaneously on proper treatment of all minorities in all countries and on a prohibition against the use of force to defend ethnic minorities abroad. Failure to do the former would be a betrayal of Western values; failure to do the latter could lead to a new era of Sudetenlands, as Bosnia and the Transdniester region in Moldova have already shown.

Fifth, Westerners must learn to adopt a balance-of-power approach in the region—just as Great Britain did on the continent of Europe for the past several hundred years—backing weaker powers against stronger ones to discourage aggression. The full range of options should be considered—security guarantees, arms sales, and so on—but Western countries should always be mindful that unless they act prudently, they could fall into a dangerous security trap, where the uncontrollable actions of others could drag the West into an avoidable war. Even if the West takes all these steps, there is no guarantee that the Russians will answer the fateful questions before them in a democratic manner.

# Strengthening Western Support for Russia

by Jeffrey Sachs

*The West has not offered sufficient help to support Russia's reform. As the IMF is not equipped for the enormity of the tasks, a special agency should be established in Moscow to ensure that reform continues. An army of technical experts on the ground is urgently needed.*

Western neglect of Russia's reforms has left the reformer struggling for survival and the economy teetering on the brink of hyperinflation, with inflation running at about 30 percent per month and rising. But while the situation is dangerous, it is far from hopeless. Russia is making startling and successful advances in creating a market economy, with a dramatic commercialization of society; broad progress on privatization; and a significant opening to market-based international trade and investment. Early actions by the Clinton Administration in putting forward a well-designed program of conditional financial assistance could be the stimulus needed to bring Russia back from the brink of financial chaos and give the reforms the crucial time that they need to take root.

The risk of hyperinflation now facing Russia could have been eliminated in early 1992. Russia's economic reforms started to work in the first six months of the year in the same general way as in Eastern Europe. Inflation was coming under control; shortages were being eliminated; markets were starting to function; the currency was stabilizing; the service sector was starting. But, as in Eastern Europe, reforms were also starting to squeeze heavy industry, including the politically powerful military-industrial complex, which began to struggle against them. Under intense political pressures and with little real backing from the West, the reformers started to acquiesce to large and highly inflationary subsidies to industry.

With a vigorous Western presence, the rollback of stabilization policies would probably never have taken place. In turn, the success of stabilization would have greatly bolstered the political stability of the reformers, just as the growing inflation has undermined their hold on power. But as it turned out, the Western role in Russia since the start of the Gaidar cabinet in November 1991 has been totally insufficient.

Western governments made the fateful choice to duck any direct responsibility vis-a-vis Russian reforms by vesting key authority in the IMF. This was an enormous mistake for several reasons. First, the IMF was completely understaffed for the task. Hundreds of technical experts are needed *on the ground* in Moscow to help with reforms in banking, budgeting, management, trade and finance. As an institution of around 1,000 staffers, however, the IMF was simply unequipped to provide the needed assistance from in-house resources. As a result and as incredible as it now seems, the IMF did not have a single monetary specialist on the ground in Moscow during the first ten months of 1992. It relied totally on fly-in missions to try to cover the workload and thereby greatly weakened its capacity to help.

*While the IMF has been overwhelmed with its assigned task, Western governments have simply stood and done virtually nothing.*

Second, it is necessarily a political task of the first order to mobilize tens of billions of dollars of Western support for Russia and to link the support to fundamental changes in the Russian economy in a systematic way. The IMF was not equipped to carry out these functions. It did not succeed in mobilizing funds; in designing an aid program in cooperation with the Russians; nor in carrying out conditionality. The $24 billion aid package announced on April 1, 1992 simply vanished. Russia received approximately $9 billion of trade credits last year, but none of these loans has been linked to the reform program. New trade credits slowed to a trickle after July. In fact, not one dollar of usable conditional assistance flowed to Russia during the first ten months of the year! The only conditional aid has been $1 billion of IMF money and $600 million of World Bank funds, but even these paltry sums exaggerate the actual resource flows. The IMF money was given under the amazing condition that Russia not use the money and most of the World Bank credit will be distributed only in 1993.

The Western effort on debt rescheduling has been equally inexplicable, being directed at getting the Yeltsin-Gaidar government to accept responsibility for the entire debt of the former Soviet Union. This has led, predictably, to a legal mess in subsequent negotiations. Moreover, the West continued to press Russia for interest servicing of the debt even when Russia was completely out of foreign reserves. The pressures contributed to Russia's macroeconomic instability. Most importantly, after a year of radical reforms, Russia has still not received any formal debt rescheduling and the balance of payments pressures arising from Russia's debt overhang continue to weigh heavily on the economy.

While the IMF has been overwhelmed with its assigned task, Western governments have simply stood and done virtually nothing. The US role has been minimal. There has been little strategic thinking in the Administration and there has been no single senior official whose main responsibility was the design and coordination of the US response to Russian economic and political reforms. The role of the other G-7 countries has been similarly problematic. The German financial role has been large in recent years; but even German credits have largely been cut off. At this point, support in Germany for further financial assistance to Russia is slight. The EC has provided a modest amount of aid, but its role has hardly been decisive. Other individual European countries have also contributed moderately to Russian assistance, but again without a decisive role.

The Japanese have so far played a harmful role, by pursuing a vocal policy of opposing large-scale aid until the Kurile Islands have been returned. This policy finally backfired in September, when President Yeltsin canceled his trip to Japan at the last minute. But the costs have been high and mutual antagonisms have grown. Russian hardliners have seized on the Kurile issue to fight against the reforms with great effect, claiming that the West has again been proved to be hostile to Russia's interests in demanding the return of islands won during the Patriotic War. US policymakers were silent as Japan pursued this

*The Japanese have so far played a harmful role.*

mutually destructive approach; we share a complicity in the downward spiral of Russian-Japan relations, through our inaction.

A new Western response is needed. There should be an urgent rethinking of the Western response to Russia by the incoming US Administration. The nature of the response must be carefully modulated to the events in Russia. If the reformers are able to survive the current political onslaught, then the West should aim to reinforce the reforms with considerable urgency. If the reformers are routed, then the West must respond in a clear way, holding back on most aid until political and economic reforms get back on track. If the situation remains muddled, then a nuanced carrot-and-stick approach would have to be used.

Financial assistance should be re-designed to give the maximum political and economic backing to the reforms. The assistance should come in forms that are easily understood by the Russian people and Russia's political leadership, so that the assistance is (correctly) viewed as vital and much too important to abandon. The money should also come largely in ways that help to finance Russia's budget deficit, so as to substitute for direct inflationary finance.

The specific types of aid will have to be determined in the course of negotiations between the Russian government and the G–7 partners. The following kind of package makes sense, in terms of the political and economic support that it would offer to the reforms:

An **Emergency Social Fund**, to help pay for unemployment compensation, emergency medical support and supplements for pensioners. The fund would be supported by direct grants from Western countries. All Russians would understand that if the aid were cut off, it would mean risking the key social safety net for the country. The money would obviously help to cover direct budgetary expenditures in Russia in a non-inflationary way.

An **Industrial Restructuring Fund**, to help pay for military conversion and other industrial restructuring operations. This money would be in the form of loans from export credit agencies and the international financial institutions. Part of the fund would be for military conversion and part for energy and agricultural investments.

A **Small-Business Loan Program**, modeled on the Polish-American Enterprise Fund, which would make loans to small-and medium-sized enterprises. This fund would be managed by the European Bank for Reconstruction and Development (EBRD).

**Balance of Payments Support**, including an IMF standby loan to help cover the foreign exchange requirements for basic imports, a stabilization fund to help stabilize the ruble and the rescheduling of the debt that was taken on by the Soviet Union before December 1991.

The key strategy in such a program is simple, but it was basically neglected in 1992. The aid package should be spelled out in *political* terms, so that everybody in Russia understands the value of the international assistance and the high cost of losing that support. The general public should understand that Western support funds emergency social protection; industrialists should understand clearly that Western support funds their access to restructuring money; small businesses should see that Western support actually provides credit to them; and everybody should understand that international support is the key to making the Russian currency stable in value via a stabilization fund.

*. . . we share a complicity in the downward spiral of Russian-Japanese relations, through our inaction.*

The funding would be strictly multilateral in character, involving funds from government budgets, export credit agencies, the IMF, World Bank, EBRD and the EC. The US budgetary contributions would have to rise, as would contributions from the Export-Import Bank (EXIM). Perhaps most importantly, the US should insist that Japan step up its contributions, in view of Japan's financial resources, its minimal contributions to date and its enormous stake in the success of Russia's democratic and economic reforms. The sums involved should be determined in the course of detailed negotiations, the sort of dialogue between the Russian reformers and the G–7 that was needed but did not take place last year. Nevertheless we can sketch roughly the sums that might be involved. The emergency social fund should be of the order of $8 billion *in grants* from the industrial democracies. The US share would be around $2.5 billion. The industrial restructuring fund would be of the same size, but in the form of loans from the export credit agencies, the World Bank and the EBRD. The small business fund should start at around $1 billion, to be covered by funds from the EBRD and private investors. The balance of payments support should include a $4 billion IMF loan and a stabilization fund of around $6 billion.

The total direct budgetary costs to the United States would come to around $3 billion per year, approximately one percent of US defense spending.

The West would also need new institutional means to deliver such a program. The G–7 should establish a political-economic umbrella, under which the IMF, World Bank and EBRD would act. In effect, the G–7 would establish an administrator for Western assistance, with a substantial presence in Moscow, that would be similar to the Economic Cooperation Administration (ECA) of the Marshall Plan. Unlike the IMF, the new G–7 office would have an *on-the-ground* team of businessmen, bankers and economists, helping the Russian government implement practical reforms in key areas. Within the US government, there should be a new senior position to coordinate US policies in support of economic and political reforms in Eastern Europe and the former Soviet Union. This person must clearly be the "President's person."

The greatest mistake would be to lose heart with Russia's reforms. Throughout history, successful reform programs have been heatedly attacked and even written off just as they were starting to prove their worth. Chancellor Adenauer and his Economy Minister Ludwig Erhard barely survived in Germany in the late 1940s, the very period in which they were putting in place Germany's economic miracle. After three years of tough politics, the reforms in Poland are only now becoming self sustaining, based on the remarkable economic turnaround that the reforms have ushered in. All reformers, from Erhard to Balcerowicz, have required international financial support to help the reforms take root. With the enormous stakes in Russia, this is the least that we can do for President Yeltsin. ■

*In effect, the G–7 would establish an administrator for Western assistance . . . in Moscow.*

*Professor Sachs is Galen L. Stone professor of international trade at Harvard University.*

THOMAS E. WEISSKOPF

# *Russia In Transition: Perils of the Fast Track to Capitalism*

*The "shock therapy" approach of the Yeltsin-Gaidar team allows the few to profit at the expense of the many. A fairer and more gradual approach to reform would enjoy more popular support and would reinforce political democracy.*

The social, political, and economic transformation currently underway in Eastern Europe and the successor states of the former Soviet Union has attracted an enormous amount of interest in the West. Rarely are the basic institutions of a society open to the kind of fundamental change now in progress. The fact that the direction of change is from a largely alien and unfamiliar system to one that is less threatening and more similar to Western capitalist market societies has reinforced a sense on the part of many Westerners that the transition should be encouraged to proceed as rapidly as possible.

Indeed, many Western economists have been advocating programs of "shock therapy" and "mass privatization" to accelerate the scuttling of command-administrative economies in favor of free markets and capitalist enterprise. This approach was embraced by Russian President Boris Yeltsin in late 1991, after the failed coup of August 1991 that marked the beginning of the end for the old Soviet Union. During the following year it was implemented by a group of "radical economic reformers" led by First Deputy Prime Minister Yegor Gaidar, and it remains official policy as of October 1992, although it has has been encountering increasing public restiveness and political opposition during the course of the year.

In this essay I seek to assess the nature and impact of the fast track strategy to transform Russia into a capitalist economy, and I explore the possibility of an alternative strategy for reform of the failed command-administrative system. I begin with a sketch of current conditions in Russia; I then turn to key aspects of the policies of shock therapy and privatization carried out by the Yeltsin-Gaidar government; and, finally, I con-

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sider economic and political elements of an alternative approach.

## *Struggle for economic survival*

In the wake of the collapse of the old economic system, the dominant concern of every Russian now is individual economic survival. Under the command-administrative form of socialism, people suffered from political oppression, poor pay, limited opportunities and ubiquitous corruption, but they were at least guaranteed a modest standard of living, job security, and price stability. Virtually everyone had low-cost access to such amenities as housing, medical care, education, transportation, cultural activities, and vacation opportunities—though the quality of many of these amenities was often poor.

Within the last year, the breakup of the Soviet Union and the disintegration of economic relations between the former Soviet Union and its East European trade partners, the freeing of prices on most goods and services, and the decentralization of economic decision-making authority has led to an increasingly chaotic social, political, and economic environment. Prices have multiplied ten, twenty, and in some cases even one hundred times during a period in which most people's wages or pensions have increased only five or ten times. Almost everyone is trying desperately to make ends meet.

The well-placed and/or lucky few have met this struggle for survival with great success. Traders and speculators with monopolistic control over commodities whose prices have shot up on the free market, managers or bureaucrats who have succeeded in gaining control of some of the more viable state industrial assets through *de facto* privatization, government officials who dispense permits and licenses worth enormous bribes, and foreign-language speakers who have caught on with joint ventures—these are all members of a small new elite that is doing very well in the new environment. They have joined foreigners in the tiny top tier of the income distribution consisting of people who deal more often in dollars than rubles and who can now find and purchase anything they want on the free market—at prices the vast majority of the population cannot afford.

That vast majority—most urban wage and salary workers, most rural residents, all pensioners—have found their real incomes dropping precipitously with the galloping price inflation. Not only have nominal wages been failing by a large margin to keep up with prices (except in the case of a small number of strategically placed workers who have successfully struck for much higher pay), but a large proportion of wages due have not been paid on time—or at all—because of a shortage of ruble notes. Checking accounts are virtually unheard of, so everyone receives wages in cash. The ability of the printing presses to produce bank notes, however, has been falling well behind the rise in nominal wages; as the presses work overtime to catch up (printing larger-denomination ruble notes), the purchasing power of the overdue wages continues to fall.

The "stagflation" that plagued Western economies in the 1970s consisted of a then unusual combination of high inflation with stagnating or recessionary levels of overall output. But Western-style stagflation would be most welcome now in Russia, where the combination of galloping inflation and plummeting real output requires a new label like "depflation" to reflect the actual conditions of depression. The decrease in output in Russia in 1991 has been estimated at about 11 percent, and production is falling at about twice that rate in 1992. Moreover, many of the goods still being produced are piling up in factory lots and warehouses for lack of buyer purchasing power. As of today, layoffs have still been relatively limited, for enterprise managers are not prepared to face the consequences of massive unemployment; they have been able to prevail upon the Central Bank to keep supplying enough funds on credit to pay their workers—if belatedly. They have not been able to pay most of their suppliers, however, with the result that the level of interenterprise debt (extended reluctantly by sellers trying to maintain markets) has risen to staggering levels. Women have been especially hard hit by the economic crisis; they are most unlikely to have ascended to positions of real power and influence in the old system, and they are the first to be laid off when falling revenues and limited credit leave no alternative but for budgets to be cut and jobs to be trimmed.

Under such circumstances people have been forced to think of nothing but where their next meal is coming from. For many, this means selling off household goods that they have acquired over the years or hoarded in the recent past, or buying some of the few low-priced goods left in state stores and selling them on the street at much higher prices. For others, it means searching for temporary service or trade opportunities during their nonwork



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time or—increasingly—during the time that they are officially on the job. In the big cities countless sidewalk vendors may be seen at every subway stop and virtually every major street corner, and during the spring and summer of 1992 a common streetside spectacle was row upon row of individuals holding up a commodity or two for sale as passersby searched for the space to proceed. In more recent months, municipal authorities and trade racketeers (the so-called "mafia") have managed to cut down on unregulated street trade; the latter have increasingly been able to monopolize the business, while the former are sharing in the proceeds. In this context, more and more people, frustrated by the difficulty of earning money through honest work or legal trade, are now simply resorting to crime.

The growing number of foreigners (in large cities, especially Moscow) looms as a potential gold mine for desperate local citizens, as a single dollar goes a very long way. A dollar was worth about 100 rubles in early June—more than most Russians could earn in a day—and it had risen to 200 in September; it reached 400 by late October, and it will surely continue to rise for the foreseeable future. These rates of exchange are way out of line with the true purchasing power of the ruble (even taking into account the rapid rate of internal inflation in Russia); they reflect a growing crisis of confidence in the Russian economy and massive speculation against the ruble. The extraordinary domestic value of the dollar results not only in continuous hawking of souvenirs and other commodities to foreigners, but also in frequent offers of services running from bed-and-breakfast stays, child care, and language lessons to fashion modeling, escort services, and prostitution. Young men accost young foreign women in the hope of developing a relationship that could lead to marriage and emigration. For Russians with foreign language skills, the opportunity to generate any kind of employment with a joint venture is irresistible. For academics and professionals with contacts abroad, the possibility of turning these contacts into funded research, business contracts, or travel abroad is immensely attractive.

Many of the current economic pressures are causing people to abandon useful and productive activities in favor of relatively unproductive activities that appear to be lucrative in the short run. Thus, women students drop out of University classes to "entertain" foreign clients; language teachers quit their teaching jobs and take on secretarial tasks with joint ventures (making phone calls and sending faxes abroad, translating business documents, etc.); and scholars abandon long-term research projects in favor of short-term contract work with local and foreign businesses. In at least one area, however, the economic pressures are generating more productive work. For families with access to land—for example, small plots near ancestral village homes or gardens around summer dachas—the opportunity to supplement store-purchased food with home-grown fruits, vegetables, and/or dairy products has been both attractive and significant. Around every large city, and in many small towns, people are intensively working small patches of land. In this respect, residents of relatively warm areas with good soil in the south are much better off than most of their compatriots who live in the colder and harsher northern regions of Russia.

## *Born-again conversion of the nomenklatura*

It is remarkable to note that so many of the same Russians who only a few years ago were loudly proclaiming the virtues of communism and central planning are now among the most vociferous advocates of capitalism and the free market. Not only were many current political leaders (for example, Boris Yeltsin himself) once outspoken supporters and prominent beneficiaries of the old system, but many of the people who now most strongly support a rapid move to capitalism—and who are doing very well in the new market environment—are from the upper echelons of the old party apparatus or the upper levels of the old state institutions (the so-called "nomenklatura"). This apparent paradox disappears when one begins to grasp the extent of the opportunism and the corruption that developed in the Soviet Union over the past few decades: by the 1980s hardly anyone really believed any more in the communist system.

The people who made it to positions of privilege and power in the Soviet Union in recent decades were—for the most part—people who knew or learned how to win within a morally bankrupt and thoroughly corrupt institutional environment. To advance one's interests one had to cultivate important relationships carefully, exchange favors, give and receive bribes, pay lip service to official platitudes, and ingratiate oneself with one's superiors. To be completely principled and honest in this environment came at an enormous personal cost, which only a few unusually strong-willed and dedicated



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individuals could achieve—often not only to their own but to their family's detriment. For almost everyone else with any ambition, opportunism on some scale was a way of life—and the more privileged one's position, the greater the degree of opportunism that was likely to have been necessary.

Here are just a few examples. Access to the most desirable summer vacation spots and to opportunities to travel abroad typically required membership and good standing in the Communist Party. Access to Western books, newspapers, and films for all but the most privileged required participation in semi-legal or illegal distribution networks, or side payments to government officials. Entry into the more desirable and prestigious departments at Universities could often be assured only with the payment of substantial sums of money to administrators involved in the admissions process. Publication of books and articles, the production of plays and movies, and promotions to high-level jobs called for careful adherence to official ideological positions and policy lines.

After the failure of Mikhail Gorbachev's efforts at economic reform via perestroika, and the collapse of the Soviet Union in 1991, there is now officially an entirely new set of rules of the game in Russia. These rules come under the noble-sounding headings of democracy and the free market. In the context of completely undeveloped democratic and market institutions, however, success in the game requires many of the same assets and talents that were called for under the old system—for example, the cultivating of relationships with key individuals, judicious payments of bribes or exchanges of favors with other people whose goods or services one needs, a willingness to bend rules and engage in semi-legal if not illegal transactions.

Clearly, the new rules of the game do allow vastly greater opportunities for the expression of creative ideas and dissenting opinions. Even though there are now often economic obstacles to freedom of expression, the elimination of ubiquitous political control represents a major social gain. Moreover, the increasingly free-wheeling market environment has opened up a much wider range of economic opportunities for resourceful and skilled individuals (as well as for unscrupulous and criminal ones). Among the beneficiaries of the new environment are enterprising people whose economic activity was in the past either greatly constrained or forced underground by government rules and regulations. Still, it should come as no surprise that some of the biggest beneficiaries of the new system are the very same people who learned so well to parlay their physical, financial, and intellectual assets into positions of privilege and power under the old system. This has led to a very widespread view among ordinary people—with considerable foundation—that "the same people as before are running things now; they are simply whistling a different tune."

## *Shock without therapy*

The economic chaos I have described above is no doubt due in considerable part to the process of economic disintegration that began in the late 1980s and intensified during the period of Gorbachev's perestroika. The sharp drop in trade between the Soviet Union and its former economic partners in Eastern Europe following the "revolutions of 1989," and the weakening of trade ties resulting from the subsequent breakup of the Soviet Union in 1991, cut deeply into both output and input markets in all of the successor states. Moreover, disintegrating central supply and distribution networks could not easily or rapidly be replaced by market forces in a context of severely undeveloped market institutions. Under such circumstances it is hardly surprising that the overall economic situation in the former Soviet Union has been deteriorating for the last several years. The situation appears to have worsened significantly in Russia, however, since the introduction of "shock therapy" at the beginning of this year.

In January 1992, shortly after assuming full power as president of the newly defined Russian nation, Boris Yeltsin initiated the program of shock therapy in an effort to revitalize the disintegrating economy bequeathed by the Soviet Communist regime. Modelled after the program introduced two years earlier by the first post-communist government in Poland, the Russian shock therapy treatment involved sudden and dramatic price liberalization and macroeconomic stabilization—with privatization of state assets due to follow. Prices of most goods and services were decontrolled in an effort to allow the market to equate supply and demand, and government subsidies to consumers, enterprises, and institutions were sharply reduced in an effort to bring a runaway government budget deficit under control. The Central Bank was instructed to reduce sharply the rate of growth of the money supply and, in particular, to cut back on the



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extension of credit to state enterprises. Plans were formulated for the privatization of state enterprises and public property.

In its embrace of a shock therapy approach to Russia's enormous economic problems, Yeltsin's economic policy team, under the leadership of Yegor Gaidar, was committing itself firmly to the economic strategy long advocated by the International Monetary Fund (IMF) to restructure state-dominated developing economies. Their commitment to this strategy reflected both the dominant economic outlook of the radical intellectuals most closely associated with the political struggle against the old Communist regime, and a strong desire to enlist IMF support in their effort to attract foreign aid and foreign capital to the new Russia. They hoped that the freeing of prices would bring scarce goods back into shops, that the curbing of budget deficits and the slowing of monetary growth would bring stability to a careening economy, and that the privatization process would encourage new entrepreneurship and the restructuring of old ailing enterprises—and that all of this would attract foreign aid and foreign investment to contribute to the process of economic revival.

It is less than a year since the Yeltsin-Gaidar strategy was initiated, and this is a short time in which to evaluate the success or failure of an economic policy. Yet the deepening economic and social crisis in Russia has already led many previous enthusiasts of rapid transition to a capitalist market economy to begin to question the shock therapy approach. The critics by no means include only hard-line defenders of the old order, unrepentant managers of state enterprises, and left-wing advocates of democratic socialism. Among them are such prominent capitalist reformers as Grigory Yavlinsky—one of the main authors of the "500-day plan" for transition to a market economy, which was proposed in the last year of Gorbachev's rule, widely applauded by mainstream Western economists, but ultimately rejected. The Yeltsin-Gaidar-IMF shock therapy approach—designed to spur a more rapid transition to capitalism—can be faulted along the following lines.

First, this strategy emphasized, above all, price liberalization and macroeconomic stabilization—before any effective program for the restructuring, demonopolizing, and privatization of state enterprises had been developed. It is of course much simpler to free prices, to cut back government spending, and to restrain monetary growth than it is to formulate and implement a serious program of restructuring and privatization. Such a program involves not only complex economic issues but also thorny political problems, requiring as it does a host of new legislation that must be approved by the executive and legislative branches of government. Although the executive is largely under the control of Yeltsin and his allies, the legislative branch—the Supreme Soviet (or Russian parliament) elected in the Gorbachev period—reflects a wide range of political and social forces in contemporary Russia and contains only a minority of deputies closely aligned with the radical economic reform movement.

The consequences of pushing rapidly ahead on the liberalization and stabilization fronts, without meaningful progress in restructuring and privatization, have become very clear this year. This approach has enabled well-placed individuals—traders and speculators who can dominate the emerging and largely unregulated markets, government officials whose authority is needed to approve various transactions, and enterprise managers with de facto control of important state assets—to enrich themselves handsomely at the expense of the general public. A process reminiscent of early capitalist "primitive accumulation" has enabled a new class of successful merchants and businessmen (some of them genuinely resourceful entrepreneurs, but many more appropriately dubbed "mafiosi" because of the illegal or semi-legal nature of their activities), as well as part of the nomenklatura, to accumulate enormous wealth. These people live lavishly in the new market environment, where anything can be bought at a high enough price, but also stand to be the ones in the best position to acquire full legal ownership of state assets once the privatization process finally gets going. Yeltsin has spoken out about his desire to assure a big class of small owners rather than a small class of big owners in the new capitalist Russia, but current developments are leading in precisely the opposite direction. Indeed, there has already been a good deal of "wild privatization"—effective takeovers of productive assets by highly placed insiders and mafiosi.

Second, the shock therapy program has been introduced without any concern about its consequences for income redistribution. The freeing of prices resulting from the policy of liberalization, and the cutbacks of government spending resulting from the effort at stabilization, have led to a tremendous polarization between the small class of well-to-do and the vast majority of the population who have been depending on the state



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for much of their income and benefits. Although the suffering of ordinary Russians has not (yet) led to the widespread outbreak of riots and revolts anticipated by some observers, it has led to increasing embitterment and resentment among ordinary people. This is evident in declining popular support in Russia for Yeltsin and his team of radical reformers and in a growing backlash against Yeltsin and Gaidar on the part of politicians representing many different parts of the political spectrum. Although this opposition is often described in the Western press as coming mainly from "hard-line conservatives" associated with the old communist rulers, in fact it comes from many other sources as well—rank and file workers, factory managers, pensioners, intellectuals, and even quite a few of the democrats associated with the political liberalization and market-oriented economic reform of the Gorbachev years.

Third, the combination of polarizing liberalization and punitive stabilization (coming on the heels of the disruption of trade ties) has aggravated the fall in overall demand for the output of domestic industries. This has deepened the ongoing depression and led to further cuts in production levels, mounting stocks of unsold goods, higher and higher levels of interfirm indebtedness, and a growing loss of jobs. There is still no evidence of any government program to bolster aggregate demand, nor to retrain workers, nor to generate new job opportunities in the context of the decline of the old industrial enterprises. It is simply hoped that the free market and the coming program of privatization will take care of such problems.

## *148 million capitalists?*

The Yeltsin-Gaidar government turned its attention seriously to privatization after the shock therapy program got underway in early 1992. It sought to accelerate the process of privatizing small enterprises, many of which were under the control of local authorities. These enterprises were to be sold primarily at auctions or via competitive tenders to the highest or most qualified bidder. In the longer run the program envisaged a form of mass privatization of medium-sized and large enterprises in which most of these enterprises were to be converted into open joint-stock companies, whose shares would then be made available for sale and trade on a market in company shares.

The process of privatization of small enterprises in Russia has thus far proved to be seriously deficient. First of all, the liberalization of prices and subsequent rapid inflation have greatly reduced the real purchasing power of what limited savings the general population had managed to accumulate in past years. This has rendered the vast majority of people quite unable to acquire any stake in small enterprises. Moreover, being excessively concerned with reducing budgetary expenses, the government has not undertaken any significant programs to support potential and actual new property owners and entrepreneurs. In spite of the proclaimed objective of getting the government off people's backs, the privatization process has actually been dependent to a large extent on government bureaucrats at many levels. There has therefore been an unprecedented growth of abuse and corruption among public officials, leading to all kinds of limitations and delays in "legal" privatization and to a great deal of "spontaneous" (quasi- or extra-legal) privatization in which bureaucrats themselves have been major beneficiaries. Finally, the critical task of privatizing land and housing remains unresolved in most parts of the country.

While plans for privatization of medium-sized and large state enterprises remained somewhat unclear in early 1992, the Yeltsin-Gaidar government—with strong support from Western economic advisors—was clearly seeking to promote a system of external ownership of firms based on an active Anglo-American-style stock market. Before the privatization process could begin, however, detailed legislation would have to be enacted by the Russian parliament. Many of the parliament members (elected while Gorbachev was still in power) were much more sympathetic to an alternative approach that would favor acquisition of enterprises by their own managers and workers, through the receipt of some ownership shares at a discount and the opportunity to buy back other shares with the help of bank credit. The stage was thus set for a drawn-out economic and political battle between supporters and opponents of the Yeltsin-Gaidar approach, which culminated finally in June with the passing of a comprehensive new law on privatization. This law established for medium-sized and large state enterprises a "voucher" system of mass privatization, similar in many ways to the voucher model introduced earlier in Czechoslavakia. Under this scheme the enterprises would be transformed into joint-stock companies with shares traded on a stock market, and every Russian citizen—adults and children alike—would receive a voucher that entitled the holder to buy shares in the new stock market.



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The June law offered medium-sized and large state enterprises two principal privatization options. The first option grants to enterprise workers 25 percent of the enterprise shares free of charge, but—unlike all the other shares—these carry no voting rights; workers are also enabled to purchase another 10 percent, and managers 5 percent, of the shares at a concessionary price; the remaining 60 percent of the shares are to be made available to external purchasers, including citizens (using their own savings and/or their vouchers) and investment funds that are encouraged to come into existence. The second option allows managers and workers together to buy up to 51 percent of the (voting) shares of an enterprise, but they must do so with substantially smaller price concessions and without access to credit from the Central Bank. This would make it difficult for most workers and managers to come up with the necessary funds. Selection of the second option requires a favorable vote by two-thirds of the workers (or their representatives), failing which the first option will be adopted. This second option was included at the insistence of supporters of insider ownership in the Russian parliament, but the fact that it requires a two-thirds majority to go into effect, and the fact that it will be difficult for workers and managers in most enterprises to come up with the funds to purchase 51 percent of the shares in the absence of significant price concessions, testify to the ability of the Yeltsin-Gaidar administration to get its way in shaping the privatization policy.

A series of decrees issued during the summer of 1992 by President Yeltsin and by the Russian State Property Committee (in charge of privatization) further specified how this privatization law was to be implemented. A target date of October 1 was set for enterprise workers to decide on their privatization options. On the same date the Russian government began issuing vouchers to each citizen, with a face value of 10,000 rubles (worth about $40 at the time, but now considerably less because of the continuing fall of the ruble against the dollar). The voucher distribution was to be completed by the end of the year 1992, after which people could put their vouchers to use—by purchasing enterprise shares, by investing in newly created investment funds, or simply by selling the voucher at whatever it could fetch in the open market. The initiation of the voucher distribution scheme led the *New York Times*, in a lead editorial under the heading "Suddenly, 148 Million Capitalists," to declare that now "every Russian will become a capitalist."

The buoyant triumphalism of the *Times's* editorial writer obscured a whole series of unpleasant realities (many of which were amply documented in a series of reports from Moscow by the *Times's* own reporters). First of all, there is widespread public ignorance about the privatization process in general and about the value of enterprise shares in particular. Most people have no idea what to do with their vouchers and will probably end up selling them to the few people who have some useful inside information. Far from creating a whole country of capitalists, or even a big class of small owners, the scheme seems likely to serve as a convenient way for those who have already acquired vast financial resources to launder frequently ill-gotten gains. Many Russians appear to agree with former USSR President Gorbachev, who declared the voucher plan "a sham . . . that will only alienate people."

While the concentration of share ownership that is most likely to result from the voucher plan contradicts the democratic and egalitarian rhetoric surrounding its inauguration, it may not be unwelcome to many of the radical reformers. Their primary goal is to establish new external ownership of state enterprises in order to force managers to restructure their enterprises or go out of business altogether (no matter what the cost of either course in terms of unemployment and social upheaval). From this point of view, it is desirable that share ownership be concentrated in controlling blocks held by one or a few wealthy investors, rather than widely dispersed among many small shareholders.

The radical reformers appear to be supremely confident that individual external large shareholders can determine far better than current enterprise managers or workers what is best for the enterprise. There is much evidence, however, that even in developed market economies, such an Anglo-American system of external ownership, linked to an active stock market with the ever-present threat of a hostile takeover, is inferior to a system with more emphasis on stable insider management, long-term employment relations and worker involvement, and monitoring by external bank creditors. This is precisely the kind of alternative found in economies like those of Japan and Germany, which have been among the most successful of the advanced capitalist countries. In the contemporary Russian economy—characterized by completely undeveloped capital markets and regulatory processes, and a very low degree of potential and actual labor mobility—it is hard to imagine how a mechanism of industrial restruc-

turing that depends on a high degree of capital and labor mobility can possibly succeed at an economic level, let alone in social and political terms.

By making it very difficult for enterprise workers to own their own enterprises and participate in their management, the radical reformers are displaying a particularly pointed distrust of workers. Their preferred privatization option is explicitly designed to prevent workers from having any opportunity to influence management. Providing workers with nonvoting shares not only contradicts practice in the West (where employee stock-ownership plans are growing in popularity and workers' shares do confer voting rights), but also flies in the face of a great deal of evidence that worker mouvation and productivity can be significantly enhanced by various forms of participation in enterprise decision-making.

If a large proportion of Russian state enterprises are economically unviable in their current mode of operation, as most observers believe, it would appear sensible to provide incentives and opportunities for their own workers and managers to render them more viable—rather than to allow external owners to break up or liquidate the enterprises, selling off their assets and dispatching their workers to the labor market. From a social and political point of view, it is even more obvious that any strategy which treats workers as dispensable commodities is going to be fiercely resisted and will give rise to enormous social costs that will ultimately have to be paid.

## *A more hopeful alternative*

However much one may justifiably complain about the effects of shock therapy and voucher-style privatization, there is simply no workable path of economic reform and revitalization in the post-communist economies other than one which leads toward price liberalization, macroeconomic stabilization, and privatization. Comprehensive government price controls distort incentives and are in any case unenforceable; rather than try to defeat the market, one has to learn to work with it. Out-of-control government budget deficits and unrestrained monetary growth simply feed inflation and uncertainty, creating an economic environment in which speculation is far more rewarding than productive economic activity; this must not be allowed to continue. Centralized state control of enterprises perpetuates bureaucratic mismanagement and corruption; some form of privatization (understood in its broadest sense as a decentralization of enterprise ownership and control to autonomous agents with responsibility and reward for enterprise performance) is surely essential for economic revitalization—and indeed unavoidable with the collapse of central economic authority in Russia. But the issue now is: what is the best form of liberalization, stabilization, and privatization, and how quickly can these essential economic reform tasks be undertaken?

Critical to the success of the economic reform process is that it be conducted in a way that maintains the impetus for reforms while they are taking place. One of the most damaging aspects of the shock therapy approach—in Poland, in Russia, and wherever else it has been tried—is precisely the way in which it has undermined popular support for economic reform. A viable and successful reform program must be one that has both the economic and political staying power to be continued over a period of many years, through thick and thin. No one can deny that there will be significant costs to bear during at least the first few years of the transition from an administrative-command to a market economy. This means that it is vitally important to limit those costs and to assure that the distribution of gains and losses during the transition is sufficiently fair and equitable to maintain popular support in a democratic environment.

A progressive alternative economic strategy, one that would promote viable and durable economic reform and reinforce, rather than undermine, political democracy, would require all of the following elements:

(a) *A gradual process of liberalization and stabilization*, designed to move to a market-based economic system while preventing the collapse of demand for domestic products and limiting the growth of inequalities in real purchasing power. Prices must be decontrolled, but the immense structure of explicit and implicit government subsidies and taxes that characterized the administrative-command system can and should be gradually dismantled and reoriented to a market environment, so as to avoid huge economic disruptions and social tensions. The government deficit must be reduced, but not in one fell swoop and not by cutting essential social and economic expenditures; instead, the deficit should be gradually brought under control through a combination of tax increases and cuts in military and other nonessential spending.



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Advocates of the drastic shock therapy approach usually argue that it is necessary to impose the pain of liberalization and stabilization suddenly and harshly in order to get it over with before public opposition thwarts it. But there is no way to compress the process into a short time period, following which confidence-building improvements would quickly begin to materialize. Instead, the sudden-and-harsh approach leads to dramatic declines in real incomes and production levels, quickly undermining public support for the economic reform process. It is true that "one cannot leap over a chasm in two jumps"; but it is surely better to take the time to build a bridge across it rather than to take one leap into the abyss.

(b) *A substantial role for the public sector*, in undertaking investment in physical infrastructure and human resource development as well as in guiding the process of economic development. Government must play a leading role in the development of desperately needed new infrastructural facilities, in the renovation of the educational system, in the promotion of job training and retraining centers, and so on—for even in developed market economies the market-oriented private sector simply does not find it profitable to undertake such essential activities. Although many aspects of the needed government activities must be funded and guided at the national level, much of the responsibility for the execution of these activities can and should be decentralized to lower levels of government.

One of the most pernicious effects of the prevailing right-wing Hayekian ideology is its denigration and rejection of a significant state role in promoting and guiding economic development, a role that has in the past proven indispensable to the economic development of all but a few entrepôt city-states. Although this anti-state position may be understandable in the light of the overweening bureaucracy and rampant corruption that characterized government in the communist era, it reflects an underlying contempt for the potential of democratic political institutions. In both the public and the private sector there are economically essential activities to be undertaken and significant potential sources of failure; neither sector can or should be expected to bear the whole burden of economic revitalization, and both require political as well as economic mechanisms of regulation to minimize behavior that serves particular, at the expense of general, interests.

(c) *A thoroughgoing and fair process of privatization*, which would transfer effective control of enterprises to people with the abilities and the incentives to make them efficient and productive and which would at the same time assure a reasonably equitable distribution of claims to the nation's wealth. First of all, a systematic effort to break up monopolies and oligopolies is essential to foster overall efficiency through product market competition. The extent of such competition is at least as critical a determinant of enterprise efficiency as the structure of enterprise ownership. Those responsible for managing individual enterprises must have a strong stake in the performance of the enterprise and detailed knowledge of the potential as well as the problems of the enterprise and its personnel. To rely primarily on new external owners to restructure enterprises is to lay the blame for past problems on enterprise managers and workers who in fact had little authority to do anything in a top-down, bureaucratically controlled economic system. Involving workers in a meaningful way in both asset ownership and enterprise control can be very helpful both in stimulating labor productivity and in internalizing some of the social benefits and costs of enterprise activity. The benefits of successful enterprise performance can spread beyond insiders to the general public through a combination of lower output prices, taxes paid for government services, and capital returns to citizens.

For the whole privatization process to be fair and to maintain popular support, huge asset acquisition by the nomenklatura, by mafiosi, or by any other wealthy individuals must be prevented, and all citizens must be assured of continuing benefits from the returns to capital assets. A voucher system designed to spread claims to the nation's accumulated capital stock equitably throughout the population may not be a bad idea—provided that mechanisms are introduced to assure that these claims do not become highly concentrated among a wealthy minority and that they do not preclude a significant role for workers in enterprise management. It is perfectly possible to design a system that combines insider responsibility for enterprise management with outsider participation in enterprise asset ownership, in such a way as to meet the dual objectives of productive efficiency and distributional equity.

What is needed for economic revitalization, most basically, is a genuine social partnership that enlists all elements of the population in a common economic endeavor—rather than pitting groups against groups and individuals against individuals in myriad strug-



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gles for economic survival and dominance. Many fundamental economic problems in market economies, whether newly developing or already advanced, require for their solution a substantial degree of coordination and cooperation, with key functions having to be performed by politically constituted public agencies. The trust on which such cooperation must be built—and the effectiveness of the democratic institutions through which public action is determined—can only be assured by fairness and a reasonable degree of equity in the distribution of property, income, and social services. An economic system based on such principles, whether it is closer to a social-democratic form of capitalism or a market-oriented form of socialism, remains the best prescription for both advanced and developing economies. Moreover, it would seem particularly appropriate for post-communist economies emerging from a system that, for all of its failures, did assure a basic modicum of economic security to virtually all its citizens.

## *The politics of an alternative strategy*

For their willingness to pursue a fast-track strategy to create a market capitalist economy, the Yeltsin-Gaidar team has received high marks and strong verbal support (but as yet precious little capital inflow) from the IMF and from Western governments. But in imposing this drastic program on the Russian people, the team may well be undermining the impetus for much-needed economic reform; indeed, they may even be endangering the long-run prospects for democracy in Russia, as more and more people long for an escape from economic chaos and a return to some semblance of order and stability. In a telling joke now circulating in Russia, the question is raised: "What has one year of capitalism achieved that seventy-five years of communism could not?" The answer: "To make communism look good."

As much as an alternative strategy of economic reform is needed, there remain formidable political problems in assembling a viable progressive political force that could lead the campaign for such an alternative. These problems include the following:

(a) Many professionals and intellectuals still don't trust anything that appears to smack of socialism, such as a significant role for the state. Their fear that this would allow old elites to maintain their power and their ways is not altogether unreasonable, but it reflects both an unwarranted distrust of democratic institutions and an unwillingness to recognize the extent to which the former elites have profited and will continue to profit from the current state of affairs.

(b) Many workers cling to a defensive position that would protect them against the rigors of a market system, rather than welcoming greater involvement in the operation of enterprises within a new market environment. Defending one's old job and benefits against the kind of economic free-for-all promoted by the most radical free-marketeer reformers is surely justifiable; but the long-run interest of workers lies in active participation in the building of a new system with greater competition as well as adequate social protection.

What can be done? Progressives should try to form alliances among the growing number of people within the radical reform camp who are beginning to realize that shock therapy doesn't work—if only because of the social and political tensions to which it gives rise—and workers and labor leaders who can be persuaded that defensive approaches are shortsighted and that their real interests lie in a gradual, equitable, worker-involved process of liberalization, stabilization, and privatization.

Even a successful alliance of this sort will face formidable political opposition—not so much from the free-marketeer camp (which is visibly weakening day by day), but by conservative and nationalist forces (which are growing in strength). It is vitally important to draw the line clearly between democratic progressive reformists and authoritarian conservative nationalists, and not to allow the former to be identified with the latter by free-marketeers.

It is of course much more difficult to devise a successful economic reform program based on gradualism, a substantial state role, and equitable privatization than it is to impose shock therapy and hope for rich external investors to come to the rescue. But the success of economic reform and political democracy in Russia depends critically on the ability of progressive forces to accomplish this enormously challenging task.

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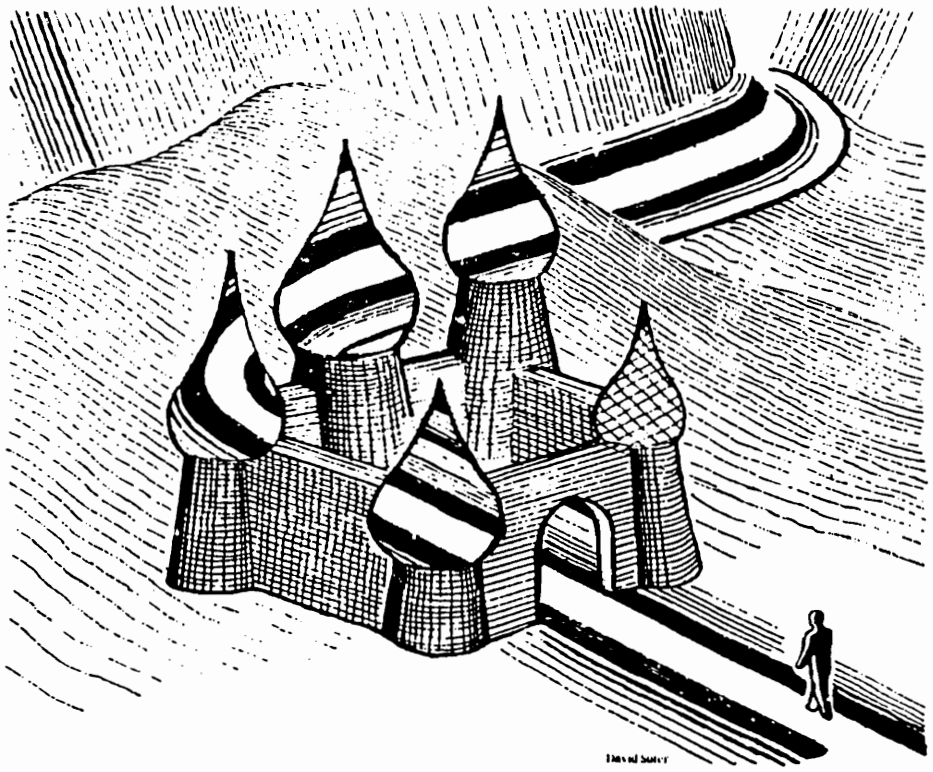
# $1.6 Billion: Just a Start

By Stanley Fischer



David Suter

CAMBRIDGE, Mass. he Vancouver summit meeting, the $1.6 billion in assistance President Clinton promised President Boris Yeltsin and the decision by 19 Western nations to give Russia 10 more years to pay off $15 billion in debt coming due this year form the first stage of a renewed Western effort to support democratic reforms.

Much more needs to be done, fast. To stabilize their economy, the Russians will need direct financial assistance of $12 billion a year for the next two years, plus even further debt relief, from the West.

Large sums, mainly export credits of the type that make up $932 million of President Clinton's package, have flowed to Russia in the last year. That aid, not tied to economic reform, has been totally ineffective. This time, the Group of Seven industrialized nations has to get it right when it meets in Tokyo in mid-month to assemble an overall aid program to help stabilize Russia's economy and currency.

Despite the impression in the West that Russia is sinking, crucial reforms are well under way, especially in the privatization of state enterprises. Many large enterprises have been turned into joint-stock companies, 700 medium and large enterprises have been privatized and auctions of the others are proceeding apace. Forty percent of all small enterprises have applied to be privatized. New small retail businesses are springing up. There are nearly 200,000 private firms compared with fewer than 5,000 at the end of 1990.

These reforms are beginning to transform the economy. However, the successes in privatization are overshadowed by Russia's failures in trying to stabilize its economy.

With inflation running at 20 to 30 percent a month, the ruble plummeting, the budget deficit at 10 percent of the gross domestic product or more and the Central Bank unrestrainedly dispensing credit, the West rightly fears economic aid would be wasted.

An 18-month impasse has made it impossible for the International Monetary Fund to deliver more than token aid. The West will give the Russians aid if they reform, but to reform successfully — to balance the budget and bring inflation down to a level that will allow other reforms to proceed — they have to start receiving aid. This Catch-22 has to be broken.

The key is to start the aid program with direct assistance from Western governments but with looser conditions than the I.M.F. normally imposes. Wisely, the I.M.F. is discussing innovative means of advancing aid with fewer up-front conditions than usual; if its members accept its proposals, this would greatly increase the chance of success of the aid program. Then, as Russia progressed toward stabilization, the I.M.F. and World Bank could provide aid through their standard procedures.

As President Clinton made clear, significant economic assistance should strengthen the Government and help keep the reform process on track. But the West has to put together a genuine aid package. After the fiasco of the $24 billion in aid pledged in April 1992 by George Bush, less than half of which was delivered — without promoting reform — mere announcements of Western programs carry no political weight in Russia.

This time, the Group of Seven has to detail exactly what aid is available. President Clinton set that realism in motion by making clear in Vancouver that his $1.6 billion package would be drawn from money that already has been allocated and is available.

After the initial $12 billion a year for two years, the Western aid can decline gradually. The West should relieve Russia of the need to repay the remainder of its $85 billion debt for five years to get the issue off the table while a serious reform program gets under way. When the time is ripe to stabilize the exchange rate, Russia should also have access to the $6 billion stabilization fund available through the I.M.F.

Of the $12 billion, about half can come from international financial institutions and half directly from governments. Indeed, President Clinton said in that Vancouver he would ask the Group of Seven "to come forward with their own individual bilateral initiatives." The donor net would have to be cast wide, to include not only the Group of Seven but also the Organization for Economic Cooperation and Development (the 24 leading industrial countries), Saudi Arabia and South Korea.

With an overall package in hand, the West would be able to sit down with Russia's key economic policy makers to agree on the measures needed to start the aid flowing. The essential requirement is for the Central Bank to rein in the growth of credit, which needs to be cut to 5 percent a month from 20 to 30 percent. Russia also needs to agree on a budget deficit target and on the need to adhere to a single rate of exchange.

The first stage of the $12 billion program should start no later than May and last three months. If the Russians agreed to cut the growth of credit, they should be given $2.4 billion in cash at the rate of $800 million a month. The $2.4 billion, from the worldwide network of donors, would take the form of long-term loans. During the three months, the Russians would be expected to make significant progress toward stabilizing their economy: that would be the condition for the program to continue.

Russia and the West would have to agree on the uses of the assistance. Russia has asked for n support imports and its budget, for financing small es, for restructuring larg prises and for converting fro tary to a civilian economy.

While continuing to suppo zation, we would have to a the Russians on mechanism stitutions to insure that aid effectively. Of course, West nical assistance should re essential part of our aid effo

Presidents Clinton and agreed that a coordinator s appointed to head the We program. This appointme help insure that the bilateral tilateral assistance all fo supporting reform.

Once the aid program g way, the I.M.F. should begin tions for its own program – that specified relatively few tant targets. I.M.F. assistan begin to flow during the sum World Bank, which has alre pared major energy sector tation loans, should begin la operations with the Russian same time. The European Reconstruction and Deve which wants to finance new ments by privatized compa ought to move rapidly by mer.

There is no guarantee th proach to aid along these lin work. It might be impossib the Russians to agree to the

## Russia need $24 billion a more debt rel

reforms needed to start aid If they didn't agree — say, the Central Bank refused t the expansion of credit — w make it absolutely clear w problem arose. If the aid effo we would at least be seen as supporting democratic and reforms. If the Yeltsin Gov fails, it will be extremely i for future democratic refor be able to tell the Russians that the West was willing to doubtless would want to help

And if the aid effort succ and a well-designed progra have a good chance of succe would all be better off.

*Stanley Fischer, professor of economics at M.I.T., was chief economist at the World Bank from 1988 to 1990.*

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# Help the Russians Help Themselves

By Richard Layard

MOSCOW As President Clinton prepares to meet with Boris Yeltsin this weekend, he must realize that if the West can ever affect events in Russia, now is the time. The Russian government has a clear plan for getting the economy under control, but the dark forces of economic reaction and dangerous nationalism are against it. If we help the government succeed, we can pave the way to prosperity and peace. But if we fail to aid the reform, the prospect is bleak indeed.

Many political crises cannot be helped by money. This one can be—although the task will take more than the $1 billion a year that early reports indicate President Clinton will offer this weekend. Mr. Yeltsin has appointed as finance minister (and deputy prime minister) a man uniquely qualified to sort out the Russian economy.

Boris Fyodorov has both the toughness and experience needed to drive through a stabilization policy. He also has the foreign work experience, in the European Bank for Reconstruction and Development (EBRD) and World Bank, needed to negotiate an effective aid package. His detailed proposals for disinflation and reform are the basis of the government's current program.

But many now question whether there is any chance that Russia will be able to carry through a reform program. After all, they ask, hasn't the reform already failed? Not so. In one year Russia has moved more than half the way to a market economy. By boldly freeing almost all prices, the Russians have largely eliminated the queues in the shops and, more important still, introduced regular business relations between enterprises. Most trade is no longer directed from the center but based mainly on freely determined contracts between businesses.

Russia is also moving at breakneck speed toward private ownership—faster than any country in Eastern Europe. Nearly half of small businesses are now private, and there are more than 200,000 private farms (not including private allotments). Half of the giant state enterprises will be privatized this year, and 99% of Russia's citizens have collected the vouchers they will use in the auctions.

So there has been much solid achievement. But major muddles and problems remain: above all inflation, which is still running at 20% a month.

That is the problem that Mr. Fyodorov now wants to tackle, and his program cannot be carried out without Western support. To see why, it is necessary to understand just how massive a squeeze will be needed to control inflation. Each month last year, the central bank printed money equal to roughly 40% of the national income (5% for government financing, 25% for enterprises and 10% for the non-Russian members of the Commonwealth of Independent States).

The government has now pledged to reduce inflation to 5% a month by Christmas. This means cutting the printing of money to under 10% of national income. The first sector to feel the pain will be the other members of the C.I.S. But the government will also have to cut drastically the rubles printed to finance the budget and the enterprises.

The problem, however, is that the Russian quality of life is already very poor. Nearly half of Russian hospitals have no X-ray machines, and there is no money for school textbooks or for retraining the unemployed. So cutting the budget further would have desperate effects on the people, reducing the chances of a good political outcome.

Many businesses have been borrowing only because it was too easy, and they have squandered their money on wages rather than focusing on restructuring, which has added to the inflationary spiral. Obviously, funding that perpetuates obsolete production of unwanted goods must be reduced. But there must at the same time be some money to promote new developments, either new enterprises or new production in old enterprises. Without funding for such developments, there will be an economic and political catastrophe. Russians will not accept a situation where people are laid off just because there is no money for business opportunities.

So some money for government and enterprises has to come from abroad, not in rubles but in dollars, most of which will be in loans. This will not be a matter of the West simply "giving Russia money." Russia has never suggested any cancellation of debt; it has huge mineral wealth and a highly educated population. The Novy Urengoy gas field alone is worth $1 trillion. Russia's potential income is so far above its current income that it should be allowed to borrow now to achieve that potential—then it can repay.

But Russia cannot currently service its debt, except by token payments. Russian imports are now only 40% of what they were in 1990. Many Russian enterprises are producing below capacity simply because foreign exchange is so scarce, and thus so expensive.

So a Western aid package is needed that includes at least $15 billion a year that can be spent on imports. The package should include an enterprise fund for lending to Russian enterprises on the condition that they execute sensible business plans, as well as budgetary support, a stabilization fund and debt relief.

Fifteen billion dollars seems like a lot of money. But at $100 a head it is about the standard assistance for countries in similar situations. If things go badly, Russia could once again threaten us with nuclear weapons, or sell them to the whole world. Thus the case for aid is surely compelling. But critics find many objections.

First, people say, it will be money down the drain. This is simply not so. The money should be offered on certain conditions, and paid out stage by stage only if the conditions are satisfied. Aid was offered to Poland at the beginning of its reform process, when inflation was about 25% a month. The West should do the same for Russia.

Second, people argue, Russians have many dollars already—either in Russia or in the West. Since these could be used to finance imports, why lend dollars to Russia? The answer is that those dollars can be mobilized only after the stabilization has been successful.

People also worry that Western help could be counterproductive. That is for Boris Yeltsin to decide. In his view Western aid is essential, and he has asked for it loud and clear for the past 15 months.

Finally, most Western governments have genuine budgetary problems. This is reflected in the size of the package that President Clinton is supposed to be offering in Vancouver. So the main support should come from the international lending agencies, which are willing to provide funds if they are convinced the time is ripe.

And that is the key point. There is now a genuine window of opportunity. If the West continues to wait until it is certain that Russia is ready, it could wait forever. A more statesmanlike approach is surely this: Make a bold offer, make it conditional, and make it soon.

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*Mr. Layard, a professor at the London School of Economics, is an adviser to the Russian government and co-editor of its publication, "Russian Economic Trends."*

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*Patrick Leahy*

# Russia, Aid, Now

Unless U.S. foreign aid policy changes with dramatic suddenness, a new, extremist regime of the right or left could emerge from the chaos and desperation in Russia and bring back the Cold War.

In a tense showdown last week in Moscow, old guard Communists and anti-West nationalists staged an assault on President Boris Yeltsin and democratic reformers. The Russian People's Congress, still controlled by remnants of the old Marxist-Leninst era, is attempting to strip Yeltsin of all executive powers, leaving the legislature as the only source of authority.

However tempting it may be to focus inward, we cannot declare victory and walk away from this one. Our present aid program in Russia is not succeeding. Neither we nor our allies and friends are giving effective help to the democratic reformers or hope to the Russian on the street.

Through the distraction of our own electoral season, through recourse to budget trickery and through diversion into important but secondary foreign policy problems, we are failing to measure up to the greatest foreign challenge to our nation since the Second World War. We are on the verge of missing a historic opportunity to give generations of peace to our children and grandchildren.

The previous administration, after deadly hesitation, finally decided to help the cause of democratic transformation in Russia. But faced with difficult decisions on where to find the money, the Bush administration resorted to budgetary gimmicks to make the U.S. aid program seem much larger than it really was. To drive up the dollar figures, it counted as aid what were in truth standard commercial loan guarantees and credits. This only forced Russia's staggering economy deeper into debt and finally into default.

The main budgetary gimmick chosen—granting billions of dollars of short-term agricultural credits backed by U.S. government guarantees in the face of a collapsing Russia economy—is not a policy that will benefit American taxpayers in the long run. And it certainly is not giving the reformers in Russia the boost from the West and they need to triumph over the ultranationalists, the xenophobes, the still strong Communists and other extremists of all stripes and hues.

The Clinton administration needs at once to break with the unimaginative policies of the past and accept that the standard terms and conditions of aid do not apply to this unique situation in Russia. U.S. policies aimed at assisting Russia through this incredibly painful and difficult transition to a democratic society and a market economy must show a daring and imagination not yet seen.

Speaking on the floor of the Senate as chairman of both the Foreign Operations and Agriculture committees, I proposed a two-step plan to shift substantial amounts of money from other parts of the foreign aid budget to provide increased food aid and concessional loans to the former Soviet Union and to maintain a vital market for U.S. farmers.

The first step in this plan is to ease Russia's current debt crisis and give its leaders a breathing spell while they restructure the country's centralized economy. If the president is willing to decide on new funding priorities, i.e., what other programs to cut, I am ready to help find $1 billion in direct grant aid for Russia and other independent states. The administration should immediately work with other creditors to reschedule Russia's debt repayments and allow it to break out of the vicious cycle of loans and defaults. Until rescheduling is completed, we should provide concessional loans and grants to meet their immediate food aid needs.

This emergency aid would be followed in the second step by a more balanced package of long-term commercial, technical and humanitarian assistance to complement efforts of other nations to get the former world superpower back on its feet. This package, carefully coordinated with Europe and Japan, should be targeted to help Russia create the conditions and institutions of a market economy and to release the productive forces of that nation of enormous potential wealth. We must get away from an aid program for Russia that is little more than a laundry list of every bureaucrat's favorite program and focus our aid on reforming key sectors of the Russian economy and on providing a minimal social safety net for the long-suffering Russian people.

The United States, for all its wealth, cannot bear this burden alone. The stakes of our friends and allies, above all Western Europe and Japan, in a democratic transformation of Russia are as great as our own. Led by a determined United States, the West needs urgently to devise a coordinated—and effective—program for Russia. The current hodgepodge of duplicative aid programs for Russia needs to be immediately replaced.

There are political barriers to what I propose. Shifting money from other parts of the foreign aid program to Russia will upset some aid recipients. Curbing subsidies for agricultural exports to pay for this year's food aid to Russia will provoke opposition. Congress and the administration need to decide—and soon—whether our national interest in a peaceful transition to democracy in Russia takes priority over other important but lesser goals in the foreign aid program, and act on that decision.

President Clinton will meet Russian President Boris Yeltsin in April. I urge the president to begin work immediately with Congress so that he will be in a position to give Yeltsin assurance of a long and lasting partnership with the United States that will carry the young Russian republic through these very hard, formative years.

That, to me, seems a far better investment than having to build up the nation's defense capabilities once more—because we lost the best chance for enduring world peace.

*The writer is a Democratic senator from Vermont.*

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**COLUMN RIGHT/**
WALTER LAQUEUR

# Beware the Captives of Yesterday

■ Those who say America should stay out of Russian affairs can't be aware of the alternatives.

Boris Yeltsin has survived the attempt to impeach him, but the real showdown between the democrats and their opponents is still to come. Is it right to support the democrats? Why get involved in what seems to some an internal Russian conflict?

As a general proposition, it is wise to put one's eggs in several baskets, but unfortunately, there are no other baskets in Moscow just now. It is certainly not a matter of one particular leader; the issue at stake is freedom in Russia and world peace.

The democrats have committed mistakes, but even the greatest political genius could not have evaded a crisis as the result of the unprecedented transition from a communist dictatorship to a market economy. If rich Germany now faces major difficulties, how could it have been different in Russia?

Yeltsin's real mistake was political: After the failed coup in 1991, he should have dealt harshly with the plotters and their supporters, called new elections and established a political movement of his own. Magnanimity in victory is a great virtue, but August, 1991, was only half a victory. As a result, Yelstin lost much of his influence and now fights for survival against those who want to turn back.

America's support for Russian democracy has not been overwhelming so far. The White House has yet to send an ambassador to Moscow. President Clinton received Valery D. Zorkin, chairman of Russia's Constitutional Court, earlier this month; Zorkin has been a leading opponent of reform. Then there was the initiative to close down the Munich-based Radio Liberty, the only effective instrument that America now has in the struggle for Russian public opinion. It is difficult to think of an idea more inappropriate and more untimely.

Those who favor America staying out of the conflict seem not to be aware of the alternative, which is not surprising. After 1917, only communism attracted attention; the extreme right was ignored. It had been defeated and did not matter. But the far right has had a spectacular comeback in recent years and with the help of the old communist Establishment, it now wants to seize power.

The extreme right is a curious blend of some of the worst features of fascism and Stalinism. In its publications, as in its demonstrations, it displays pictures of Stalin together with those of Hitler. Its emblem is the swastika, but it does not neglect the hammer and sickle. It publishes Hitler's "Mein Kampf," but also the writings of Stalin. Its heroes are Slobodan Milosevic and Saddam Hussein; its believers are anti-American, hate Jews, democrats and Freemasons, and, for good measure, Boy Scouts, Rotarians and Jehovah's Witnesses. They believe in the craziest conspiracy theories and are firmly convinced that the whole world has ganged up to ruin Russia. For the extreme right, all democrats are emissaries of Satan.

**'The extreme right is a curious blend of some of the worst features of fascism and Stalinism.'**

But surely there must be some sane people among Yeltsin's opponents in Moscow? And isn't it true that some of them were on the right side of the barricade at the time of the coup in 1991? Yes, and Mussolini was a socialist before he became a fascist. The democrats' "centrist" opponents are respectable, in a way: former party secretaries of the Brezhnev period, former managers in the military-industrial complex, members of the old *nomenklatura* with no firm convictions but colossal ambitions, some Christian Democrats who have moved from democracy to the fascist camp, some army and KGB commanders.

They are yesterday's men and they are mortally afraid of losing their last privileges. There are a great many chiefs among them but few Indians; for mass support they need the cohorts of the extreme right, who can get thousands of their supporters into the street. Since an old-fashioned military dictatorship would not work now in Russia, these people are opening the gate to the right-wing extremists. And since the old communist slogans now have little appeal, they have embraced many extreme nationalist slogans to replace Marxism-Leninism.

These are the issues now at stake in Moscow—not the personalities of Yeltsin, Ruslan Khasbulatov or Alexander Rutskoi. If the red-brown coalition should win, it will mean much more than the end of reform. This coalition stands for the reconquest of lost territories; it needs conflict with the West. Only on the basis of a state-of-siege mentality can the maintenance of a big army and huge military expenses be justified.

In brief, the fate of world peace could be decided in Moscow these days. It is for this reason that another Cromwell is needed to tell an unrepresentative Parliament that it is not fit, and that it should now give place to better men.

*Walter Laqueur is the author of the forthcoming "Black Hundred: the Rise of the Russian Extreme Right" (Harper / Collins).*

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*Charles Krauthammer*

# Enough of Sideshows

At the height of the Vietnam War, Sen. George Aiken of Vermont proposed his famous formula for extrication: "Declare victory, and get out." He was a prophet ahead of his time. Last week, special U.S. envoy to Somalia, Robert Oakley, declared his mission a success and announced that he was returning home. On the same day, Defense Secretary Les Aspin declared three days of air drops in eastern Bosnia a "great success" and announced that they would be suspended.

Aspin's Bosnia claim was so patently ridiculous—some of the Bosnian enclaves we were supposedly relieving were overrun the very day we declared success—that it was immediately overridden by the president. The air drops continue.

That does not relieve our Bosnia policy of its fatal incoherence. If the air drops had any point, it was to show political support for the besieged Muslims. But the president insisted, to the contrary, that they were purely humanitarian. The food will be available for all, he promised. The air drop "is not a political issue with us," he said, as if in Bosnia one may have humanitarian, but not political, objectives.

The air drops are a product of the "do something" school of foreign policy. We have no political objectives. So we take the path of mindless moralism: half-measures—gestures, really—that achieve little, leaving us with a choice between the embarrassment of retreat or the disaster of deepening involvement.

*Moscow is the main event.*

In Somalia, to be sure, retreat entails minimal embarrassment thus far. Food is getting through. Starvation deaths have apparently ended. The United Nations is poised to take over from the United States. But according to Somali human rights activist Rakiya Omaar, America is "leaving an ill-prepared U.N. to deal with . . . the prospect of a violent aftermath." If the U.S. departure precipitates another Somali slide into anarchy, Operation Restore Hope will take on quite a different tinge.

In Bosnia, the choice between embarrassment and disaster is even starker. Our tepid intervention has predictably backfired. The American air drops were intended to relieve Muslim strongholds under Serbian siege. The Serbs figured that if the Americans are going to interfere with siege warfare, they had better try direct assault. Hence the fierce fighting that followed the air drops.

Aspin had the right idea: Given the choice between deeper involvement and retreat, retreat. In these and other intractable civil wars, it is the only choice. The United States may be the world's policeman, but there are certain neighborhoods that even this cop chooses not to patrol.

The critics howl at such moral insensitivity. What about ethnic cleansing? they protest. But if the issue is moral, why no howls for the appalling suffering of, say, Nagorno-Karabakh, to pick a place on the doorstep of Europe, where the locals could give the Yugoslavs lessons in the art of ethnic cleansing?

The more hardheaded critics say that the refusal to patrol Bosnia sends a signal to Russian irredentists that they may do to the Baltics, Ukraine and other parts of the Soviet empire what the Serbs are doing to former Yugoslavia. The critics assume that whacking Serbs will deter Russians. It will do nothing of the sort. It is one thing to intervene against Serbia. It is another to intervene against a nuclear Russia. The single clearest lesson of the nuclear age is that great powers do not go to war against each other. If the bad guys take over in Moscow and decide they want back, say, the Crimea, we are not going to intervene no matter what we do in Bosnia.

Moreover, there is something truly cockeyed about trying to signal Russia through Bosnia. If Russia is the priority, the way to address it is not through symbolic actions in the Balkans, which promise to be either empty or highly risky, but directly. Indeed, the preoccupation with Bosnia, Somalia and the world's other brush fires is a convenient distraction from the overriding foreign policy issue facing the United States: helping save the Russian experiment in democracy. It is on Moscow, not Mogadishu, that the peace in the post-Cold War world hinges.

The danger to that peace is not theoretical. The reactionary Russian parliament trying to overthrow Yeltsin considers Russia's current pro-Western foreign policy not just supine but treasonous. The anti-Yeltsin forces would halt nuclear disarmament, try to reclaim the Soviet empire and make Soviet-style mischief in places like Iraq.

To his credit, President Clinton is waking to the threat. He has scheduled a summit with Yeltsin. He has sent repeated signals of political support. He has called for an emergency meeting of the G-7 states to give aid to Russia.

What kind? Will it help? The debate on these questions has dragged on for so long that Western aid efforts have been paralyzed. My view is: Try everything. Build housing for soldiers. (In the end, the army will decide who rules Russia.) Lift all U.S. tariffs for Russian products—unilateral free trade—to nurture their export industries. Try financier George Soros's safety net proposal: Western hard currency given directly to the casualties of Russian economic reform. If it takes $6 a month to sustain an unemployed worker, what better use of foreign aid than smoothing the dismantling of Russia's military-industrial complex?

Enough of sideshows. Somalia, Bosnia may engage our humanity, but they cannot be allowed to monopolize our foreign policy. The main event is Moscow. An American president is finally turning his energies in that direction. Let's hope it is not too late.

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# Clinton's Greatest Challenge

By Richard Nixon

Those who would disagree, as I do, with some of the specific proposals in President Clinton's economic program must give him credit for his boldness and political courage in advocating them and for his indefatigable efforts to sell them to the American people.

If he demonstrates the same leadership qualities in addressing the major foreign policy issue of our time, he can secure his place in history as a great President. That issue is the survival and success of political and economic freedom in Russia.

That is not to say that the Mideast, Iraq and Bosnia are not also important, or that the nations of Eastern Europe and the other former Soviet states do not also deserve priority attention where they have democratically elected governments and have initiated serious free-market economic reform. But what happens in Russia will have an enormous effect on those nations, on our allies and on the United States.

Without a substantial increase in aid from the West, the Yeltsin Government will not survive. The U.S. must lead in providing it. It is a very tough sell for the President. The last Gallup poll showed that only 4 percent of voters considered foreign policy to be an important issue. In Mr. Clinton's nationally televised town meeting, there was only one question concerning foreign policy. It was about Bosnia. His political advisers understandably will tell him, as they did in the campaign, "It's the economy, stupid!"

But foreign and domestic policy are like Siamese twins — one cannot survive without the other. If Boris Yeltsin's democratic Government collapses and is replaced by an aggressive, hard-line nationalist government, this will have a far greater impact on the American economy than all the Clinton domestic programs combined. The peace dividend will be down the tubes. The defense budget will have to be increased by billions of dollars rather than cut. This would mean that the President's plan to cut the deficit would have to be taken off the table.

The Russian democracy is going through a deadly crisis. The negative factors are frightening. Russia has 31 republics and provinces that have declared their sovereignty and 132 nationalities. Before the peaceful revolution of December 1991, the Russian people had never known either political or economic freedom. What works in Poland, the Czech Republic and Hungary will not work in Russia.

Russia is going through an economic downturn worse than the Great Depression of the 1930's in the United States. In 1992 inflation was 25 percent a month, the gross national product was down 20 percent, and living standards were down 50 percent. There has been an alarming increase in crime and corruption. Separatist tendencies and nationalistic conflicts which had been cooled by the cold war are getting hot again, ranging from bloody war in the Transcaucasus and Central Asia to confrontation over minority rights in the Baltic states.

But despite these overwhelming odds, the conventional wisdom of most of the American media that the Russian democracy is doomed is off the mark. There is still strong support for reform among political leaders and the Russian people. The real political battle today is not between reformers and reactionaries, but between different kinds of reforms.

There are those like Mr. Yeltsin who prefer to act swiftly and decisively, and those like the Civic Union which would rather move more gradually. The fact that all political leaders except for the extreme reactionaries pay at least lip service to a free market economy means there will be no turning back to Communism.

The negative news from Russia has completely obscured the positive news. Just as Washington is not America, Moscow is not Russia. While political infighting is big news in Moscow, privatization and growth are proceeding irreversibly in other parts of Russia. Twenty percent of the G.N.P. is now produced by private enterprise. More than 30 percent of Russian workers are in private enterprise. The press is free. Privatizing the economy has helped to eliminate shortages. No one talks about the possibility of starvation, as was the case when I was in Moscow just nine months ago.

Most important, as experts like James Billington and Gerald Corrigan have pointed out, the caricature that Russian workers are not responding to economic incentives is false. In a meeting in St. Petersburg two weeks ago, private entrepreneurs unanimously agreed that, when given the opportunity to enjoy the benefits of a free society, Russian workers are among the best in the world. They are also among the best educated: Ninety percent have graduated from high school — a higher percentage than in the United States.

Can Boris Yeltsin survive? Some Western leaders I talked to question it. Some of his opponents in Russia doubt it. Most shocking, the State Department officer who was in charge of aid to Russia publicly predicted last month that he would not last. With friends like that, Mr. Yeltsin needs no enemies.

His approval rating is down sharply because of the economic downturn. But he is still the most popular politician in Russia. He has made serious mistakes in dealing with the Parliament he inherited from Mikhail Gorbachev. But while revolutionary leaders are generally good at destroying old orders but not good at governing new ones, Mr. Yeltsin has surprised even his critics by his political skill in handling what must be the most difficult political position in the world.

**The West must wake up: Russia is the key to global stability.**

To his credit, he is attempting to find a compromise with the Parliament rather than becoming authoritarian, as many predicted. Those who would count him out should bear in mind that he has remarkable recuperative powers. He is a fighter. When he seems to be down and out, he gets up and continues the battle.

Most important, President Yeltsin shares our values. Unlike Mr. Gorbachev, he has repudiated both socialism and Communism, believes in a free market and supports the private ownership of property. Mr. Yeltsin unequivocally supports a non-aggressive foreign policy. After meeting all the major leaders in Russia, I am convinced that our choice is not between him and somebody better, but between him and someone worse. He deserves our help, both to further our interests as well as his.

In addition to increasing aid, President Clinton should consider calling for an emergency meeting of the Group of Seven major nations. The crisis in Russia should be at the top of the agenda. He should take the lead in persuading our allies, particularly the Germans and Japanese, to join us in rescheduling for 15 years the $84 billion debt Mr. Yeltsin inherited from Mr. Gorbachev.

Shortsighted Western governments and bankers have to face up to the fact that if the debt is not rescheduled, they are likely to get nothing from any government which replaces Mr. Yeltsin's. We should demand that the bureaucrats running the International Monetary Fund not treat Russia like a third world country.

We should insist that the allies we helped recover from World War II now help Russia and the other independent nations in Eastern Europe and the former Soviet Union recover from the cold war. The Germans have their plate full with eastern Germany. But the Japanese participation in the multilateral aid program is shockingly inadequate. The Japanese should quit conditioning aid on Russia's return of four tiny northern islands. If Mr. Yeltsin fails, they will never get the islands back.

Why should we even consider aid to Russia in view of our problems at home? Because aid to a non-aggressive democratic Government in Russia is an investment in peace. Russia is the only nation which has the power to destroy the United States. Russian diplomatic support in hot spots like Iraq, the Mideast and Bosnia is indispensable.

During the cold war, many thought the Soviets were evil. None thought they were crazy. That can't be said for some of the smaller nations trying to acquire nuclear weapons. Russia and America, as the only two nuclear superpowers, must play the crucial role in preventing proliferation of nuclear weapons.

Aid to a free-market economy in Russia is an investment in prosperity for the United States. Consider these facts. Russian G.N.P. last year was seven times as great as China's. China's trade with the U.S. was eight times as great as Russia's. Why? Because China's private enterprise produces over one-half of its G.N.P. Russia's private enterprise produces only one-fifth of its G.N.P. As Russia's private sector grows, this will mean thousands of jobs and billions in trade for the U.S.

Even greater stakes are involved. For 75 years, Communist Russia, as a major Soviet state, tried to export Communism to the rest of the world. Today, democratic Russia can serve as a powerful example of how political and economic freedom is the best choice for nations who want to progress. If political and economic freedom fails in Russia, this will encourage the reactionary leaders of other nations to resist reform. If it succeeds, this could have a major impact on a nation like China, which has significant economic reform but no political reform.

Above all, it is time to quit treating Russia like a defeated enemy. Russia did not lose the cold war. The Communists did. The U.S. and our allies deserve great credit for maintaining the military and economic power to resist and turn back the Soviet aggression. A democratic Russia deserves credit for delivering the knockout blow to Communism in its motherland. Russia should be treated as a proud struggling friend, not as a weak former enemy looking for a handout.

The demise of Soviet Communism was one of mankind's greatest victories. But the victory will not be complete until Russia and its neighbors can enjoy the benefits of political and economic freedom. It would be tragic if, at this critical point, the United States fails to provide the leadership only it can provide. By leading abroad as he has so effectively at home, President Clinton will establish himself as the world's preeminent statesman. □

*Richard Nixon, the former President, recently returned from his third trip to Russia in three years.*

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# Eastern Europe's Economic Reforms

### Big Bang vs Gradualism

Bruno notes that experience from hyperinflation and high-inflation episodes "points only to the clear advantage of the big bang approach at the inflation stabilization stage." The question of how fast one should proceed with other reforms—trade liberalization and privatization, for example—is more complicated. A related issue is the speed with which various markets adjust to changes in policies and policy signals. In this regard, Bruno notes that, whereas asset markets adjust extremely fast and incur few transitional costs, commodity and labor markets can take three to four years to adjust to changes.

Therefore, "the advocate for a big bang has to make clear which particular portion of the policy package is implied," Bruno stresses. He adds that, in the case of Eastern European countries, "there seems to have been overoptimism at the onset of the programs about the speed of the supply response and other behavioral responses that could come in the wake of a drastic change in the economic environment."

### Initial Price Shock

Bruno indicates that in all the countries except Hungary, the initial price shocks following the adoption of reforms were much larger than expected. He suggests that the possible sources of these shocks include a large, unabsorbed monetary overhang; the underprediction of the effects of large initial currency devaluations; and the monopolistic behavior of state enterprises anticipating price controls.

Could the initial price shocks have been smaller? Bruno suggests that, "technically, the answer is yes." He compares the Eastern European experience of stabilization with that of Israel in July 1985. Despite substantially eliminating subsidies, he notes, Israel limited its initial price shock to 27 percent by opting for a slower rate of devaluation (relative to what fundamentals seemed to warrant) combined with price controls that were gradually removed. Bruno adds, however, that Israel had neither monetary overhang nor the degree of price distortions that prevailed in Eastern Europe.

On balance, says Bruno, most Eastern European countries have achieved far-reaching liberalization "together with a reasonable measure of macroeconomic stability, in spite of a highly distorted starting point and immense economic and political risks."

### Output Collapse

Noting the substantial declines in output experienced by Eastern European economies during 1990 and 1991, Bruno suggests that the most relevant issue for policymakers is how these declines can be reversed. He notes, in this context, that although public sector output is continuing to collapse, the small-scale private sector, especially in trade and services, is thriving. However, given this sector's small initial size, even large increases in its output are unlikely to be able to stem the overall decline in output. In Poland, however, the private sector may, by 1992, have been large enough to contribute to the positive GDP growth that was recorded for that year.

### Fiscal Problems

Bruno notes that in the fiscal area, the initial budget outcome seemed satisfactory in most countries. The price shock led to an unexpected fall in real wages, resulting in larger-than-expected profits and higher tax revenues. These revenues were supplemented by those from taxes on capital gains, as well as by foreign currency deposits. But serious problems emerged in the second and third years of programs. Once real wages rebounded and profits were squeezed, returns on the profits tax fell substantially.

A critical problem in all five Eastern European countries is the transition from a relatively egalitarian and well-endowed social welfare network to one in which all the income and wealth distribution problems, unemployment risks, and other adverse social side effects associated with a market system suddenly emerge. Bruno contends that policymakers will face strong political pressures to continue the existing generous social security services and to correct for their recent erosion brought about by the sharp price increases. But despite these pressures, he suggests that there is room for streamlining the social welfare system.

"One way or another," Bruno points out, "the net budget outcome is likely to be a permanent imbalance unless output, sales, and the profit base rebound quickly or new taxes are imposed."

Should some fiscal deficit be allowed until the tax reform is fully in place? Bruno maintains that this question should be considered in the context of each economy. In general, it is important that annual budget plans be embedded within a medium-term framework of three years at least. Ideally, the country should commit itself to a budget trajectory for each year and aim to regain full budget balance within three years, with the deficit in no year exceeding a certain percentage of GDP, say, 4 percent or 5 percent. Bruno stresses that the deficit should be financed not by the central bank but by borrowing.

### Bad Loan Portfolios

Bruno notes that all the Eastern European countries have inherited a legacy of bad enterprise debts that have continued to mount and have been stacked in the portfolios of the commercial banks. This problem—and that of mounting inter-enterprise debt—has been exacerbated by the stringent stabilization programs, the credit crunch, and the collapse of the ruble zone export market. Outstanding bad debt is estimated at 15–20 percent of total bank debt in the former Czechoslovakia and Hungary, and about 30–40 percent in Bulgaria and Poland .

Bruno suggests that, when confronting the debt problem, these countries avoid extreme solutions, such as leaving the issue out of the government's budget altogether and allowing the banks to deal with it. This approach would, apart from sending wrong signals in the credit markets, eventually lead to a banking crisis, which would force the government to intervene on a much larger scale than would otherwise have been necessary. The other extreme is to yield to political pressures from the debt-ridden enterprises and pass blanket debt-cancellation laws. Besides being indiscriminate, this solution reinforces bad borrowing behavior.

The ideal solution, according to Bruno, is "a credible onetime cleanup of the books," with the government buying up enterprises' debts through the commercial banks on a case-by-case basis. Enterprises whose debts are so rationalized should have a clear recovery plan and be subject to tight conditionality and strict budget constraints.

### Privatization

In all five Eastern European countries, Bruno points out, the privatization of mainly small-scale trade and service enterprises has moved briskly, but that of large-scale enterprises—primarily in the manufacturing sector—has been at a virtual standstill.

Bruno suggests that in privatization, as in loan cleanups, extreme solutions (such as completely discarding or continuing with past methods) are not workable. The problem, he contends, which has not been systematically addressed, is how to instill market-oriented behavior in management and workers without unduly delaying privatization.

He points out that the variety of experiences across countries suggests that there may not be one way of resolving the privatization issue; the political and social context is important. But no matter what strategy a country adopts, transparency is important: to minimize uncertainty, clear signals should be sent to investors, managers, and workers. Also, micro management policies should be integrated into the general macroeconomic policy framework.

**Eastern Europe: Comparison of IMF Programs**

| Indicator | Hungary | Poland | Former Czechoslovakia | Bulgaria | Romania |
|---|---|---|---|---|---|
| Date | February 20, 1991 | February 5, 1990 | January 7, 1991 | March 15, 1991 | April 11, 1991 |
| Length | 36 months | 13 months | 14 months | 12 months | 12 months |
| Exchange system | 15 percent devaluation in January, then managed | Initial sizable devaluations, then fixed | 35 percent devaluation in October 1990; 15 percent devaluation and unification with tourist rate in December 1990, then fixed | Floating interbank | Official rate fixed; floating interbank; convergence of official and interbank rates |
| Wages | Tax-based incomes policy | Tax-based incomes policy | Tax-based incomes policy | Real wage cut by 35 percent, implemented by ceilings on wage bills | Tax-based incomes policy |
| Interest rates | With abolition of interest rate, ceilings will be market-based | Establish positive real interest rates | Increase before program and flexible management thereafter | Very large increase before program; flexible adjustment thereafter | Complete liberalization; CD's with flexible rates |
| Privatization | Continued in 1991 | Continued in 1991 | Started in 1991 | Started in 1991 | Started in 1991 |
| Two-tier banking system[1] | 1987 | 1990 | 1990 | 1989 | 1990 |

[1]The establishment of a two-tier banking system ended direct central bank involvement in commercial banking.



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THE NEWSLETTER ABOUT REFORMING ECONOMIES
Transition and Macro-Adjustment Division • Country Economics Department • The World Bank

# How to Contain Economic Inertia in the Transitional Economies

*"No one said it was going to be easy... and no one was right..." (President George Bush, after Yogi Berra)*

The restoration of capitalism initiated in Central and Eastern Europe by the 1989 revolutions, and in the former Soviet Union by the coup, countercoup, and then revolution in August 1991, was expected to set the economies in the region onto a path toward greater efficiency, technical progress, and prosperity. A "shock therapy"—of price liberalization, monetary and fiscal austerity, opening up of the economy to unrestricted free trade, internal currency convertibility for residents—was understood to require initial sacrifices, but sacrifices that, thanks to stabilization, privatization, and other economic and political reforms, would be short-lived.

These expectations were premature. The first two years of this therapy in Central and Eastern Europe, and the first year for the states of the former Soviet Union, have led to a drastic deterioration in general economic conditions. Between 1989 and 1991 national income in the Central and Eastern European countries dropped on average by about 15 to 20 percent, and industrial output by about 25 to 30 percent. Employment has fallen much more slowly, though fast enough to create unemployment of 8 to 12 percent or more of the economically active population; in Poland unemployment measured 13.8 percent in September 1992. Initial inflation, often hyperinflation, has been brought down but not defeated.

By the end of 1992 the first signs of a turnaround had appeared in Poland. In September industrial output was 9 percent higher than in September 1991, and industrial output in December 1992 was expected to be 13 percent higher than a year before. In October 1992 modest industrial growth resumed in Hungary. The Washington-based PlanEcon observed the first signs of recovery in Poland and Hungary—though recovery still insufficient to reverse the decline in GDP for 1992 as a whole—and forecast a resumption of growth in Bulgaria and the Czech Republic.

The UN Economic Commission for Europe was more pessimistic in its latest forecast *(see page 19)*. It expects Albania, Romania, and states of the former Soviet Union to remain in a deep recession well into 1993. The restructuring of productive capacity has hardly begun in the region and is delayed by drastic investment cuts. In 1988-91 gross fixed investment fell on average by about 37 percent. In 1992 it continued to fall, more slowly in Poland and the CSFR but precipitously in the former Soviet Union. These investment trends engender a sober view of the medium-run sustainability of incipient recovery. Supply inertia, not the desired supply response, has been the standard predicament of transitional economies.

This state of affairs is not a necessary concomitant of transition, nor a consequence of shock therapy that might be eased by a more gradual approach, but the unnecessary consequence of policy failures:

- The failure to modify performance criteria for the managers of state enterprises, aggravated by the failure to announce and consistently implement a clear and coherent privatization program
- The failure to accelerate the liquidation and bankruptcy discipline, the financial restructuring of enterprises and banks, and the antimonopoly measures
- The failure in government management of the state sector, evidenced by instances of excessive taxation of state enterprises, the continued redistribution of financial resources from profitable to unprofitable state enterprises through credit policy, and the neglect of intersectoral and interregional supply links, including international supply links *(see box)*.

### Managerial Behavior

Entrepreneurship, defined by Schumpeter as a combination of organizational skills and the ability to anticipate demand, is not absent in state enterprises, even in centrally planned economies. It exists there in a modified form, oriented toward the security of supply sources rather than the penetration of market outlets, and directed toward playing strategic games with central planners—anticipating their demands—rather than with potential competitors and clients.

In transitional economies managers of state enterprises are gradually liberated from central control. Their dependence on branch ministries is loosened; direct commands are replaced first by government contracts, then by contracts with suppliers and clients; and their subsidies are cut but they can fix their own output prices. Managers must search for new supply links and sales outlets; and market prices for inputs and outputs create opportunities for profitable input substitution and product differentiation. Their external financial resources are also squeezed: interest rates are raised substantially in nominal and real terms, and budgetary allocations become scarce.

In these new conditions state managers are still not motivated to maximize profits. There are no capital markets to assess an enterprise's value as a going concern. Even if managers were concerned with bankruptcy constraints, they would continue to be motivated to preserve employment and output and to maintain wages at levels far higher than would maximize the value of the enterprise. Indeed, an enterprise could reach a point at which its net capital value is zero—beyond which the bankruptcy constraint might begin to operate. As a result, not much profit, let alone amortization funds, will be available for reinvestment.

This situation will change only if managers are subjected to effective control by financial markets through the exercise of shareholders' voting rights, and the associated threat of hostile takeovers. Neither the dispersion of shares among a large number of uninformed private shareholders nor the concentration of shares in investment funds is likely to achieve such effective control; diffused share ownership will leave managers still quite comfortable to exercise their discretionary powers.

### Some Are Overprotected, Some Are Overtaxed...

Governments of transitional economies have undertaken policies that have contributed to the supply inertia of state enterprises.

- In many instances taxation of state enterprises has been excessive. The tax base has often been unrelated to enterprise performance. For example, in Poland a "dividend" is levied on state firms regardless of actual profits and required reinvestment finance. The dividend is therefore a tax geared to the state's equity stake in enterprise capital, revalued in line with inflation.
- Cross-subsidization within the state enterprise sector has continued in most postsocialist economies. It is no longer effected through fiscal subsidies, however (though enterprises have been allowed to accumulate unpaid tax bills), but through monetary policy. Creditworthy state enterprises have been prevented from gaining access to funds, while ailing state enterprises continue to benefit from generous credits or official acquiescence to the buildup of unpaid interest and amortization on their outstanding loans.
- Preservation of essential intersectoral and interregional supply links has often been neglected. In the change from direct or indirect central allocation to direct contacts between enterprises, short-term profit opportunities have been pursued at the expense of longer-term supply links.

The initial gross undervaluation of national currencies has diverted output to exports that will not remain internationally competitive in the medium run. And it has disrupted traditional supply lines and led to either unused capacity—due to input shortages—or to "distress imports" of crucial components—often identical to those that had been sold as "distress exports." There is good reason to believe that the disruption of international supply links—within the ex-CMEA, ex-USSR, ex-CSFR, and ex-Yugoslavia—has been an important factor in the recession.



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International Monetary Fund

JEL Classification Numbers
E2, O5, P5

Summary of
WP/92/59

"The Output Decline in the Aftermath of Reform: The Cases of Bulgaria, Czechoslovakia, and Romania"
by E.R. Borensztein, D.G. Demekas, and J.D. Ostry

This paper analyzes a number of issues surrounding the declines in economic activity experienced by three Eastern European countries--Bulgaria, the Czech and Slovak Federal Republic, and Romania--in the period since market-oriented reforms were initiated in these countries. As the review of developments in these three countries indicates, price and trade liberalization--including the dismantling of CMEA trade practices--should set in motion a series of changes that, over time, would be responsible for a radical transformation of their productive structures. This process of resource reallocation could easily generate a decline in aggregate output initially, especially if an expansion of activities that were profitable under the new relative price structure was delayed by significant adjustment costs and uncertainty.

Apart from these long-term, "structural" factors, output in the three countries under review has also been affected by more conventional macroeconomic forces. The combination of large increases in domestic energy prices (as subsidies for energy use were reduced) and policies necessary to contain inflation in response to price liberalization created a contractionary situation for output owing to both supply-side and demand-side factors. This raises two empirical questions that may help to explain the declines in output in these three countries. First, to what extent did the fall in output for each country reflect structural change (a reallocation of resources across sectors) rather than a conventional recession? Second, to what extent have demand-side versus supply-side forces been dominant in generating the output decline? The paper uses simple econometric techniques to investigate these two questions. Regarding the first, the empirical findings are remarkably strong in pointing toward conventional macroeconomic factors as the main explanation for the output declines. Regarding the second, the findings are more mixed.

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# Anti-Depression Cure for Ailing Postcommunist Economies

## Interview with Janos Kornai

Against all official predictions, economists await the first signs of economic revival in Hungary. By the end of 1992, gross domestic product—according to reports by (Hungarian) Economic Research, Ltd.—had dropped by almost 20 percent, and industrial production by 32 percent, compared with 1989 production levels. The number of registered unemployed is approaching the 700,000 benchmark—a 13 percent unemployment rate in a country that hadn't had statistically meaningful unemployment since the communist takeover in 1948. In Hungary, the "reform model-economy" has resulted since 1989 in a decline in output that has been steeper than industry's contraction during the 1929-32 Great Depression. The dimensions of the economic free-fall are alarming even allowing for contributions to GDP of the "invisible" second economy (not captured by official statistics). Hungary is not alone, or even worst off, as it weathers the seas of change—economic decline, unemployment, and high inflation are the unwelcome companions of practically all new postcommunist democracies of Europe and Asia.

In a recent presentation at the World Bank's Washington headquarters Janos Kornai, Professor of Economics at Harvard University and the Hungarian Academy of Sciences, and permanent fellow of the Collegium Budapest, Institute for Advanced Studies, warned that persistent economic depression in the post-communist world could have repercussions of global proportions. *Transition* editor Richard Hirschler asked Janos Kornai for his diagnosis of the postsocialist economic ills and what form anti-depression therapy might take. Professor Kornai maintains that although the transformation process cannot avoid destroying old structures, policymakers in the postcommunist nations are responsible for saving these economies from economic underachievement, and for preventing a surge of political extremism.

***Q**. You use the phrase "transformational recession" to describe the economic decline afflicting the economies in Eastern Europe and the former Soviet Union. A World Bank-spon-*

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*sored conference in Washington in June 1992 (*Transition, *July-August 1992) concluded that measured output declined sharply when comprehensive reforms were put in place. Other current research efforts also trace the causes of the recession in the postcommunist world. How much do you rely on this research and are there findings that could be used to improve governments' anti-recession policies?*

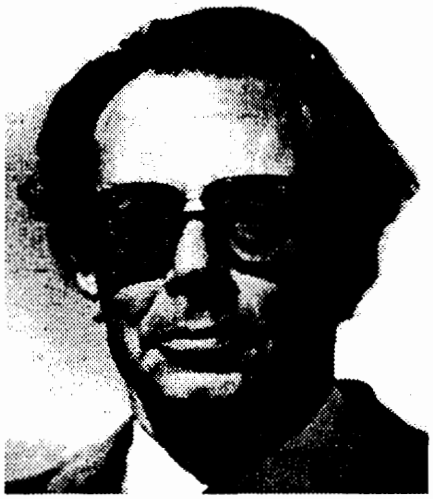
**A.** Much current research focuses on the economic decline and stagnation of the postcommunist societies. Some studies explain the downfall with a single cause, such as the collapse of the Soviet market and the breakdown of the Comecon arrangement, or the extreme contraction of aggregate demand, provoked by excessively restrictive monetary and fiscal policies. I cannot accept these explanations.

I think what happened was the combined effect of several, strongly related factors. Of course I'm not the only one searching for a multi-causal explanation; I have found several papers—including World Bank research, such as the Simon Commander and Fabrizio Coricelli study—that take similar approaches. *[Editor's note: see also "Persistent Economic Decline in Central and Eastern Europe" by Mario Bleier and Alan Gelb,* Transition, *vol. 3, no. 7, July-August 1992.]*

We are working with a team of experts to evaluate the transition from socialism to a market economy in Hungary. Preliminary results show six main causes of the postcommunist recession, all reflecting the fundamental changes required in attitudes and behavior to achieve an altered economic structure :

- Shift from a sellers' to a buyers' market
- Contraction of investment
- Shift in the composition of output
- Shift in the composition of foreign trade
- Disruption of coordination
- Enforcement of financial discipline.

These factors are all at work in the postcommunist transformation in Hungary and, furthermore, they occur in all postcommunist countries of Eastern Europe and the former Soviet Union. Although the blend varies because the relative weight and sequencing of the ingredients differs from country to country, in all cases it adds up, to a unique phenomenon:



Janos Kornai

transformational recession. We expect that the research framework applied to Hungary will also be applicable in the analysis of other postcommunist countries.

***Q.** Could you explain in more detail the uniqueness of transformational recession, perhaps starting with the shift from a sellers' to a buyers' market, the shift from Marx to market...*

**A.** In a somewhat immodest way let me quote a sentence from the UN European Economic Commission's 1992 report: "Emerging unemployment, elimination of shortages, and restoration of basic monetary equilibrium are all symptoms of transforming the Kornai type supply-constrained economies to Keynesian type demand-constrained ones." This is well proven by the quarterly surveys of Kopint-Datorg Inc. (Institute for Economic and Market Research and Informatics) in their polls of Hungarian enterprises. Insufficient demand has become a major constraint to production; in 1992, 62 percent of surveyed enterprises complained about inadequate demand, compared with only 26 percent in 1987. Meanwhile, bottlenecks in the supply of labor, domestic and imported materials, and parts became negligible impediments to production. For example, in 1992 only 1.5 percent of polled enterprises complained of insufficient supply of hard currency imports, while in 1987, 42.6 percent of enterprises mentioned shortages of imports as a major obstacle to increasing production.

***Q.** In your earlier work "Anti-Equilibrium," published in 1970, you suggested that the shift from a sellers' to a buyers' market could be done without a decline in output. Have you revised your opinion on this?*

**A.** At that time I thought one could shift from a sellers' to a buyers' market and eliminate the shortage economy with much less sacrifice. I thought that while supply grew at a steady rate, demand could be decelerated, ensuring a market equilibrium with potential slacks in the economy. I have to admit I was too optimistic. Aggregate demand is declining, and it is dragging down aggregate supply even more steeply. Although restricted demand results partly from a deliberate government policy to eliminate shortages through open inflation, it is also partly happening against the will of policymakers.

***Q.** Consumers are feeling the squeeze—consumption fell steeply in recent years. But what happened to investment, the other basic component of aggregate demand. Where are the investors hiding?*

**A.** A drastic fall in investment is another cause of the transformation recession. In Hungary, investment on comparable prices dropped 25 percent between 1981 and 1992; the ratio of fixed capital formation as a percentage of GDP fell from 28.8 percent in 1980 to 18.6 percent in 1991. Under socialism enterprises didn't require

additional stimulus for investment; public money fed their insatiable hunger for investment and expansion. This is over. Political accountability—and how tax money is spent—is now subject to public scrutiny. Spending restrictions and new oversight measures have been imposed. The government has had to curtail public investment, including infrastructure and social expenditures, as budget revenues have diminished and the budget deficit has grown.

State enterprises have also been afraid to invest: many are in financial trouble; those left in the public sector fear that budget constraints will harden and that their cash flow will dry up; state-owned enterprises expecting privatization are practically paralyzed; and state managers are not prepared to commit themselves to any enterprise development before property questions are settled. And private firms, even if ready to grow, also face various obstacles: the capital market is still weak, the tax burden is heavy, and the banking sector is extremely cautious and charging high interest rates.

**Q**. *That is one more reason to go ahead with the adjustment process, restructure the economy, and generate the proper supply response...*

**A**. Output structures developed under the communist regime have to be changed. Forced growth shaped a certain output composition, with strong emphasis on heavy industry and military production, neglecting production of consumer goods, provision of services, and development of infrastructure. Buyers were forced to accept the distorted structure with its distorted prices and shortages.

Restructuring the economy takes time. It is not simply a Keynesian type problem, to be solved by boosting aggregate demand. It includes the Schumpeterian process of creative destruction: those able to develop new products and apply new technologies to meet demand win the competition, while the losers go bankrupt and exit the market. If the pace of creation is slower than the process of destruction, if new capacities satisfying new demands cannot counterbalance the rapid liquidation of obsolete capacities, the net result is recession. That is what we are witnessing now.

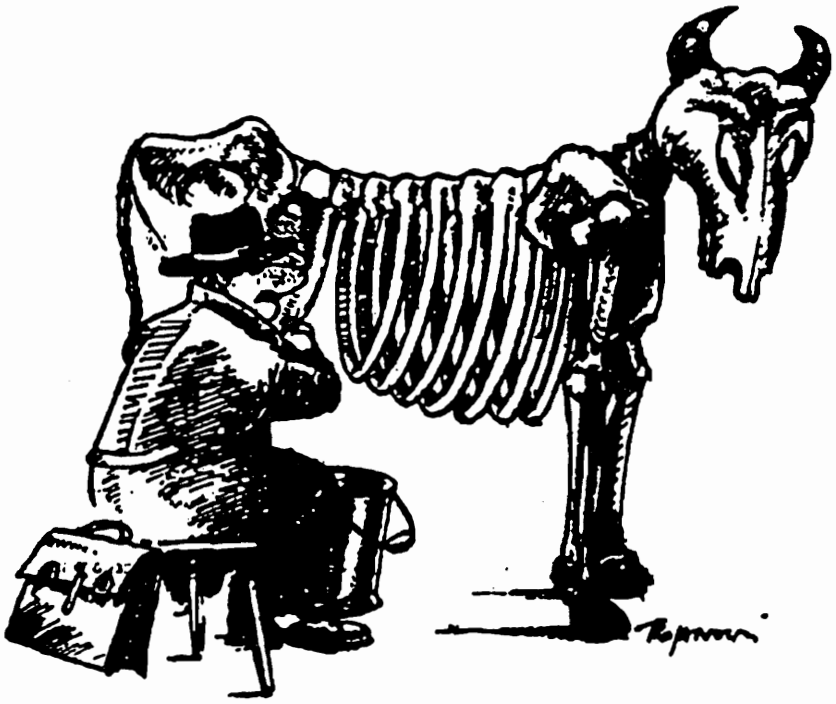
**Q**. *How about the external shock, as the collapse of the Comecon is defined?*

**A**. The collapse of Comecon trade, and especially of the Soviet market, is another crucial factor in the economic demise of the postcommunist nations. Calling it "external shock" is misleading. The collapse of Comecon was part of the overall collapse of communism, very much an internal affair. The Comecon system provided a soft market, always ready to accept the partners' products, competitive or not. The shift from a sellers' to a buyers' market was closely related to the collapse of the CMEA.

**Q**. *What do you mean by "disruption of coordination," and "enforcement of financial discipline," the last two factors on your list of causes of the recession?*

**A**. Many experts had the naive idea that once the command economy was abolished, a market would start to function almost automatically. But one has to recognize that a coordination void develops. This has clearly been the case in the states of the former Soviet Union and in Bulgaria and Albania where the elimination of the old regime was not preceded by a sustained process of economic reform. Hungary, with twenty-five years of reform experiments, has fared much better in this respect, but institution building remains an important condition for further development. For example, the housing industry is still ill-equipped to perform its role as a leading growth sector—it needs a network of real estate agents, developers, contractors, mortgage institutions, and the like.

As to the enforcement of financial discipline and efficiency, the hardening of budget constraints in the state sec-



From the Polish economic weekly, *Zycie Gospodarcze*



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tor, the wave of bankruptcies, the threats of bankruptcy procedures, and the expansion of the private sector have many beneficial consequences. Nonetheless, in the short term they contribute to the deepening of recession. There is a stronger stimulus, for example, for cost reduction, elimination of excessive inventories, and elimination of "unemployment on the job." Thus, a wave of new layoffs has begun in Hungary, further contributing to the general contraction. So, yes, privatization ultimately leads to more efficiency, but in the meantime it leads to massive layoffs, contributing to the contraction problem. This process can go even further. According to official data, production has declined faster in the past two years than has employment, indicating that even dying firms have been reluctant to shed their labor.

*Q. What is the bottom line of your analysis?*

**A.** If these countries suffered from "conventional" business cycles, they could be cured by standard anticyclical policy, beginning with increasing aggregate demand. There are strong political forces all around Eastern Europe and countries of the former Soviet Union demanding just that. But far from following a regular business cycle, these economies are in a transformational recession. And to emerge they cannot, after the contraction phase, go back to pursuing an expansionary policy and reestablishing old structures to keep alive loss-making firms and maintain obsolete jobs. They must move forward and continue the parallel processes of destruction and creation, eliminating unprofitable product lines and unproductive jobs while encouraging the evolution of profitable ones.

*Q. What role would you preserve for the postcommunist government?*

**A.** Hungary and other transition economies cannot rely exclusively on market forces. Private business and the market are still weak, and these countries would likely suffer low-level economic activity and high unemployment—in a word, stagnation. Governments must therefore provide carefully designed recovery packages. These programs must not generate further inflation by injecting more money in the economy; rather, they must focus on stimulating private investment. Specifically, the Hungarian government should:

- Introduce preferential taxes to encourage business investment, including housing development;
- Reduce the heavy tax burden on enterprises once budgetary reform occurs and social institutions are reorganized;
- Develop additional state-owned credit guarantee institutions, thus persuading commercial banks to take more risk while providing long-term investment credit to entrepreneurs;
- Devise fiscal and monetary policy to help bring down interest rates and induce investment;
- Encourage private savers to invest in shares and bonds;
- Accelerate privatization of state-owned companies by providing attractive credits to potential investors. Investment contracts should permit investors to acquire state property, free of earlier debt obligations, contingent on the investors' pledge to upgrade production and create jobs;
- Ensure early settlement of questionable property rights, including agricultural estates and state-owned apartments;
- Stimulate foreign investment, primarily among investors ready to undertake fixed capital investment, install new technologies, establish new production cultures, and create jobs;
- Promote private sector development by improving telecommunications, establishing industrial parks, and so forth.

*Q. You suggested many of these measures three years ago, and some have already been integrated in the government program. Just recently a very advantageous government-guaranteed credit was announced to help small investors in Hungary. Why are you now emphasizing once again this expansionary side of the program? Have you put anti-inflationary efforts on the back-burner?*

**A.** I would not say so, but economic priorities must be considered in the current context, and the anti-depressant cure must be provided without delay. In 1989, I gave top priority to anti-inflationary policy and the servicing of foreign debt. Past events justified that position. Changes in priorities are now necessary. I do not mean a complete U-turn, only a 45° shift. I would not push, for example, for achieving a one-digit inflation rate from the present annual rate, because I think the price would be too high, the present recession would worsen. And we cannot afford that.

My sense is that the people, having experienced economic stagnation and decline for many years, are fed up. Strong popular discontent could endanger the newly acquired liberties of Eastern Europe. We know pre-Hitler German history, the fate of the Weimar Republic following the Great Depression. That depression had a smaller impact in terms of economic decline and unemployment than the present demise of many postcommunist economies.

One cannot formulate policies without taking into account the political mood of the nations involved. Hungary in 1989 enjoyed the first fruits of political change, and a national consensus emerging support of tough economic action. But in 1993, that national consensus seems to have evaporated. Under the circumstances, we cannot risk a high unemployment rate. I am convinced that a reconsideration of economic policy is now essential by the decisionmakers who are responsible for the political future of Hungary and other postcommunist nations. □

## Slow Implementation

The adverse effects of an unchanged incentive structure are amplified by the usually slow progress of essential reform steps—the breakup of monopoly power, the implementation of liquidation and bankruptcy procedures, and the financial restructuring of enterprises and banks.

- Centrally planned economies were characterized by extremely high industrial concentration, with single-product producers and producer associations responsible for supplying not only domestic markets but often the entire CMEA and exports to the rest of the world. Once enterprises are given autonomy in determining their pricing and output, the monopoly and oligopoly power built into such industrial concentration and specialization is bound to exacerbate inflationary and recessionary trends.
- Delays in implementating liquidation and bankruptcy procedures are responsible for enterprises being able to pursue with impunity policies of greater disinvestment than those allowed by a solvency constraint, and to maintain higher wages and higher, noneconomic employment than would otherwise be possible. The lack of liquidation and bankruptcy procedures encourages enterprises to accumulate debt. Arrears owed the state budget and banks are equivalent to a monetary expansion. But interenterprise arrears reflect a redistribution of profits from viable enterprises with growth potential to nonviable enterprises sustaining loss-making output—and lead to inflationary disinvestment.
- The enforcement of liquidation and bankruptcy procedures requires the prior financial restructuring of enterprises and banks. Activities might be liquidated which, although unable to make enough profit to service past debts, have a present value as a going concern higher than their liquidation value. Thus, nonviable activities should be closed down, and viable activities should if necessary be recapitalized through new capital injections or debt cancellation. Banks should be recapitalized to compensate for canceled debt. Recapitalization of state enterprises and banks should be a net claim on the state budget, competing with other claims.

## Policy Suggestions

Supply inertia is a distinctive feature of the stabilization and liberalization experience of postcommunist economies. To contain the resulting transition costs, the following measures should be considered:

1. After state enterprises have been turned into joint stock companies, managers could be required to fix their companies' value (to be considered the selling price if bidders emerge during privatization). Based on this valuation, managers would have to make a normal rate of profit thereafter (including subsequent capital growth), and would receive a predetermined share of profits above that norm. Workers would receive shares worth a year's wages at that valuation, transferable gradually to "outside" holders over the next five years. This structure would expose managers to a discipline equivalent to that of their capitalist counterparts: they would benefit from profitability, reinvestment, and growth, and would be subject to a takeover of assets if their valuation was too low. Workers would have no incentive to urge distribution of profits and assets. In due course the development of a stock exchange could strengthen this incentive structure and bring it closer to the standards of advanced market economies.

2. Monopolistic behavior could be checked by introducing external competition, even with a moderate degree of tariff protection; by splitting enterprise associations and multiplant enterprises; and by setting upper price limits with direct reference to world price levels.

3. Until liquidation and bankruptcy procedures are put into effect, disinvestment could be prevented by legal obligations for enterprises to maintain the level of their real capital (assessed as indicated above, and not on the basis of historical capital, even if revalued in line with inflation). The accumulation of interenterprise debts could be prevented by applying punitive interest rates on such arrears (as attempted in Hungary, though at too low a rate to make a significant difference), or by the outright imposition of a cash prepayment constraint.

4. Recapitalization of state enterprises and banks should be an early and urgent undertaking. This merits Western support more than the achievement of formal convertibility at fixed exchange rates.

5. Taxes on state enterprises should relate to their real performance, at rates that allow the firms to plough profits back into restructuring both directly and through external funds. Their access to finance should be based on an evaluation of their general creditworthiness and the estimated present value of investment projects for which funds are sought.

6. The disruption of essential intersectoral and interregional supply flows could be avoided by diffusing more information about enterprises' input requirements, without reinstating any administrative planning machinery. Internationally, introducing automatic multilateral clearing—the transferability of bilateral trade balances among trade partners within former trade blocs, even short of anything as ambitious as the post–World War II European Payments Union—could help preserve or restore those trade flows that, given the sunk costs of past good and bad investments, still correspond at least temporarily to comparative advantages.

*Domenico Mario Nuti*
*Professor, University of Rome, and Advisor to the Commission of European Communities in Brussels.* *The article is based on his paper "Economic Inertia in the Transitional Economies," forthcoming in Impediments to the Transition, EUI Monographs in Economics, edited by E. Espa and others. Florence: European University Institute, 1993.*



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# Economic Guesstimate 1993 for Central and Eastern Europe

## PlanEcon is Optimistic, Oxford Analytica is Cautious

The year 1993 will be an average year for Central and Eastern Europe—worse than 1992, but much better than 1994, according to a Hungarian joke. Fortunately, the professional clairvoyants are less gloomy. The Washington-based PlanEcon Research Inc. predicts an economic upturn for Poland, Hungary, and the Czech Republic this year, assuming that those economies have reached rock-bottom in 1992. True, the prospects are bleaker for Bulgaria and Romania, as well as the combatting states of the former Yugoslavia, but—assuming a satisfactory peace settlement among the warring factions there—an upturn of economic activity is expected in late 1994, even in the Balkans. PlanEcon acknowledges that even the best-performing CEE economies would not be able to reach 1987 output levels by 1996. But it questions the reliability of those "pretransition" 1987 figures, and whether output figures can quantify improvements in quality of life, availability of consumer products, elimination of supply-bottlenecks, and the like. PlanEcon's Director, Keith Crane,

### Foreign direct investment in Eastern Europe—less than expected

Despite a major surge in foreign direct investment (FDI) in Eastern Europe in 1992—total FDI in the region was approximately $3 billion, with two-thirds going to Hungary—the overall level has fallen short of the expectations of most recipient countries and remains below the level required for long-term sustained growth, asserts Oxford Analytica.

**Hungary.** The level and structure of foreign investment in Hungary as of 1992 provides some indication that Western companies are starting to consider establishing manufacturing bases in Eastern Europe. Major investors at the end of 1991 were the United States (with investments of about $1 billion), Germany ($500 million), Austria ($325 million), and France ($275 million). Recent official data indicate that the 1991 investment level was sustained in 1992. Total FDI in the first half of 1992 was estimated at $750 million (above the levels for the first half of 1991, but below the levels of the second half), bringing cumulative foreign capital participation in Hungary to an estimated $4.4 billion (or about $500 per person).

By the middle of 1992 nearly half the 13,500 joint ventures were registered in trade and services. Yet these sectors received only 12 percent of foreign capital invested. Manufacturing, on the other hand, received 58 percent of foreign capital invested but accounted for less than a quarter—only 22 percent—of registered joint ventures. In fact, since 1989 between 65 and 70 percent of foreign investment in Hungary has been concentrated in manufacturing.

The bulk of foreign investment in industry has been concentrated in food processing, the car industry, chemicals, electrical equipment, and cosmetics. Investment in manufacturing is highly concentrated, with fourteen companies accounting for 32 percent of all foreign investment. There is a far wider dispersal of ownership in trade and services.

**The Czech Republic and Slovakia.** The former Czechoslovakia was the second most successful East European country in attracting FDI. Cumulative FDI by the end of 1992 was $1.0–$1.5 billion. The Czech Republic attracted more than 80 percent of FDI, although it accounts for only two-thirds of the population. Germany is the major investor in the Czech Republic, while Austrian companies are the major investors in Slovakia.

**Poland.** Poland has been the least successful CEE country in attracting foreign investment, despite the large number of Polish emigrés who were the major source of foreign investment in 'Polonia' companies under communism. Cumulative FDI in Poland was $1.5–$2.0 billion by the end of 1992. And while U.S. companies are the largest investors in Poland, German firms remain the most numerous. There are some indications that the tide will turn and that Poland will become a major target for Western investors in the longer term.

**Romania.** By September 1992 Romania had attracted a total of $500 million in foreign equity investment in 17,143 registered joint ventures. This figure includes investment that has yet to become operational—actual financial inflows associated with joint ventures are probably running at only a quarter of this level (although contributions of equipment and materials considerably round out the investment figure). Oil exploration has proved to be the principal attraction for Western investors in Romania and is responsible for $100 million of investment. Consequently, Holland (Shell), the United Kingdom (Shell and Enterprise Oil), and the United States (Amoco) are the largest sources of foreign capital, with each country investing $63 million, followed by Germany, which has invested $58 million and has the largest number of joint ventures (2,126).

**Bulgaria.** Bulgaria has attracted less than $200 million of foreign investment in joint ventures so far, despite its tourist potential. Major factors inhibiting Western firms are political uncertainty, the slow pace of the privatization program, and laws that restore land to former owners, making ownership entitlement extremely uncertain. However, debt-for-equity swaps could boost foreign investment in the future.



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takes a country-by-country look in his forecast.

*Poland*. Last year's gross domestic product increased by 1.2 percent, and industrial production by 3.5 percent, breaking the downward trend for the first time since 1988. The decline in industrial output, which was the key factor pulling the economy down, began to bottom out in November 1991. And by March 1992 industrial output exceeded levels for the previous year. Construction activity grew strongly throughout the year. Foreign trade also performed well in 1992, with exports rising faster than imports for most of the year, generating a sizable trade surplus and a modest current account surplus. Average economic growth should reach an annual rate of 4 to 5 percent between 1993 and 1996.

*Hungary*. GDP fell again in 1992, but is forecast to grow 4 percent in 1993. Industrial output appears to have hit bottom in May 1992, and by September 1992 surpassed the previous year's levels. Economic growth is expected to average 5 percent annually over the next four years. The recovery will be driven by increases in industrial output and construction as Western investments come on stream.

## Oxford Analytica: There are grounds for optimism, but...

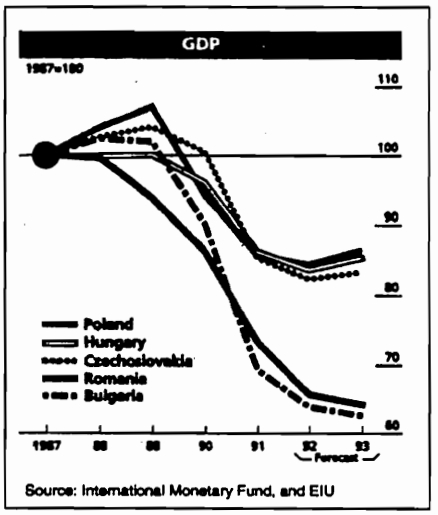
Economic performance in Eastern Europe in 1993 will continue to be adversely affected by a combination of internal and external factors, including:

- Deflationary effects of macroeconomic stabilization programs.
- Restructuring of domestic demand following the elimination or reduction of consumer subsidies, which has affected consumption of meat, dairy products, and clothing.
- The potential for industrial unrest, as "hidden" unemployment in heavy industry is converted into open unemployment.
- Loss of markets caused by the recession in Western Europe, and growing calls for protection against East European steel products in particular.
- Deterioration in German economic growth and performance, which would affect prospects for growth of German investment in Eastern Europe.
- Continued deterioration in economic performance in the states of the former Soviet Union and the failure to establish a satisfactory payments mechanism to facilitate trade links between the former Comecon economies.
- The likely spread of the conflict in the former Yugoslavia, with the Balkan economies most seriously affected.

The three-year decline in industrial output and GDP in the three Central European economies (Hungary, the Czech Republic, and Poland) should bottom out in 1993 and be replaced by modest growth later in the year. Inflation for the same period should run at a modest level in the Czech Republic—in the neighborhood of 10 percent annually. Inflation in Poland, however, is expected to continue at an annual rate of 40 to 50 percent. [Editor's note: Hungary's inflation rate is expected to reach 15 to 20 percent this year.] But any growth in GDP or even industrial output will be accompanied by substantial growth in unemployment, attributable to industrial restructuring and increased efficiency in the state sector. This will lead to accelerated decline in labor demand and the growth of open unemployment.

The growing number of unemployed will not be able to be absorbed by the growth of demand for labor in the private sector. In all three countries the (estimated) level of industrial employment in the state sector in mid-1992 was 80 to 90 percent of the 1989 level, while recorded industrial output since 1989 had fallen to a low of 55 to 65 percent of the 1989 level. This indicates that, unless there is market growth, there will be a substantial increase in open unemployment before even the 1989 levels of output per worker are restored.

Out of the pit, slowly




Source: International Monetary Fund, and EIU

From the *Economist*, London

Unemployment in Hungary was estimated to be more than 12 percent at end-1992, and is expected to rise to 17 to 20 percent in 1993. Unemployment in Poland was edging upward to 15 percent at the end of 1992, and could reach 20 percent in 1993.

Continued decline in industrial output and GDP in Romania and Bulgaria is to be expected as the effects of industrial restructuring begin to be felt, with gains from the growth of private sector activity not kicking in until the end of 1993 at the earliest. Romania's GDP is expected to fall by 8 percent in 1992 and by a further 2 percent in 1993. The decline in output could be more severe in Bulgaria, with GDP falling by 10 percent in 1992 and 3 to 4 percent in 1993. Annual inflation is approaching 200 percent in Romania, and is greater than 100 percent in Bulgaria.

Despite the bleak external conditions facing the East European economies, there are grounds for optimism:

- Signs of a return to more centralized economic models (in the Balkan economies in particular) simply reflect a shift in emphasis in the face of serious economic hardship—not a return to central planning.
- Greater attention and assistance from the West may be expected under the Clinton administration in the United States.
- Trade links with Russia are improving.
- An agreement to improve clearing arrangements between former Comecon countries, supported by the EBRD, should help restore trade links in 1993 and in turn make investment in Eastern Europe more attractive to multinationals.



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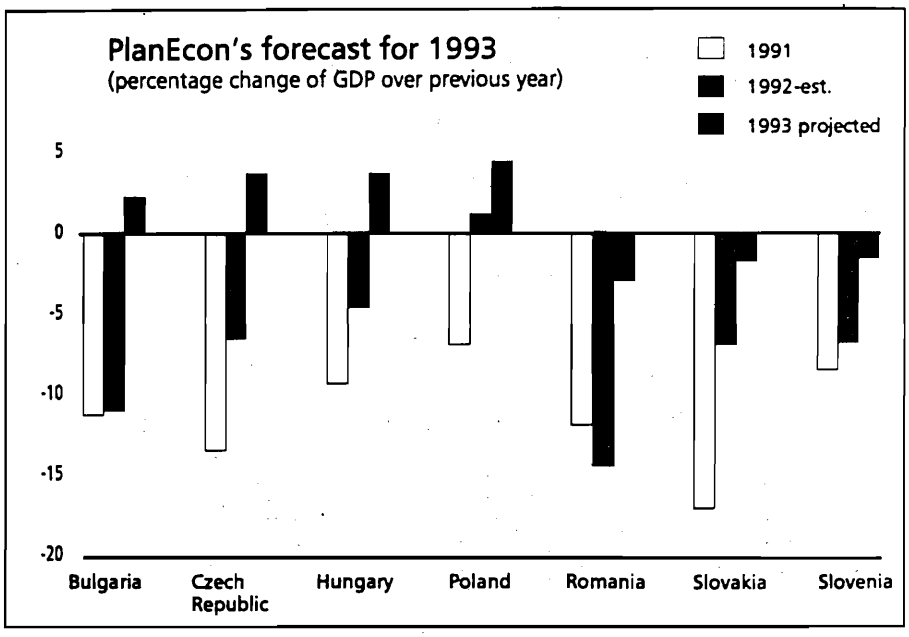
*Czech Republic and Slovakia*. Due to differences in economic potentials and likely divergence in economic policies, prospects for an early recovery are brighter in the Czech Republic than in Slovakia. GDP in the Czech Republic is expected to grow 4 percent in 1993, while in Slovakia a 2 percent drop in GDP is likely, with a turnaround expected in 1994.

*Bulgaria*. 1993 should mark the end of recession and the achievement of a 2 percent growth rate. The optimistic forecast is based, not so much on signs of a solid upturn, as on the assessment that the economy cannot deteriorate any further.

*Romania*. The economy will probably continue to decline in 1993, with an annual growth rate of 3 percent, before bottoming out in the first half of 1994. An increase in GDP is forecast for 1994 at the earliest. Assuming that the government continues to rely on formal or informal price controls and rationing, little positive supply-side response from the enterprises is expected this year.

*Slovenia*. A 1.7 percent decline in GNP is expected in 1993, as the country continues to suffer the effects of the Bosnian war. A modest upturn is expected for 1994.

*Other former Yugoslav republics*. Until peace is restored, these economies will continue to spiral downward. If the war ends with a Serbian withdrawal to Serbia proper, both Bosnia and Croatia will need to repair the damage from the war. Recovery should come quickly as these countries rebuild, although it will take years to return to former levels of output. Serbia, Montenegro, and Macedonia will certainly benefit from an end to the embargo. If the war ends with a Serbian victory, continued widespread guerrilla warfare and endemic political instability might follow, with bleak prospects for economic growth.




Source: PlanEcon Inc., Washington, DC.

**What is driving recovery?**

In our view, the fledgling recovery could rely on the following factors:

- Entrepreneurs have responded to the new legal framework and freedoms with alacrity. Initially, private firms focused on retailing, services (such as automobile repair), and restaurants; now efforts are shifting to manufacturing, wholesaling, and transportation.

- Foreign investment inflows in kind or cash continued last year and were likely to run well over $1 billion each in Poland, Hungary, and the Czech Republic. Most investments are going into automobile production, food processing, telecommunications, and machine building (especially power-generating equipment). The share of foreign investment in these countries is running at 2 to 6 percent of GDP when converted at market exchange rates—a percentage comparable to Mexico or Malaysia. Direct foreign investment in other CEE countries has lagged because of war, political instability, and financial problems.

- Winners are emerging in state industry, usually in those areas where foreign investors have taken strong interest in starting joint ventures, such as automobiles and food processing. Wood products and metalworking have also done surprisingly well. (But there are also losers. Textiles and leather goods have faced some of the steepest declines in output and will probably not recover because Asian textile producers are likely to capture these markets when demand does increase. Poland, for instance, is now Thailand's second largest market for textiles, after the United States. Producers of hopelessly outdated electronics and precision machinery are also hard hit by the transition.)

- Exports to the West should increase strongly in 1993 as new plants constructed by foreign investors come on stream. Because they are owned and operated by multinationals, these plants should enjoy more stable demand than do traditional exporters.



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REPORT ON EASTERN EUROPE

# Privatization in the Czech Republic and Slovakia

by Barry D. Wood

*Voucher privatization in the Czech Republic and Slovakia won great popular participation once people were offered high rates of return.*

Czech prime minister Vaclav Klaus says voucher privatization, whether it succeeds or fails, will be noted in the text-books as the first contribution of the Czech school of economic analysis. In the year before the break-up of the federation on January 1, 1993, vouchers gave Czechoslovakia a clear lead among post-communist economies in mass privatization. It is estimated that 75% of the adult population now own shares in roughly 950 Czech and 540 Slovak enterprises.

The Czechoslovak voucher program was two and a half years in preparation. Czechoslovak citizens over 18 could obtain a voucher book for 35 crowns at the local post office. To register the book and thus participate in the bidding for shares, citizens were required to pay a further 1,000 crowns ($35) as an administration fee, roughly one week's average wage. The purpose of the fee was to ensure that participants took the proposal seriously, not to let the state reap large profits from privatization.

Unlike the voucher program in Russia, the Czechoslovak voucher carried no cash denomination and could not be traded prior to registration. The book contained 1000 points in units of 100. A computerized system is linked to 600 bidding offices throughout the country.

Beyond vouchers, Czechoslovakia used three other privatization methods: the restitution of property seized by the state after 1948, the auctioning of small businesses and the conventional sale of state enterprises to foreign and domestic investors. By the end of 1992, roughly 100,000 properties had been restored to previous owners, 30,000 properties been auctioned to private bidders and nearly $2 billion of foreign capital had been invested or committed to the two republics.

Long-time Klaus associate Dusan Triska, who devised the voucher program in March 1990 recalls being impressed by Friedman's proposal (in *Capitalism and Freedom (1962)*) that public educational aid in the United States be distributed as a cash voucher directly to parents of school children. Klaus and Triska wanted the voucher scheme to be transparent so that public confidence could be maintained. The program was quite candidly a gamble and it was acknowledged that some fraud was likely. This was accepted as the paramount objective was speed. There was, said Klaus, neither time, money nor expertise for enterprises to be restructured and properly valued before privatization.

Privatization ministries were set up in both republics, the process being decentralized from the start. Managers of about 2,500 large enterprises were required to submit privatization proposals. Outside proposals were also invited. By October 1, 1991 nearly 1,500 enterprises, producing about 50 percent of GDP and employing some 1.3 million people (20 percent of the labor force), had been turned into joint stock companies and placed wholly or partly – 60 percent on average – into the voucher program. Under all methods of privatization, three percent of prospective shares were to be reserved to finance restitution claims.

The list of firms whose shares could be exchanged for vouchers was made public through the finance ministry's Center for Voucher Privatization which was assisted by the UK government's Know-How Fund. A free 35-page booklet explaining the voucher program was also distributed.

Five rounds of bidding were envisaged, starting in the spring of 1992. For each enterprise the number of shares was proportional to nominal book value. In the first round of bidding, the shares of all companies were to be offered at the same starting price, 100 points for three shares. If the demand for particular shares exceeded supply by 25 percent, no bids would be accepted and the shares would be offered again in the next round at a higher price. Undersubscribed shares were to be sold at the offer price and the remaining shares offered in subsequent rounds at lower prices. Prices would be adjusted in consecutive rounds until all shares were sold.

The program attracted only moderate public interest until January, 1992 when some of the 400 or so newly established (and at that time still unregulated) investment funds, promised to buy voucher books placed with them as portfolio managers for 10,000 crowns - ten times their original cost - one year after the opening of a stock exchange. With these promises of generous returns, participation jumped from two million in early January to 8.5 million just a few weeks later, more than twice as many as predicted. Seventy percent of them chose to avoid the complexities of direct bidding and placed their vouchers with the new investment funds. The nine largest gained control over nearly half the voucher points. Several of the funds are undercapitalized and are not expected to survive. However, the existence of the funds has alleviated concerns about excessively diffuse ownership.

The first round of bidding began in May 1992 and, like the subsequent four rounds, lasted for three weeks. It coincided with the beginning of the last parliamentary campaign in Czechoslovakia. Critics of Klaus say this was hardly coincidental. They emphasize that Klaus's name appeared on each page of the voucher book and that, as minister of finance, he urged participants to "choose and vote" for their chosen enterprises.

Klaus's party was the biggest winner in the Czech Republic but populist ex-communists, cool to vouchers, prevailed in Slovakia. Convinced that constant Slovak grousing under a looser federal structure would imperil his reforms, Klaus chose to accede quickly to Slovak demands for independence. Remarkably, the impending break-up did not disrupt the subsequent bidding rounds, which ended days before the end of the federation. Many more Slovaks chose to invest in Czech companies than vice-versa. Officials in both republics say shares will be distributed as planned.

It is too early to evaluate Czechoslovakia's voucher privatization program. The most popular enterprises were hotels, breweries, banks and glass factories – some of whose prices rose to as high as 800 points per share. The price of the least popular firms declined to as low as 90 shares per 100 points. Key questions remain. It seems certain that the largest investment funds, those linked to larger financial institutions, will be active instead of passive owners. Stock exchanges have yet to open. In Prague an active over-the-counter market is contemplated, using the technology developed for the voucher scheme. Investment funds may come under early pressure to sell shares to satisfy obligations. Securities laws have only recently come into effect. The creation of separate currencies for the two republics presents potential obstacles.

The Czech Republic remains enthusiastic about voucher privatization and a second wave is planned for the middle of this year. Slovakia has no such plans. ■

*Mr. Wood is a Washington-based economics correspondent who received a grant from the Wilson Center to study privatization in Czechoslovakia.*

# Seminar Explores Sequencing of Reforms in Former Socialist Economies

As former centrally planned economies immerse themselves further in the details of their economic transformation, the question now most commonly posed is not whether to reform but rather how best to structure those reforms. Which steps effectively deepen and sustain the reform process, and which, given limited resources and the intricate nature of the process, can, and perhaps should, be delayed?

The wide-ranging debate over the most effective sequencing of reforms formed the basis of a recent IMF Economic Forum seminar. The discussion presented both an economic and a political analysis of the process and featured the perspectives of Peter Isard, an Advisor with the IMF Research Department who was a member of the staff team working with Lithuania over the past year, and Susan Woodward, a Visiting Fellow of the Brookings Institution, who will shortly be publishing a book on Yugoslavia. Gérard Bélanger, Senior Advisor with the European I Department of the IMF, served as moderator.

### An Economic Perspective

"A single sequence of individual reforms is not the right concept," Isard observed. "It is better to think in terms of a set of economic ministries, each needing its own agenda and timetable. For Lithuania, this entailed separate menus and timetables for each of a dozen or so different areas." The appropriate sequencing and speed of reforms may vary greatly with the circumstances of each country. "Countries that enter the reform process with a functioning economy and without pressing macroeconomic problems are unlikely to be interested in undertaking radical changes rapidly," he said.

Tensions arise in the transformation process, Isard noted, from three distinct, but interrelated, needs: structural reform, macroeconomic stability, and social security and political support.

In analyzing the proper sequencing of reforms, Isard cited and agreed with three basic elements of the strategy discussed by Stanley Fischer and Alan Gelb in a 1991 article on the process of socialist economic transition:

- macrostability should be emphasized at the outset, because this is a necessary precondition to the successful development of market economies;
- countries should move quickly to align internal relative prices for tradable goods and services with external relative prices, because appropriate relative prices are critical for obtaining the appropriate allocation of resources (hence the importance of price liberalization, trade reform, and exchange rate unification); and
- economies in transition can afford to postpone labor market reforms and the liberalization of financial markets. Labor markets do not work well initially, as noted by Fischer and Gelb, and state-owned firms will not have the appropriate incentives to bid rationally for labor. Likewise, the banking system, which is often exclusively or predominantly state-owned, may be needed to deal with state enterprises.

*Isard: the question of large state enterprises should be addressed early.*

An early effort to liberalize the financial sector by liberalizing interest rates can, Isard cautioned, can be counterproductive. He also warned that a banking system that starts out with bad loan portfolios and tries to ration credit by simply letting interest rates rise to market-clearing levels may invite unintended, and unwanted, results.

Isard believed that Fischer and Gelb had not put enough emphasis on another element of the strategy: very early attention to the question of large state enterprises. "The sooner we address the problems of these large state enterprises, the better it will be for the reform process," he said. These problems, he added, lie at the core of the transformation effort, require a great deal of time to resolve, and ultimately will be the key, to maintaining the social acceptability of the process.

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Isard noted that privatization is an important but long-term process, and, in the interim, appropriate incentives will be needed for both workers and management. Appropriate accounting procedures must be devised to gauge how well these enterprises perform, and budget constraints must be hardened. This process of hardening budget constraints, which implies a discontinuance of automatic subsidies, does not require, he maintained, a sharp cut off of all state support for these enterprises. "If the state wants to continue supporting enterprises and builds that support into the enterprises' budget constraints ex ante and hardens constraints beyond that," Isard argued, "it will still provide enterprises with the right incentives." He noted, moreover, that a hard budget policy would not be credible or effective, unless its implications were socially and politically acceptable.

"In transforming the large state enterprise sector," Isard observed, "government has to play a fundamental role." Restructuring would proceed very slowly under a laissez-faire strategy, and the government would find itself either having to support inefficient state enterprises or having to pay unemployment benefits to displaced workers.

Isard argued that it was better to have government involved in either identifying the restructuring needs of state-owned enterprises or in catalyzing enterprises and outside experts to identify these restructuring needs. He was not, he added, advocating a return to planning or advising government interference in the emerging private sector, but he cautioned that "unless government is able to become involved and take an active interest in getting other people involved in dealing with the large state enterprise sector early, the transformation process is going to be very difficult indeed."

***Woodward: too little attention has been paid to the political consequences of economic reforms.***

### A Political Perspective

Woodward made the case for leavening the heretofore exclusively economic debate over sequencing with a healthy dose of political reality. Too little attention has been given to the political consequences of economic policy decisions, she argued. "The creation of a market economy and the creation of a democratic government are two very separate but interdependent processes, and market economies will not succeed and long-term political stability will not occur without democracy." She hastened to clarify that by "democratic" she was suggesting not the narrow definition of holding competitive elections but a deeper commitment to the rules of democratic competition and to peaceful means of regulating conflict. It is essential, she observed, that all sides be willing to accept temporary defeat, whether in the courts or in elections, with the understanding that they be guaranteed the right to fight another day and be assured a free flow of information.

Political considerations do matter in a transition, she contended. Economic change is profoundly political—it is a redistribution of resources, and therefore of power. And although much of the transformation process is directed at the state, and at statism in economics, the government must provide leadership for much of this reform process. It must write the new laws, extend guarantees, adjudicate contracts, define property rights, and negotiate trade agreements.

Experience in Eastern Europe and the former Soviet Union, which has yielded economic patterns, has also indicated that there are political stages that parallel their economic counterparts. She examined briefly the political consequences of macroeconomic stabilization and price liberalization; privatization; and structural adjustment.

***Macroeconomic Stabilization and Price Liberalization.*** Woodward argued that many of the economic reforms intended to open up the economy carried within them the seeds of political conflict. Ironically, early efforts to reform socialist economies emphasized decentralization, while the introduction of market economies demanded a recentralization of monetary authority, often, she noted, leading to territorial conflicts—something now attributed to nationalism.

Highly restrictive monetary and fiscal policies also led to conflicts between presidents, who tended to be politically most attuned to what was socially acceptable, and prime ministers, who were often technocrats with strong ties to outside organizations, such as the IMF. Disputes between presidents and prime ministers have prompted delays in the drafting of constitutions in several countries, including Bulgaria, Poland, and Romania, which have wrestled with the attendant legal and political questions.

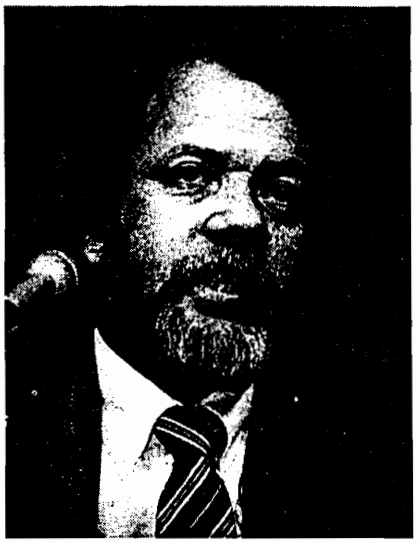
Woodward also cited the conflicts created between governments and those who could organize wage earn-

ers, and conflicts that have developed within coalitions, as carefully assembled political support has begun to unravel amid disputes over unemployment or pensions, for example.

Most serious, Woodward contended, was the causal link she argued existed in the socialist reformed systems between the pressures created by macroeconomic stabilization programs and hyperinflation. (Bélanger argued that the established link was not between hyperinflation and financial programming but between hyperinflation and a very rapid growth of money resulting from an inability to control budget deficits.) Woodward noted that hyperinflation had profoundly destabilizing social and political consequences for these countries—often forcing them to rely more extensively on personal bonds (and by extension, ethnic bonds) and frequently leading to increased crime and greater social disintegration that fed, in turn, into identity reformation and religious revival.

***Privatization.*** The more rapid the privatization, Woodward theorized, the more likely that managers in the state enterprises would translate their position in the socialist economy into advantage in the new economy. And "capitalization of the *nomenklatura*," she said, had political as well as economic ramifications in these countries. People were generally quick to recognize who was benefiting. Anticommunists often attempted to slow the privatization process precisely so that they could allow those who lacked positional access to gain property rights.

Woodward observed that it is important for these countries to decide whether the purpose of privatization is to expand revenue for their state budget or to infuse new capital into the firms. The method chosen to pursue privatization will determine who gains. Local politicians will find it useful, she noted, to use their power to choose among contending requests for licenses to gain votes—something that has wryly come to be dubbed "the Chicago model." Privatization also raises questions of citizenship, because it unavoidably entails decisions on who has the right to own property.



***Gérard Bélanger, Senior Advisor in the IMF's European I Department, served as moderator of the seminar.***

To date, however, privatization has functioned most successfully in instances of restitution, although restitution itself has occasioned an enormous number of legal battles and delayed agricultural production.

***Structural Adjustment.*** A critical political question under structural adjustment has been bankruptcies. How quickly should they be allowed and what legislation is needed? The temptation for political authorities is to slow down bankruptcies in order to gain votes. Safety-net issues also pose difficult political questions: what should be done about housing, child allowances, health care, and personal sense of worth?

Perhaps the primary problem for structural adjustment is foreign trade links—it is difficult for transforming economies to know what to restructure for. In answer to a question from the audience, Woodward expressed concern that domestic and external sequences were out of sync. Comparing the economic reforms of southern Europe (Greece, Portugal, and Spain) with those of Eastern Europe, she noted that "a promise of European Community membership was offered if the southern European nations met certain criteria after ten years. That promise made all the difference politically." There have been no promises, she added, forthcoming for Eastern Europe. "Their trade agreements are for 'four years and then we will see.' They have built in uncertainty rather than incentives."

Overall, Woodward argued, sequencing in these countries will depend on more rather than less state involvement, particularly where economies are lagging further behind and resources are scarcer. She reiterated her grave concern over hyperinflation and asked whether there could not be a "reasoned reconsideration of the economic reform packages and sequencing in order to incorporate the real circumstances of these countries." These countries need new ideas rather than marginal adjustments in allowable budget deficits, she said.

## SDR Rates

| Week Beginning | Rate of SDR Interest and Charges (percent) |
|---|---|
| December 21 | 5.87 |
| December 28 | 5.65 |
| January 4 | 5.54 |
| January 11 | 5.56 |

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

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# Transforming Poland's Economy

*Early experience after the "big bang" of 1990*

Timothy D. Lane

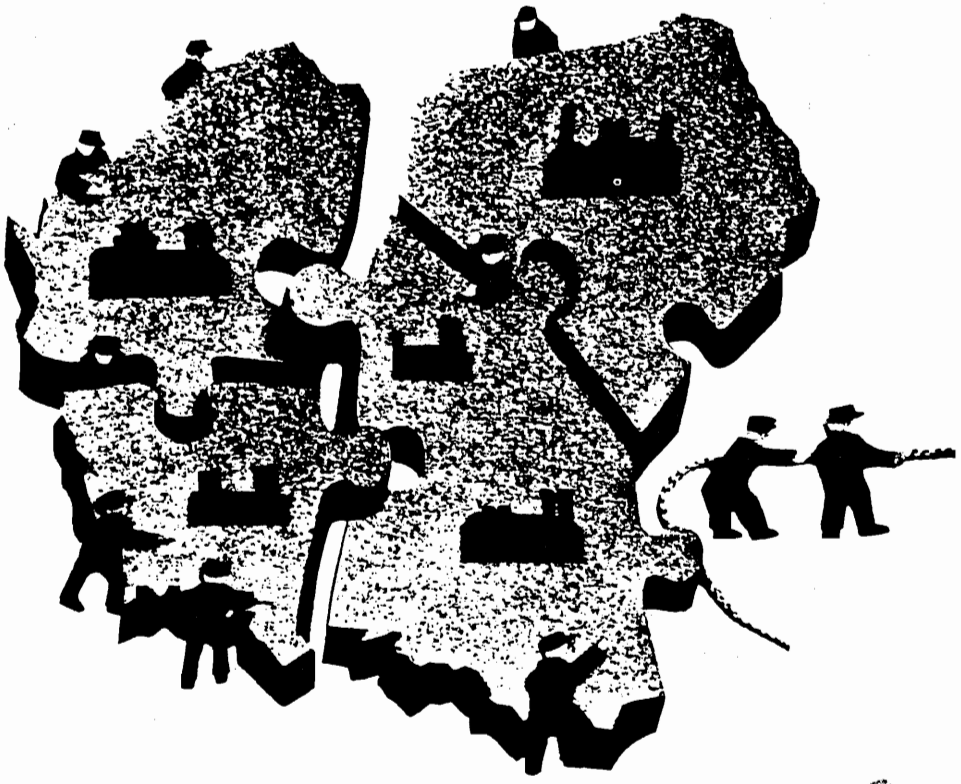
In January 1990, Poland embarked on a bold program of economic reform designed to stabilize an economy whose situation was rapidly deteriorating and to move toward a market economy. The stabilization objectives of the program were highly ambitious in themselves, aiming to bring inflation down abruptly from near-hyperinflationary levels. The attempt to build a market economy had few historical parallels in its scope and rapidity. Combining these two objectives demanded considerable boldness.

Because Poland was the first socialist country to adopt such a radical program of stabilization and reform, its early experience is of particular interest to other countries contemplating market-oriented reforms, especially the former republics of the Soviet Union. Although even now the situation remains too fluid to permit an overall assessment, this article attempts to provide an account of the program and an explanation of the course of events during its fiscal year.

## Background

The Poland of 1989 was not a textbook case of a centrally planned economy. Although most productive activity remained in state hands, the private sector accounted for more than a quarter of economic activity, including most of agriculture. Reforms undertaken during the 1980s dismantled the structure of central planning and increased the autonomy of the state enterprises—leading to a situation that was "neither plan nor market," that is, an economy in which enterprises were subject to neither the control of the central planner nor the discipline of the market. The increased economic efficiency that the authorities had hoped would result from the reforms did not materialize, and shortages of many goods and materials persisted.

In 1989, the Polish economy had reached a state of crisis. A "wage-price maneuver"—price increases accompanied by a smaller wage increase—early in the previous year had not only failed to correct economic imbalances as intended, but also triggered a wage-price spiral. By mid-1989, monthly inflation rates were close to double digits, labor unrest was mounting, the state budget deficit was burgeoning—the result of flagging tax revenues and expenditure overruns—and the external current account was deteriorating sharply. In the face of worsening food shortages, the government decided in August to liberalize prices of most food products. As a result, food prices more than doubled in a single month. External debt also remained a major problem. The debt, which had had to be rescheduled for the first time in April 1981, had accumulated through the 1980s, as interest was capitalized—reaching $40.8 billion,





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nearly five times Poland's annual exports in convertible currencies, by the end of 1989.

The critical economic situation, together with electoral setbacks, led the communist government to embark on the Round Table discussions to determine the country's political future. These talks, which began in April 1989, included representatives of Solidarity and other political parties. In September, the coalition government, in which Solidarity was accorded a major role, gained power; this government—the first in decades to enjoy broad popular support—had to devise a new set of economic policies. It decided to try to stabilize inflation quickly and, at the same time, begin a radical transformation to a market economy.

## Early results of the program

The program that was adopted combined monetary and fiscal stringency with other measures: the exchange rate was fixed as a nominal anchor; wage increases were limited to less than inflation; prices of many producer and consumer goods were freed, with substantial increases in administered prices, notably energy prices; the zloty was made convertible for trade in goods and nonfactor services; most trade restrictions were dismantled; and the authorities initiated a number of structural reforms, including the breakup of monopolies, privatization, and financial system modernization.

The early results of the program were nothing if not dramatic. Inflation was brought down successfully from the verge of hyperinflation, after an initial corrective price jump—80 percent in January 1990—but then lingered at levels around 5 percent monthly for most of the year. Measured real wages decreased sharply (see Charts 1 and 2). But what was more astonishing and a source of deep concern was the dramatic drop in measured output—by 30 percent in the first half of 1990 compared to the level a year earlier. Naturally such a situation begged an explanation, but, as discussed later, there were no clear or immediate answers on how this output decline should be interpreted. Two favorable developments in the program's financial performance—the surprising improvements of the government budget and balance of payments—made it easier for the authorities to continue with the program: Both the external account and the budget swung from deficit into a sizable surplus (see Charts 3 and 4).

Chart 1
Retail price inflation
(Percent per month)

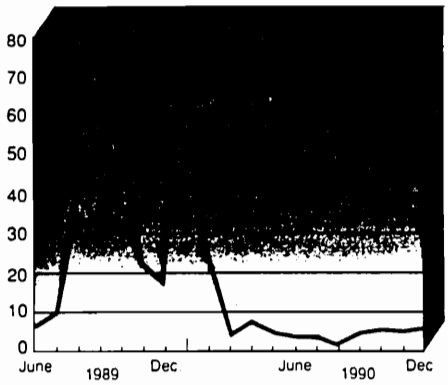



Chart 2
Real wages
(June 1989 = 100)

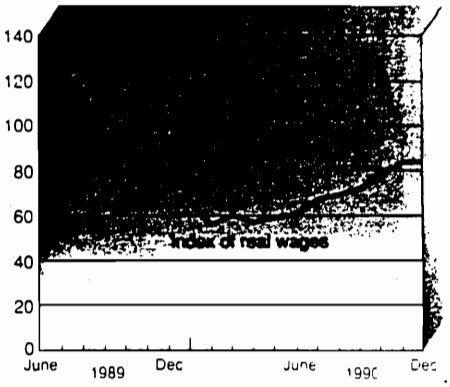



Chart 3
Balance of payments
(In convertible currencies; in millions of US dollars)

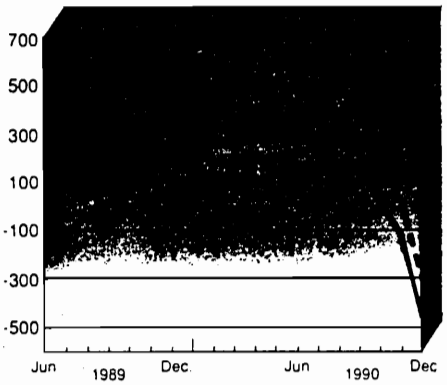
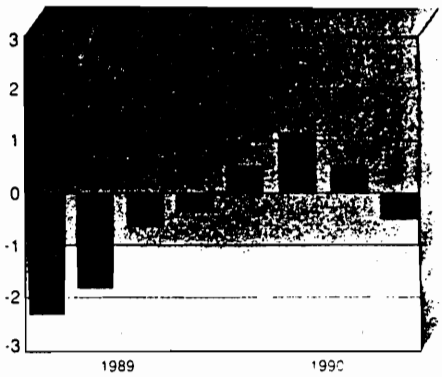
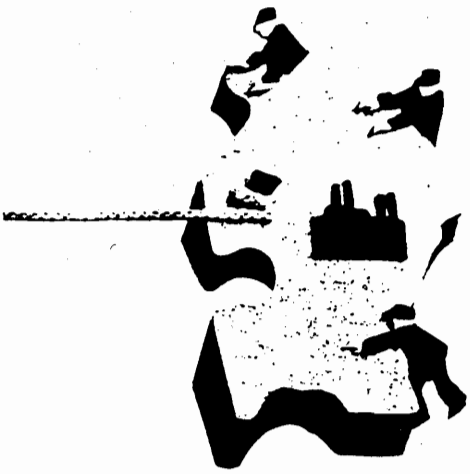



Chart 4
Government budget balance
(In trillions of June 1989 Zlotys)




The transformation to a market economy also began. Shortages disappeared; instead, there was talk of firms "hitting the demand barrier." Seventy percent of retail outlets were sold off to private individuals, as were most of the trucks used for road transport. There was also a surge in informal private trading activity. Street markets sprang up, offering consumers an ever-expanding range of products.



The early attempts at structural reform were encouraging, but also revealed the enormous practical and political difficulties in store. A privatization law emerged after prolonged parliamentary debate and compromise, setting the ground rules for privatization of enterprises by public share offering. An antimonopoly office was established and set to work addressing a broad agenda of breaking up the monopolies assembled by the central planners, as well as responding to complaints about monopolistic practices; its resources, however, were tiny in relation to its agenda. A program of financial sector modernization was begun, but the solvency of banks remained in doubt. Clearly, even with widespread agreement that the general direction of reforms should be toward a market economy, determining the details of these reforms would be a politically charged process, and one whose results were fraught with uncertainty.

## Mid-year shift

The Polish economy changed direction around the middle of 1990. This was partly

*This article is adapted from the author's IMF Working Paper WP/91/70, "Inflation Stabilization and Economic Transformation in Poland: The First Year," available from the author.*

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because there was mounting pressure to "reactivate the economy": interest rates were cut, and an unlimited amount of credit was provided at preferential interest rates to finance the harvest; government expenditures that had been held back earlier in the year were resumed; and the wage control law was softened. In addition to these explicit policy changes, some automatic forces were at work. The wage control law, which stipulated a cumulative wage norm, permitted wages to recover some of the ground they had lost earlier in the year; the zloty appreciated in real terms, as the exchange rate remained fixed against the US dollar and inflation continued; and the budget, which early in the year was boosted by tax revenues accruing from temporarily high enterprise profits, began to weaken as this temporary boost ended.

As a result, inflation resurged, bouncing back from below 2 percent monthly in August 1990 to average 5.5 percent monthly over the fourth quarter. There was also a small increase in industrial output, which was about 4 percent higher in the second half of the year than in the first half. By the end of 1990, inflation stabilization was still incomplete, while the level of economic activity (as measured by real GDP) was an estimated 12 percent lower than the previous year.

## The financial program

At the core of any successful stabilization program is a solution to the fiscal imbalance that is being financed through inflation. In Poland, fiscal adjustment was complicated by some particular features of the economy. To begin with—as is typical in socialist economies—the tax base consisted almost exclusively of the state enterprise sector: taxes and transfers from the state enterprises, including banks, amounted to about 90 percent of the revenues of the state budget. This meant that the profitability of the state enterprises was the key to fiscal balance. A second element was the enormous quasi-fiscal expenditure, namely the large implicit subsidies provided to enterprises by banks' lending to them at negative real interest rates. Both fiscal and quasi-fiscal expenditures had to be financed by tax revenues and seignorage.

The logic of the financial plan for 1990 was as follows. There was a large cutback in government spending, particularly on subsidies. Interest rates were moved to levels projected to be positive in real terms, with the intention of eliminating the implicit interest subsidy. Revenue measures were carried out, with a view to increasing tax revenues from a given tax base. Another crucial element of the fiscal equation was the incomes policy—restraining wages would increase enterprise profitability and thus raise tax revenues. Together, the program was intended to bring the budget from a large deficit into approximate balance, while stopping the erosion of the real value of zloty money associated with seignorage.

In the event, the performance proved better than expected. Three circumstances played an important role. For one, the higher-than-expected initial inflation resulted in capital gains for the enterprises on their inventories, which led to higher tax revenues. A second element was interest rates: In January 1990, banks raised lending rates to as much as 55 percent monthly, compared with the National Bank's refinance rate of 36 percent. Since deposit rates stayed much lower, the spread gave the banks huge (taxable) profits. A third surprise element was wage policy. As the wage control law limited wage increases to 30 percent of the increase in the cost of living in January 1990 (and 20 percent in February through April), the unexpectedly high initial inflation resulted in an unexpectedly steep drop in real wages. The extent to which this real wage decrease reduced workers' real consumption possibilities is debatable, since shortages of consumer goods were eliminated at the same time. What is not disputed is that it helped raise the enterprises' taxable profits.

*At the core of any successful stabilization program is a solution to the fiscal imbalance that is being financed through inflation. In Poland, fiscal adjustment was complicated by some particular features of the economy.*

The unexpected budget surplus of the first few months of 1990 could not last, however. The extraordinary capital gains on inventories were a one-time event, which ended as inflation was brought down. The spreads between banks' lending and deposit rates shrank as the overall level of interest rates fell with inflation, and as households shifted a larger fraction of their money holdings out of foreign currency deposits into zloty-denominated deposits bearing higher interest rates. Wages also recovered strongly, rising 42 percent in real terms in the second half of 1990, and this lowered enterprises' profits. In the second half of 1990, the state budget recorded a slight deficit.

## The output collapse

During 1990, the most widely quoted economic figure in Poland perhaps was the decline in output sold by state enterprises—about 30 percent in early 1990 relative to the same period a year earlier. Opinions on how to interpret this output decline differed widely—ranging from the view that it signaled an economic catastrophe to the view that most of the output eliminated was essentially "scrap." The alternative interpretations imply divergent views on what lessons should be drawn.

***Measurement problems.*** It is widely agreed that these output figures cannot be taken at face value. To begin with, January 1990 saw a move from a shortage economy to an economy in which markets were clearing. Many goods of poor quality or unsuitable specification that could be sold in a shortage economy, due to spillovers of unsatisfied consumer demand, could no longer be sold once the shortages were eliminated. For some products, value added may actually have been negative, because of their poor quality and the wasteful use of energy and other inputs in their production. Eliminating output of such products would actually be beneficial. Moreover, the official output statistics cited included only the state enterprises, an important omission at a time when the private sector was growing by leaps and bounds.

***Demand side contraction.*** Many economists, while accepting that the output decline was not as large as officially recorded, have recognized that there was some decline and have sought to explain it. To begin with, disinflation generally results in some decline in output. This effect is often attributed to a demand-side contraction, given price stickiness and sluggish expectations; price stickiness might have been particularly important in the Polish context due to nonprofit-maximizing behavior by state enterprises, while the adjustment of expectations might have been delayed by the public's (understandable) lack of complete credence in the success of the stabilization program. For these reasons, a reduction in the rate of monetary expansion did not immediately result in a proportional reduction in the inflation rate, but in some persistence of inflation and in some temporary decline in real output. This view would also be consistent with the observed improvement of the trade balance and with the temporary decline in money, and therefore credit, in real terms.



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***Credit crunch.*** An alternative way of viewing Poland's output contraction is the idea of a "credit crunch." Some economists have argued that the real contraction in credit in early 1990, resulting from tight control of nominal credit expansion together with the large price increases, was so severe that it impaired enterprises' ability to continue financing their productive activities. This is a supply side explanation, in contrast to the view that a demand-side contraction was at work. Real bank credit did fall sharply in the early months of 1990, continuing a trend from the latter part of 1989; this largely reflected the usual effect of inflation in demonetizing the economy.

Another way of viewing the same developments, however, is that inflation was erasing enterprises' debts in real terms; the resulting capital gains, augmenting enterprises' own resources, partly offset the decrease in the real credit. The decline in credit in early 1990 may also have been from an artificially high level that reflected enterprises' borrowing to purchase materials in anticipation of price increases. Moreover, over 1990 as a whole, credit actually increased in real terms, but the drop in output persisted. Therefore, although credit may have played an important role in the 1990 developments, it is hard to believe that the real contraction of credit in January 1990 was the main factor responsible for the output decline.

***Monopoly power.*** Other authors have focused on the role of monopoly power in the state enterprise sector, arguing that freeing prices enabled enterprises to exercise their market power, cutting output and raising prices. This argument should not be driven too far, however. Enterprises producing tradable goods but having a domestic monopoly would not cut back their production, but only channel more of their total output into exports. Moreover, in cases where prices had initially been fixed below the market-clearing level, so that there were shortages, even a monopolist's response might be to increase both price and output. Finally, it should be noted that the freeing of prices in Poland was not an abrupt move in January 1990, but a stepwise process—in contrast to the decline in output, which was abrupt.

***Other factors.*** Another potentially important factor is the collapse of trading arrangements in Eastern Europe and the disruptions in other countries in the region. In 1990, their impact on Polish exports was offset by various subsidies, so the volume of exports to countries actually rose by 15 percent from 1989 to 1990, but in 1991 these developments had a strong negative effect on the Polish economy. The decline in output was also prolonged by the need for myriad adjustments, at the microeconomic level, from a shortage economy to one in which the "demand barrier," as well as the risks associated with the possibility of bankruptcy, are relevant.

## Policy implications

Debate continues on which of these explanations of the output decline carries the most weight. These explanations have important implications for whether the program should have been designed differently, and thus for whether other countries should avoid similar policies. The credit crunch explanation suggests that credit was so tight as actually to hinder the stabilization of inflation; the monopoly explanation suggests that inflation stabilization should perhaps have been postponed until vigorous measures to break up monopolies had been undertaken. Some output decline is to be expected from disinflation in any country, though, and in Poland, this might have been exacerbated by the unusual rigidities of the existing economic system. In addition, economic and social adjustment costs are inevitable with such a major economic transition and some decline in measured output would result simply from eliminating shortages. A more gradual stabilization might have reduced the output decline somewhat, but might also have prolonged the high inflation: a rapid approach to stabilization may have been needed to create the perception of a genuine change in policy regime and break the cycle of inflationary expectations. Faster progress with structural reforms, however, could help reverse the output decline, by creating a framework in which new economic activity can emerge.

## Challenges ahead

The achievements of the first year of the program were considerable. They included a substantial reduction in inflation and the end of shortages; the correction of budgetary imbalances; the convertibility of the zloty for trade purposes and substantial liberalization of trade; rapid expansion of private sector activity; substantial progress in demonopolization and small-scale privatization (notably in retailing, road transport, and food processing); and early steps toward the privatization of large state enterprises. These achievements seem modest only in relation to the program's extremely ambitious goals and to the immense tasks that lie ahead. By the end of 1990, there were continuing sources of anxiety, notably the persistence of inflation; the severity of the output decline in the socialized sector; the emergence of unemployment, which reached 8 percent of the workforce excluding private agriculture by the end of the year; the transitory nature of some factors that had aided fiscal adjustment; and emerging signs of popular impatience with the program.

The events of 1991 have heightened fears about the successful continuation of the program. The disruptions in the Soviet economy and the breakdown of trading arrangements in Eastern Europe led to a slump in the sheltered sector of the economy that had specialized in selling to the Soviet market. This also had larger than expected spillover effects on other sectors of the economy. The decline in the economy's GDP over the two years 1989–91 reached an estimated 20 percent. Enterprises also turned out to be less profitable than had been apparent, with the ending of the transitory factors that had increased their profits; many teetered on the edge of bankruptcy, and the revenues of the state Treasury fell off sharply. The reform program began to falter—notably, the plan for mass privatization of 400 enterprises was delayed as the authorities feared that many of the enterprises were not viable and sought to avoid the social consequences of mass shutdowns of newly privatized firms.

In the wake of the shocks affecting the fiscal position, it was difficult to reach agreement on a new plan of fiscal adjustment toward an agreed target path, and this in turn made it impossible to maintain other aspects of the stabilization program. In early 1992, the Government faced a dilemma between calls to stimulate the economy through increased spending and concerns that the resulting budget deficits would re-activate inflation.

The road ahead is a long and uncertain one. Even the progress that has been made so far is in jeopardy. Given the shocks that have occurred, a resurgence of high inflation is possible; there is also pressure to slow down the pace of reform, and in some instances to reverse it. Maintaining the momentum toward a market economy, without renewed inflation, will require political cohesion, as well as considerable patience. ■

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International Monetary Fund

JEL Classification Number
P20

Summary of
WP/92/64

"Output Collapse in Eastern Europe: The Role of Credit"
by Guillermo A. Calvo and Fabrizio Coricelli

Output collapse in Eastern Europe after the implementation of the recent economic transformation programs has exceeded expectations by a wide margin. This paper argues that a large proportion of the fall could be explained by "trade implosion," that is, a situation in which trade--both domestic and international--is destroyed for lack of market institutions, not just as a consequence of textbook changes in relative prices or movements along transformation frontiers.

We single out the credit market as one of the key underdeveloped institutions in Eastern European economies and advance the hypothesis that negative output effects associated with monetary contraction may be significant when credit markets are underdeveloped, as evidenced in the cases of Bulgaria, Czechoslovakia, Hungary, Romania, and especially Poland.

There are different ways to ensure that firms have access to the necessary liquidity to operate at full capacity. An obvious one is to adjust bank credit initially in order to ensure that "real" credit--in terms of input prices--stays unchanged. Afterwards, credit could be as tight as necessary to ensure the achievement of low-inflation targets. A common criticism of this approach is that the initially easy credit policy may impair the credibility of the program, making escalation from the initial price into persistent high inflation more likely. Another criticism is that credibility may be a function of credit tightness. Initially easy credit may thus end up being treated by firms as a substitute for previous subsidies. Since banks have no expertise in evaluating creditworthiness, they may be unable to detect "bad loans" until it is too late; and the central bank--to avoid financial panic--would be forced to monetize enterprises' liabilities, jeopardizing the effectiveness of the stabilization program.

Tight credit could, however, have a negative effect on credibility. A single firm may be induced quickly to "put its house in order," but if its managers realize that many other firms are in the same tight credit situation, they may decide to postpone adjustment in the expectation that the government will bail out everybody in trouble.

Another suggested solution to the credit-squeeze problem is a swap of government debt for enterprise debt. Through this operation firms receive government bonds, for example, in exchange for their own debt. However, this solution may not be effective for a PCPE because there usually is no well-developed market for government debt instruments.

Finally, a more gradualist policy, as in Hungary, may be followed, involving a gradual dismantling of subsidies and a consequent smoother increase in input prices. However, gradualism could detract from policy transparency and lead to speculative behavior and may invite future postponement of reforms.

*John M. Weinstein*

# One, Two, Many Chernobyls

After the explosion and fire at the Chernobyl nuclear power plant—an event that released more than 15 times as much radioactive debris into the atmosphere as the Hiroshima explosion—a huge sarcophagus was built to entomb the obliterated reactor's ravaged containment building. It was intended to last 30 years.

That was in 1986. Today the shell is already cracked and crumbling. Russian and Ukrainian on-site physicists and engineers believe it is certain to collapse before the decade is out unless there are massive efforts to repair it or build another structure over it. If it does collapse, it could release into the atmosphere many tons of radioactive dust from the reactor's melted fuel, which is by now solidified.

***The nuclear power situation is only the tip of an iceberg of environmental neglect and devastation.***

Although there was humanitarian help from around the world after the Chernobyl disaster, there has been no similar outpouring of technical assistance. The International Atomic Energy Agency, the United Nations body meant to deal with such matters, has not visited the site to date. Technicians—known euphemistically as "biorobots"—still inspect, repair and monitor radiation inside the deteriorating sarcophagus. They use obsolete robotic and other technical equipment and lack adequate funds to do the job right.

Some estimates of long-term deaths from the disaster reach into the tens of thousands. Almost 200,000 people had to be permanently resettled from the surrounding area, and more than 50,000 square miles of choice farmland (an area approximately the size of Alabama) in the breadbasket of the former Soviet Union were contaminated. The disaster has cost more than $270 billion in lost crops, lost electrical power and resettlement.

According to a November 1991 General Accounting Office report, additional billions of dollars must be spent by the year 2000 for decontamination, resettlement and additional construction efforts to prevent further radioactive contamination. Contaminated ground water continues to back up behind a concrete barrier near a reservoir that supplies water to Kiev's 2.6 million residents. Other emergency costs will have long-term impacts. For example, while no plans exist to decontaminate the rich but affected topsoil, more than 75,000 people continue to farm the land, further propagating radioactive fallout into the food chain and generating potentially enormous strains on already limited medical resources.

The Chernobyl disaster and its continuing dangers pose monumental political and economic problems for Ukraine. A country urgently in need of economic development faces reduced agricultural output and productivity, an increasing strain on a medical system already overwhelmed by shortages of skilled personnel and the most basic supplies, and housing shortages.

Further complicating matters is the question of who is responsible for the costs of the cleanup, Ukraine or Russia? One thing is certain: If the sarcophagus at Chernobyl collapses, Ukraine's beleaguered national government will suffer a serious loss of popular support.

As for Russia and the other republics, they could be facing Chernobyls of their own at any time. A recent GAO report—citing the absence in older Soviet reactors of the most basic safety features, such as emergency core cooling systems, protective structures to contain radioactive releases and skilled personnel—concludes that "many of the 40 aging nuclear power plants of Soviet design operating in the former Soviet Union and Eastern Europe are viewed as too dangerous to operate over the long term and have the potential to create a Chernobyl-type accident. . . . Up to $50 billion may be needed to refurbish, repair or replace [these] nuclear reactors."

Particularly worrisome is the continued operation of 19 Chernobyl-type graphite-moderated reactors, which are known to be unstable at low power output levels and whose design the IAEA considers fundamentally unsafe. Even Chernobyl's undamaged number three reactor, which the government had shut down for safety reasons, has been reactivated. Its energy output is considered increasingly critical, especially in light of serious problems in the fossil fuel sector of the former Soviet republics' energy industries.

Moreover, the nuclear power situation in the former Soviet republics represents only the tip of an iceberg of environmental neglect and devastation. The correction of these ills lies far beyond the technical and financial resources of the former Soviet republics. In conjunction with a high-level Ukrainian government review that identifies immediate needs and priorities, prompt and massive assistance from the United States' and other industrialized nations' governments and private sectors is urgently needed to sustain continued economic development and political stability of the new republics. Improving the quality of life in the former Soviet Union is intimately associated with U.S. national security.

*The writer is chief of policy at the U.S. Nuclear Command and Control System Support Staff, Department of Defense.*

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FOREIGN POLICY

# Clinton on Diplomatic Tightrope With New Policy on Bosnia

*Lawmakers stand behind president's decision but are wary of possible troop involvement*

Broad congressional backing for the Clinton administration's new diplomatic initiative to resolve the conflict in Bosnia-Herzegovina masked the concern of many lawmakers that the plan might ultimately achieve too little even as it commits the United States to do too much.

Yet there was a widespread sense that because of past U.S. inaction on Bosnia and the complex nature of the crisis, the president had few alternatives for action.

REUTERS

**A Bosnian boy in Sarajevo carries wood past a barren hillside in January. The city has been stripped of trees as residents try to heat their homes.**

Lee H. Hamilton, D-Ind., chairman of the House Foreign Affairs Committee, said the president and his top advisers "had made a very important choice: They've decided to engage U.S. power and diplomacy in support of the peace effort."

In announcing the new policy Feb. 10, Secretary of State Warren M. Christopher said the administration's objective was to bring a "just, workable and durable solution" to the conflict and to ensure the survival of Bosnia as a state.

Christopher outlined a six-point plan to build on the controversial peace process spearheaded by former Secretary of State Cyrus R. Vance, representing the United Nations, and Lord Owen, the former British foreign secretary representing the European Community. *(Box, p. 324)*

Putting some teeth into the U.S. support for the diplomatic effort, Christopher said that if Bosnia's three communal factions — Serbs, Muslims and Croatians — reach a binding agreement, the United States is prepared to participate in a multilateral military action to enforce the accord.

*By Carroll J. Doherty*

While Christopher declined to provide specifics on possible military intervention, some senators said they had been told that the U.S. contribution to a multilateral force might ultimately involve as many as 10,000 troops.

That prospect touched a nerve with some Republicans. "I'm deeply and gravely concerned — first, about what they will do and, second, under whose command they will serve," said Sen. John McCain, Ariz. "Are they to be stationed at the airport like the Marines at Beruit?"

In 1983, 241 U.S. Marines on a peacekeeping mission in Lebanon were killed in a terrorist bomb attack.

Christopher disputed a news report that he had used the 10,000 figure in a conversation with Sen. Richard G. Lugar, R-Ind., although he did not deny that sending in ground troops was being contemplated.

Democrats generally brushed off questions involving possible troop deployments as they endorsed Clinton's first major foreign policy initiative.

Hamilton, who had consulted closely with Christopher on the proposal, insisted that "this is not a commitment of American military power to fight in the Balkans; it's a commitment to enforce an agreement that the parties themselves have consented to."

### A Departure

With its strong emphasis on a diplomatic resolution of the conflict, the administration's plan marked a departure from the muscular approach toward Bosnia that Clinton had advocated during the presidential campaign. And that drew criticism of a very different nature from some Republicans.

As a candidate, Clinton had urged the Bush administration to consider multilateral air strikes as a means of ensuring the delivery of humanitarian aid to Bosnia's besieged Muslims.

He was so insistent in raising the issue of military intervention that former presidential spokesman Marlin Fitzwater once called Clinton "reckless." Fitzwater pointed to his statements on Bosnia to raise doubts about Clinton's competence to handle national security matters.

Clinton has continued to express outrage over the notorious Serbian practice of "ethnic cleansing" — the use of systematic murder and rape to displace Muslims from wide portions of Bosnia. But the administration's new policy places greater importance



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# The Reluctant Warriors

Congress' longstanding demand that it have a voice in decisions to deploy U.S. forces abroad is frequently summed up with an aphorism: "If you want us in for the landing, we'd better be in on the takeoff."

But for more than a generation, presidents have not been eager to invite Congress along, and most lawmakers have preferred to remain safely on the ground.

In recent months, more than 20,000 U.S. troops have been dispatched to Somalia. The only action taken by Congress on that mission occurred Feb. 4, when the Senate — with no hearings — approved by voice vote a resolution (S J Res 45) authorizing the deployment. *(Weekly Report, p. 277)*

With the Clinton administration raising the possibility of new U.S. military intervention in Bosnia-Herzegovina, some lawmakers and foreign policy analysts say it is essential that Congress become more assertive on questions involving the use of force.

Morton H. Halperin, who is expected to become the Pentagon's point man for U.N. matters, recently wrote in The Washington Post, "Simple prudence dictates that there be a clear consensus that includes Congress before the nation goes to war."

But presidents have resisted sharing the responsibility for sending troops into battle, and most lawmakers seem relieved to hand such politically explosive decisions to the executive branch.

Halperin said Congress voted in 1991 to go to war in the Persian Gulf only when "public pressure for it to act became too great to resist," adding that "members of Congress prefer to avoid the responsibility."

Complicating matters further, the primary mechanism for congressional participation in authorizing military action — the 1973 War Powers Resolution — has been consistently evaded by presidents and lawmakers alike.

During confirmation hearings for Defense Secretary Les Aspin, Senate Armed Services Committee Chairman Sam Nunn, D-Ga., questioned the law's relevance and its requirement that the president withdraw troops from hostile action after 60 days unless Congress authorizes their presence. *(Box, this page)*

"It's never going to work," Nunn said. "It's never worked in the past; it's never going to work. That automatic trigger makes any president reluctant to acknowledge that hostilities are imminent."

Joseph R. Biden Jr., D-Del., a senior member of the Senate Foreign Relations Committee, is expected to introduce legislation within the next several weeks to address many of the law's shortcomings.

Biden's proposal would extend the 60-day period and grant the president limited advance authority to use force in implementing U.N. Security Council resolutions.

But Aspin was dubious about any efforts to revamp the law. "It's always been assumed that to try to amend it would be such a humongous fight and raise such enormous hackles, and in the end it's not clear whether you'd get anything much better," he said.

Congress and the White House performed their customary dance around the issue when President George Bush announced the Somalia operation in December.

The administration told congressional leaders that U.S. forces would not be in jeopardy, despite the threat posed by armed Somalis. "The statement is that there is no imminent likelihood of hostilities," House Speaker Thomas S. Foley, D-Wash., said Dec. 4 after a White House briefing.

Foley's ready acceptance of that assertion indicated that he shared the president's reluctance to trigger the 60-day countdown. Two months later, with no timetable in place for withdrawing those troops, Foley still seemed to be in no hurry for the House to take up the Senate resolution.

*—Carroll J. Doherty*

**The War Powers Resolution (PL 93-148) has two key requirements:**

DEFENSE DEPARTMENT

- "In the absence of a declaration of war, in any case in which United States armed forces are introduced

"(1) into hostilities or into situations where imminent involvement in hostilities is clearly indicated by the circumstances;

"(2) into the territory, airspace or waters of a foreign nation, while equipped for combat, except for deployments which relate solely to supply, replacement, repair or training of such forces; or

"(3) in numbers which substantially enlarge United States armed forces equipped for combat already located in a foreign nation, the president shall submit within 48 hours to the Speaker of the House . . . and to the president pro tempore of the Senate a report in writing, setting forth . . . the circumstances necessitating the introduction of United States armed forces . . . the constitutional and legislative authority under which such introduction took place and . . . the estimated scope and duration of the hostilities or involvement."

- "Within 60 calendar days after a report is submitted or is required to be submitted . . . whichever is earlier, the president shall terminate any use of United States armed forces with respect to which such report was submitted (or required to be submitted), unless the Congress (1) has declared war or enacted a specific authorization for such use of United States armed forces, (2) has extended by law such 60-day period, or (3) is physically unable to meet as a result of an armed attack upon the United States.

"Such 60-day period shall be extended for not more than an additional 30 days if the president determines and certifies to the Congress in writing that unavoidable military necessity respecting the safety of United States armed forces requires the continued use of such armed forces in the course of bringing about a prompt removal of such forces."



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# Clinton's Plan

President Clinton's plan to help resolve the crisis in the former Yugoslavia, presented by Secretary of State Warren M. Christopher on Feb. 10, commits the administration to:

REUTERS

**Owen, left, and Vance talk about Bosnia with reporters at the United Nations on Feb. 2.**

- Bring "the full weight of American diplomacy to bear" on the negotiations being led by former Secretary of State Cyrus R. Vance and British diplomat Lord Owen.
- Communicate "to the Bosnians, Serbs, and Croatians that the only way to end this conflict is through negotiation" in which each party must "accept a resolution that falls short of its greatest goals."
- Work "to tighten the enforcement of economic sanctions, increase political pressure on Serbia and deter Serbia from widening the war." In particular, the United States warned it would "respond against the Serbians in the event of a conflict in Kosovo caused by Serbian action."
- Take steps "to reduce the suffering and bloodshed as the negotiations proceed." Clinton called on all parties to stop the violence, urged enforcement of the "no fly" zone over Bosnia, set up a U.S. team to urgently assess humanitarian needs and pledged to seek a "war crimes tribunal at the United Nations."
- "Do its share to help implement and enforce an agreement that is acceptable to all parties." If such an enforceable agreement is reached, "the United States would be prepared to join with the United Nations, NATO, and others, in implementing and enforcing it, including possible U.S. military action."
- Consult with allies, particularly Russian President Boris N. Yeltsin.

on bringing peace to the war-torn country than on rolling back Serbia's territorial gains.

Senate Minority Leader Bob Dole, R-Kan., said he was disappointed with Clinton's plan "because it is far less than the tough action he promised during the campaign.

"His plan won't be near enough to stop the bloodshed and ethnic cleansing, so I doubt the Serbs will back off."

Christopher said that the administration would work within the United Nations to try to enforce a "no-fly zone" over Bosnia and create a special tribunal to prosecute alleged war crimes by Serbian forces and others.

The administration's acceptance of the negotiating process begun by Vance and Owen, however, worried Bosnia's Muslims and their U.S. supporters. The two diplomats had proposed that the country be divided along communal lines, which many U.S. officials said would reward Serbian aggression.

The secretary insisted that the new diplomatic effort is not intended to "impose" a peace agreement on the three factions, a charge that has been leveled at Vance and Owen.

The administration's initiative not only represented a step back from Clinton's campaign rhetoric, it also diverged sharply from the tough policy recommended in bipartisan congressional resolutions on Bosnia that await action.

Identical measures introduced in the House (H Res 35) and Senate (S Res 11) in January urge the president to seek the immediate lifting of the U.N. arms embargo against Bosnia so that the Muslims can obtain defensive arms.

The resolutions also support the use of air strikes to neutralize Serbian mortars and other heavy weapons. The Senate measure, which has been referred to the Foreign Relations Committee, won the backing of Dole and Majority Leader George J. Mitchell, D-Maine.

But Christopher said that the administration, after consulting with U.S. allies, had ruled out both proposals.

Three countries with peacekeeping forces in the former Yugoslavia — France, the United Kingdom and Canada — "felt that their troops would be gravely endangered if we lifted the embargo on weapons to the Bosnians," the secretary said.

Similar considerations were involved in the decision not to press for multilateral air strikes against Serbian gun emplacements. "This situation has evolved a good deal," Christopher said. "I must say it has gotten worse. It is less simple."

### Party Loyalty

Perhaps not surprisingly, Democrats tended to be much more optimistic than Republicans that Clinton's plan might begin a process for bringing peace to the former Yugoslavia.

Sen. Joseph R. Biden Jr., Del., a member of the Foreign Relations Committee, enthusiastically supported the Clinton plan. He called it "a clear-cut rejection of appeasement" and praised Clinton on a "much-needed act of American leadership."

Yet Biden previously had urged much more aggressive steps. Last year, he sponsored an amendment to the foreign aid appropriations bill (HR 5368 — PL 102-391) that authorized the president to provide up to $50 million in U.S. military equipment for Bosnia.

And on the NBC News program "Meet the Press" in January, Biden had been sharply skeptical about the Vance-Owen negotiations that the Clinton plan attempts to bolster. "It seems to me, absent the knowledge that there is credible force behind the assertions being made by the West as to what should be done, nothing much is going to happen," Biden said.

Though most Democrats lined up behind their president, there were a few dissenting voices. Dave McCurdy, Okla., the former chairman of the House Intelligence Committee, said in an interview that the Vance-Owen negotiations are "structurally flawed."

The probable outcome under Christopher's plan, McCurdy said, "is that we end up not being able to exert real pressure on Serbia and we become committed militarily in a way that would have been my last resort."

The idea that U.S. ground forces might be dispatched to a region whose ethnic and communal hatreds date



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back centuries could prove troubling for many in Congress.

Aware of the sensitivity of that issue, Clinton said at a "town meeting" near Detroit on Feb. 10 that the plan envisioned the United States becoming "more involved in what is going on in Bosnia, not in committing our ground troops now or anything like that."

**Complex Challenge**

Although some lawmakers have found fault with Clinton's approach, more agreed with Christopher that the administration inherited an immense challenge in trying to develop a coherent policy toward the former Yugoslavia.

The Bush administration came in for considerable criticism for failing to address the crisis until the country had virtually disintegrated.

Christopher noted that Clinton had said during the presidential campaign that "an early and forceful signal might well have deterred much of the aggression, bloodshed and ethnic cleansing."

"Because those actions were not taken," he said, "we face a much more intractable situation with vastly more difficult options."

Clinton also had to be concerned with the impact a punitive policy against Serbia might have had on U.S. relations with Russia, which has longstanding ties to Serbia. Many lawmakers have argued that military action against Serbia should be taken under the auspices of the United Nations, but Russia could block any such plan with its Security Council veto.

A critical aspect of the administration's initiative was to invite Russia to join the peace process. Clinton's newly appointed special envoy for the negotiations, veteran diplomat Reginald Bartholomew, was sent to Moscow for discussions with Russian leaders before meeting with Vance and Owen.

Perhaps the most formidable obstacle standing in the way of a tougher policy was how it might play with Congress and the American people.

Despite widespread revulsion against ethnic cleansing and other horrors, the Republican reaction to Clinton's plan demonstrated that there is broad apprehension over becoming ensnared in a messy Balkans war.

The administration's policy is "credible because it doesn't stretch the support of the American people," said Robert E. Hunter, director of European Studies at the Center for Strategic and International Studies. "The American people don't know why they're being asked to do anything at all." ■

FOREIGN POLICY

# Diplomatic Strategy on Bosnia Leaves Many Still Skeptical

Fervent hopes in Congress for the success of the Clinton administration's new diplomatic initiative for Bosnia-Herzegovina are tempered by the grim reality of a war that has proved stubbornly resistant to negotiation.

And there is a sense that the administration's policy is in jeopardy of being overtaken by the deteriorating situation on the ground in Bosnia, the former Yugoslav republic where brutal ethnic conflict has raged for nearly a year.

The Democratic chairman of the Senate Foreign Relations European Subcommitee, Joseph R. Biden Jr., Del., has backed the administration's plan despite his past calls for much tougher steps to counter Serbian aggression in Bosnia.

But by hosting several critics of the administration's approach at his subcommittee Feb. 18, Biden clearly conveyed his continuing concerns. Perhaps more significant, Biden also took the unusual step of inviting Bosnia's foreign minister, Haris Silajdzic, to testify.

The urbane foreign minister described a "surrealistic situation" in eastern Bosnia, where about 200,000 Muslims have been besieged by Serbian irregular forces. Those who have escaped from the siege "tell us the horror story of starvation," he said.

The Pentagon reportedly is considering a plan to parachute relief supplies to civilians in eastern Bosnia, which would deepen the involvement of U.S. military forces in the conflict.

But a Pentagon spokesman said the air-drop proposal, which drew Silajdzic's strong backing, "may not be a feasible option" because the relief flights would need to be protected by U.S. military aircraft.

In unveiling the administration's initiative Feb. 10, Secretary of State Warren M. Christopher said the administration had "not ruled out quite determined steps that might be taken to make sure that the aid gets to those in the country who are starving and need medicine." *(Weekly Report, p. 322)*

*By Carroll J. Doherty*

REUTERS

**Russian Cossack soldiers, above, have joined Serb forces in Bosnia as volunteers.**

Since then, the United Nations cut off desperately needed aid operations in a show of frustration. The U.N. was particularly angered by a Serbian blockade of food shipments to eastern Bosnia. But the crisis appeared to ease Feb. 19 when U.N. Secretary General Boutros Ghali ordered the resumption of the aid operation.

### On Arming Bosnia

Silajdzic said he hoped that Christopher would reverse his decision not to press for an end to the U.N. arms embargo for Bosnia. If the international community does not intervene to "provide a measure of effective protection for our people," he said, "then minimum decency demands that we not be denied the right to protect ourselves."

Biden supports that step, and a resolution (S Res 11) calling on the president to seek the immediate lifting of the embargo has been referred to the Foreign Relations Committee. But Christopher has said that key U.S. allies oppose the proposal. With Democrats reluctant to press ahead with a resolution that could embarrass the administration, its fate is uncertain.

While Biden avoided any direct criticism of the administration's plan, a leading Republican spokesman on the issue, Sen. Richard G. Lugar, R-Ind., expressed frustration with Christopher's heavy reliance on diplomacy. Lugar, who has called for the establishment of a huge, multinational military force for Bosnia, said he feared that the negotiations would drag on "for months and years" and that the administration was "kibitzing around the situation."

Former high-ranking officials who testified before the European subcommittee were vocal in attacking the administration's initiative and urging U.S. military action.

The former U.S. permanent representative to the United Nations, Jeane J. Kirkpatrick, said former President George Bush and Clinton share the blame for allowing the crisis to fester. "It is a bipartisan problem," Kirkpatrick said. "And I fear it is rapidly becoming a bipartisan failure."

A particularly harsh assessment of the administration's initiative came from Christopher's Carter administration colleague, former national security adviser Zbigniew Brzezinski, who testified Feb. 18 before two subcommittees of the House Foreign Affairs Committee.

"The powerful rhetoric used by Secretary Christopher to justify the U.S. engagement was, much to my regret, refuted by the toothless and essentially procedural steps that then emanated from the rhetoric," Brzezinski said.

In the House, Indiana Rep. Frank McCloskey has emerged as the sharpest Democratic critic of the Clinton plan. Appearing Feb. 19 at a news conference with Silajdzic, McCloskey said that the United States and its allies had responded to Serbian atrocities with "hypocritical diplomacy."

"To the people of Bosnia," McCloskey said, "the message has been . . . stay where you are and reach some compromise with the thugs who are slaughtering you and raping you and starving you." ■



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## On My Mind

A. M. ROSENTHAL

# America's Allies in Serbia

If you have any ideas about new options in Serbia and Bosnia, the President said on the phone after the summit talks, let me know. So I did.

The answer popped out: Mr. President, please get your Administration and the Western allies to pay a lot more attention to Serbian democrats.

They hate what their government is doing. Put your arm around them and let the world see, give them the legitimate aid they need to be heard at home and abroad. It won't end the war in Bosnia. But if the war does end, Western attention now to the democrats against Serbia's "ex"-Communist rulers might prevent the fighting from starting all over again.

I had been speaking from New York to a Government official on Air Force One just after it took off from Vancouver when the President walked into the compartment. He picked up the phone so I could ask about the summit. I do not want to hear another press complaint about lack of access to the President, not one more word!

I asked what he and President Yeltsin had said to each other about the Bosnian Serbs' rejection of the Vance-Owen peace plan. As long as that rejection stands, the peace negotiations are at a dead end; the killing goes on.

## For Clinton, a Presidential option.

Mr. Clinton said that Mr. Yeltsin told him that he would do everything he could in the week or so ahead to persuade the Serbs to change their mind. That will take courage. His enemies back the Serbs as brother Slavs and are beating him hard with that emotional stick. But Mr. Clinton said he believed Mr. Yeltsin would carry out his word and try hard.

Meanwhile, President Clinton said, the U.S. will take a look at its options. I had been told before Vancouver that they could include pushing Britain, France and Russia to approve lifting the arms embargo against the Bosnian Muslims and fiercely tightening the sanctions against Belgrade — maybe cutting off international communications, a deep-freeze isolation.

No — no change in the Clinton policy of not sending U.S. ground troops except perhaps as peacekeeping forces, and that is not yet decided.

Now, American latter-day hawks deride limiting military action to peacekeeping forces. They say it is Presidential passivity.

But they choose to ignore something obvious. If peacekeeping forces are sent, and I think that much will be essential, it carries the unavoidable risk of involving U.S. troops in fighting.

If the Serbs break the peace U.S. troops could find themselves not on peacekeeping patrol but in peace-restoring combat.

For that reason alone, strengthening a Serbian democratic movement that would be opposed to breaking the peace becomes an American security objective.

And the movement exists. Last December it got 34 percent of the vote against President Slobodan Milosevic, who harassed and blanketed the opposition through Election Day. It was like getting 34 percent against Mussolini.

Think of Walesa and Havel, I suggested. Without strong Western backing and day-to-day attention, could they have lived through Communism, let alone moving from house arrest or jail to presidencies? They do not think so.

But for Serbian democrats, no public embrace. Since no one person is world-famous, all are virtually ignored by foreign governments and press, neatly perpetuating oblivion! When they needed a little help — a new TV transmitter so they could be heard by voters outside Belgrade — the U.S. turned them down.

Receive them, Mr. President, get the Secretary of State or the national security adviser to receive them — with photographers. Help them tell their story to the important American Serb community. Milosevic reaches them all right, through satellite broadcasts.

The best speech of the U.S. Presidential campaign, for me, was one in Milwaukee by Mr. Clinton saying that in America's interest, support for democratic movements would be basic to his foreign policy.

He ought to make that kind of speech again soon, this time specifically about Serbia. It might shake up all Westerners who search out democrats everywhere in Eastern Europe, Asia and the Middle East, everywhere but Serbia.

I did not think to make that particular suggestion to Mr. Clinton. So I am putting it in writing now, just in case I happen not to be on the phone the next time he strolls through Air Force One.

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# Shrink Bosnia to Save It

By John J. Mearsheimer

CHICAGO

The Vance-Owen plan for peace in the former Yugoslavia is already a failure. The Bosnian Muslims dislike it and have accepted it grudgingly. The Serbians thumb their noses at it: their response is expressed in the horrors they are inflicting in Srebrenica and the rest of eastern Bosnia. Only the Croatians have endorsed the plan with any enthusiasm.

Yet the need for peace is more urgent than ever. Without it, the murder of Bosnia's Muslims will continue and the war will likely spread back to Croatia and onward to Kosovo. This carries with it the threat of escalation beyond Yugoslavia's borders.

The best hope for peace is a more ambitious plan, backed by the U.S. and, it is hoped, the United Nations. The plan should be based on three main considerations:

First, ethnically homogeneous states must be created. Who can seriously believe, after all the inter-communal slaughter, that Vance-Owen's Bosnian state of 10 multi-ethnic but semi-autonomous provinces would be stable? We should create instead a Bosnian state peopled almost exclusively by Muslims, a Croatian state for Croatians and a Serbian state made up mainly of Serbians.

Creating homogeneous states would require drawing new borders and transferring populations. Croatians, Muslims and Serbians would have to concede territory and move people. For example, the Serbians might acquire Krajina in a final settlement but cede Kosovo to Albania.

Furthermore, a new Muslim state about a third the size of the present Bosnia must be created by concentrating Muslims now scattered across the region into central Bosnia. Remaining Bosnian territory should be given to Croatia and Serbia. Perhaps one million people — approximately 600,000 Muslims, 300,000 Serbs and 100,000 Croats — will have to move. Many others have already relocated.

Critics will say that altering borders is a bad precedent and that in many instances it rewards Serbian aggression. The unpleasant truth is that some borders are untenable and preserving them causes conflict, not peace. Moreover, whether we like it or not, borders in the Balkans are going to change. Serbian military power has seen to that. Wouldn't it make good practical and moral sense to organize and plan the border changes rather than to allow the chaos of war to decide them? Wouldn't it make better sense to move populations peacefully rather than at the end of a rifle barrel?

Second, a comprehensive settlement must address problems across the Balkans. The Vance-Owen plan focuses on Bosnia while ignoring the conflicts in Croatia and Kosovo. But settling conflicts one at a time will not facilitate peace; instead it will probably encourage Serbian aggression. The Serbians prefer to operate in one region at a time. They do not want a multifront war. Stopping the fighting in Bosnia will only make it easier for them to turn to Kosovo. After all, the January 1992 cease-fire with Croatia gave them a free hand in Bosnia in April 1992.

Third, the U.S. and its allies must threaten to use force to get the Serbians to go beyond Vance-Owen and to settle on this ambitious plan. The goal should be to make the Serbians, as well as the other ethnic groups, understand that the alternative to a peaceful settlement is a long and bloody war with no winners.

**Create three separate states for Serbs, Croats and Muslims.**

If Serbia does not accept a settlement, the U.S. should bypass the U.N. arms embargo and send weapons and ammunition to the Bosnian Muslims, the Croatians and perhaps the Albanians. This strategy would cost America few lives and little money. It would also turn up the heat on Serbia, putting it in the position of having to fight a three-front war. This circumstance alone should create a powerful incentive for peace. If not, at least it would allow the Muslims in Bosnia and Kosovo to defend themselves.

The threat of U.S. air power against the Serbian Army should be held in abeyance. The emphasis should be on letting Serbia's enemies balance the Serbians. Under no circumstances should the U.S. send ground forces to the Balkans, even as part of a NATO peacekeeping force.

Of course, incentives will be needed to gain a settlement. The U.S. and its allies might accept the principle of a greater Serbia and help create it with border changes and population transfers. They should also promise to lift economic sanctions and perhaps even to help rebuild the Serbian economy.

But as we have learned after almost two painful years, incentives alone will not do the trick. Regrettably, lives can be saved in the Balkans only by threatening to take lives.

Carlos Llerena Aguirre

*John J. Mearsheimer, professor of political science at the University of Chicago, is a visiting scholar at Harvard's Olin Institute for Strategic Studies.*

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*Henry Kissinger*

# Avoiding the Quagmire in Bosnia

As a way to devise an honorable diplomatic role for the United States backed by nonmilitary, largely economic pressures, the Clinton administration's position on the Bosnian negotiations is extremely skillful and deserves support. Yet we must take care lest its enforcement provisions land the United Staes in a morass from which extrication will be difficult.

For Bosnia is not a nation in any except a geographic sense. It is composed of Greek-Orthodox Serbs, Catholic Croats, and Croats and Serbs who under Turkish occupation converted to Islam. There are no Bosnians per se. It remains a mystery why it should ever have been thought that the same ethnic groups that had refused to coexist in a relatively large Yugoslavia would be able to coexist in tiny Bosnia.

The best solution would have been a U.N. or European Community trusteeship for Bosnia, which would have permitted the introduction of an international force. Because none of the various nationalities would have had to submit to each other but to a presumably neutral international authority, this might have either prevented or ameliorated the civil war. But to believe that the appalling results of that conflict can now be reversed by a negotiated settlement that all the parties, in Secretary of State Warren Christopher's words, would "voluntarily embrace" is an illusion.

There are two basic military options. One would be massive pressure to undo the Serbian gains of the past year and redraw the borders in the plan proposed by Cyrus Vance and Lord Owen (a plan that is not a "solution" but a stopgap attempt to reduce Serb-conquered territory and prevent worse depredations and suffering, at least for a time). The other would be a significant military commitment to at least keep the parties from overthrowing the Vance-Owen arrangement or a variation of it.

But if the United States opts for altering the situation on the ground by military means, it will face the dilemma of Vietnam—an open-ended commitment with no viable exit. If it undertakes a major enforcement role, it will be on the road to an embarrassment similar to that in Beirut.

A third option is to punish Serbia for its atrocities by aerial attacks. This option should be kept open to deter and to punish a new round of ethnic cleansing and other outrages. I would also favor air drops to besieged Muslim communities. None of these measures could undo past transgressions, however.

The Clinton administration's strategy seems to be to persuade the reluctant Muslims to acquiesce in the loss of territory by promising to protect them against renewed Serbian aggression. A figure of 30,000 peace-keepers has been mentioned, half of whom would be supplied by the United States.

U.N. enforcement has a plausible ring to it. It derives from the Wilsonian notion of collective security, which assumes that on issues of peace, the interests of all key actors and their willingness to take risks run parallel. That is emphatically not the case in Bosnia, however, where not all countries—and surely not all parties—perceive the same threat or are willing to run similar risks.

*"Collective security" assumes parallel interests and similar willingness to take risks. That is emphatically not the case in Bosnia.*

Precisely because of the stopgap nature of the Vance-Owen plan, enforcing it on the ground could turn into a nightmare. The Serbs will, no doubt, seek to link their enclaves together and sooner or later join their area to Serbia itself in quest of their centuries-old dream of a greater Serbia. The Muslims will attempt to reconquer territories from which their populations were expelled. Though the Croats have not been heard from, it would be amazing if they remained quiescent for long. The central government, with limited but real powers proposed in the Vance-Owen plan, will be a weak reed for enforcement purposes.

In these circumstances, it is difficult to believe that the 10 proposed ethnic enclaves in Bosnia can be protected by the small force envisaged. Either more troops will have to be sent, or the enforcement mechanism will be seen to be impotent.

It eludes me why the United States should supply half the entire peacekeeping force in this morass in the center of Europe. If such a force is created, by far its dominant element should be European. If Europe is not willing to preserve the peace and human rights on its own territory, the United States may be walking into a heartbreaking trap by attempting to act as a substitute.

The operation and composition of the proposed enforcement mechanism raise all the problems of collective security mentioned earlier. The administration plan obviously foresees a major role for Russia, both in the negotiations and presumably in the enforcement. But it is already clear that Russia's attitude is not identical with America's, nor can it be. Serbia has been Russia's most dependable historical ally. Russia went to war in defense of Serbia in 1914, even though Russia had no national interest in the immediate issue.

The present Russian government, already under attack for neglecting its national interest and for excessive subservience to the United States, is in no position to bring real pressure on Serbia. We must take care not to recreate in the name of enforcement the alignment prior to World War I, with the Catholic regions of Croatia and Slovenia on the Western side, Greek-Orthodox Serbia supported by Russia, and Bosnia a no-man's-land in between.

Like millions, I am disgusted by Serbian conduct. I applaud Christopher's eloquent call for a standard for the fair treatment of minorities. He is right to invoke the impact on our consciences of accepting such brutality. And yet, when American lives are being risked, American foreign policy must define the national interest being served. In this world of upheaval, there are many events offensive to our values in which we are unable to interpose military force and for the easing of which we apply many measures short of war. Some of these measures are available in Yugoslavia—the tightening of sanctions on Serbia, for example. But the near-permanent stationing of American forces in the Balkans requires a clearer demonstration of the national interest.

Any U.S. participation in enforcement should be confined to aerial measures. It will not avoid the dilemma of America's standing between reluctant parties, but it will reduce the danger of American forces becoming hostages. Moreover, if we are serious about participating in enforcement, we should recognize that it must not be improvised. Bases and command machinery will be needed. Most of these will have to be in Italy. A meaningful step would be to explore what bases are available and what command machinery can be created now for either enforcement of the Vance-Owen plan or for possible reaction to ethnic cleansing in Kosovo, Macedonia or Bosnia. We will then know at least what our real possibilities are.

It fell on me to have to end a war started by previous administrations with the highest of motives and the widest possible support. Knowing the anguish of such an effort, I would hate to see another idealistic administration slide into a comparable quagmire.

*The writer, former secretary of state, is president of Kissinger Associates, an international consulting firm with business interests in many countries abroad.*

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PERSPECTIVE ON BOSNIA

# A Tragedy Worsened by Cowardice

**The West's pursuit of the expedient is a chronicle of folly worse than that of the 1930s. The stage is set for another Lebanon.**

By WILLIAM PFAFF

The shots first fired in Sarajevo, a year ago this week, were rifle fire directed by Serbian militants against a mass demonstration by Serbs, Croats and Bosnian Muslims demanding that their city not succumb to the madness of ethnic partition—that the three communities go on living together, as they had successfully done until then.

A year later, hate is installed nearly everywhere. The United Nations, to save lives from what it judges an impending slaughter, is itself conducting the ethnic cleansing of Srebrenica, evacuating refugees of that Muslim town, against the objection of the Bosnian authorities, before it falls to Serbian forces. The Bosnian Serbs, their forces structured by the Serbian secret police and enjoying Serbian army support, are on the brink of complete success in conquering the Greater Serbia demanded by Serbian nationalists since early in this century.

The international community—meaning the European Community and the United Nations, together with the United States—has imposed an arms embargo which, without seriously inconvenencing the Serbian side, has kept from the Bosnians the weapons and resources they need to resist their enemies.

The Western powers now intend to impose on Bosnia a map of ethnic partition and, implicitly, of Serbian and Croatian national expansion, drafted by the EC's and United Nations' own special representatives. They are at this moment intensifying pressures on Serbia to force the Bosnian Serbs to accept the victory that the Vance-Owen plan awards them.

Having refused to intervene to sanction the threat to minority rights in newly independent Croatia in June, 1991, or to block or penalize the military aggression by Serbia and the atrocious "ethnic cleansing" that followed, the United Nations now contemplates deploying military force in Bosnia on a scale that two years ago could have deterred the horrors Yugoslavia has since experienced.

It does this despite the evident fact that a Bosnia partitioned according to the Vance-Owen plan will be much less stable than the Yugoslav federation whose ethnic explosion produced this war. The plan is an arbitrary and artificial segmentation of the country which none of the communities really accepts. The Bosnian Serbs still overtly oppose the plan; the Muslims covertly do so, but like the Croats have formally accepted it for tactical reasons.

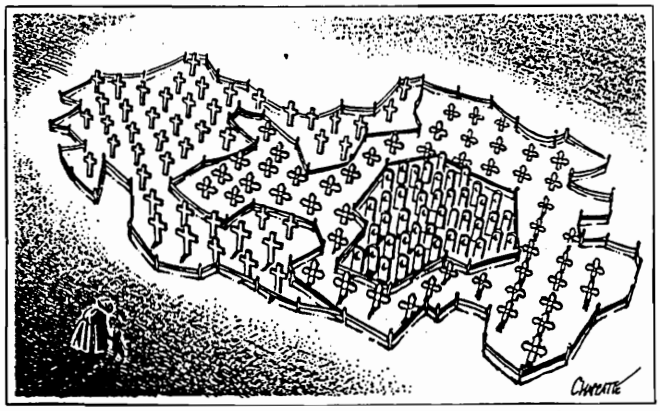
The U.N. Protection Force, which, reinforced, is supposed to enforce this partition of Bosnia, has already proved incapable of disarming the militias in the regions of Croatia it now occupies, or of establishing impartial civil authority or policing there. Its mission was to do both, and to resettle in these occupied Croatian territories the refugees driven from their homes in 1991. It has not done so, and no one imagines that it will ever do so in the future. However, the frustrated U.N. soldiers are now asked to do even more in Bosnia.

It is fantasy to think that even an expanded peacekeeping force in partitioned Bosnia will be able to impose its authority upon Serbian militias who believe themselves cheated in the Vance-Owen settlement, and who remain determined to link up their parts of Bosnia with Serbia itself. It is equally unrealistic to think that U.N. (and U.S.) troops can prevent the usurped Bosnians from terrorist actions and a continuing guerrilla campaign against the Serbian cantons that are to be legally ratified under the Vance-Owen plan.

This is not a plan for peace, but at best for an armistice, during which the conquests of the Serbian and Croatian aggressors will be formally recognized by the international community. The United Nations will then attempt to protect the Bosnian Serbs against the continuing effort of their victims to avenge themselves, and to block the Serbian conquerors from extending their holdings. This is a far more daunting and open-ended military assignment than a direct military intervention to halt the aggression would have been a year or two ago.

Then, air and naval retaliation for the Yugoslav national army's invasion of Croatia, or later arming and supporting the Bosnians to defend themselves, or even active intervention in their support, would have been missions with clear political rationale, and military objectives and limits. A military intervention to impose the Vance-Owen settlement upon a population that is virtually unanimous in rejecting it is a task without limits or a clear definition of success.

An attempt by an international force to contain military and guerrilla resistance to the Vance-Owen plan is likely to go on much longer, and to involve more casualties, than the Western publics will be willing to tolerate. For this would really be a new Ulster or even a Lebanon—on a huge scale, and with all sides hostile to the peacekeepers. It is truly bizarre that the British, French and American governments, which refused intervention to prevent the partition of Bosnia because they said it threatened a new Ulster, now plan a vastly larger intervention in order to enforce Bosnia's partition.




CHAPPATTE, La Tribune de Geneve, Switzerland

Ethnic cleansing.

If that intervention fails, as is most likely to be the case, U.N. troops will be pulled out in disarray. Full-scale war may be expected to resume in Bosnia, and Serbia itself no doubt will again intervene. The discredit of the United Nations and the European Community will be complete.

To this outcome have we been brought by political and military cowardice in the West, futile good intentions and the relentless pursuit of maximum expedience and the line of least resistance. It is a chronicle of diplomatic and political incompetence and folly worse than that of the 1930s. What will follow? We are certainly still at the beginning of something, not the end.

*William Pfaff is a Los Angeles Times syndicated columnist based in Paris.*

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**Foreign Affairs**

LESLIE H. GELB

# *No Peace Without Keepers*

## The truth about the Bosnia plan.

A joke about Bosnia is running through the Clinton Administration. What's the only thing worse than the Serbs saying "No" to the Vance-Owen peace plan? The Serbs saying "Yes."

Behind the dark humor lies a still darker truth: If the Serbs were to say yes, the U.S. and others would have to put up the 100,000 or so peacekeepers necessary to carry out the plan — and they won't. No peacekeepers, no peace.

Not Washington, not London, not Paris, Bonn, Tokyo or Moscow is at all likely to contribute the required forces. Nor is anyone at all likely to pony up the perhaps $10 billion yearly to pay the peacekeeping bill.

If this assessment is wrong, let the leaders of these nations stand up now and make their firm pledges. Thus far, they have either danced artfully around the issue or said nothing.

If this assessment is right, the U.N. policy has been a cruel joke. President Clinton and the others know they can't or won't provide the necessary peacekeepers to make a peace. So they owe a new and honest policy to the Bosnians, who will otherwise perish in a barrage of bullets and bulloney.

A word about Cyrus Vance and David Owen, the U.N. mediators. They are not appeasers. They are tragic heroes attempting the impossible — to fashion a peace among irreconcilable warring tribes without the power to force them to a peace. They nobly sought to stop the killing. But the U.N. members denied them the necessary means. And the two mediators failed to ask for those means.

Most needed are troops to enforce an exceedingly complicated treaty that would carve up Bosnia into 10 largely autonomous, ethnically mixed enclaves. NATO studies show the operation would require 50,000 to 150,000 troops, depending on how much fighting is expected after the agreement is signed. If it needs 50,000, NATO counts on 20,000 U.S. troops, or one division. And so on.

The odds are poor that Washington is willing or able to deliver any such number. So far, the Clinton Administration has signaled a general willingness to participate in peacekeeping, but has made no commitments.

Defense Secretary Les Aspin and Gen. Colin Powell oppose sending any significant number of U.S. ground troops. And they would send troops only if it were absolutely clear the warring factions would stop fighting — which is totally unlikely. Otherwise, they fear, U.S. forces would inevitably be sucked into an open-ended and bloody ground war — and they're right. On the other hand, Secretary of State Warren Christopher would commit U.S. peacekeepers, but hasn't talked numbers or conditions.

Mr. Clinton's compromise was to authorize Mr. Christopher to say: "If there is a viable agreement containing enforcement provisions, the U.S. would be prepared to join with the U.N., NATO and others in implementing and enforcing it, including possible U.S. military action." Formidable weasel words.

Mr. Clinton is afraid to say more. Mainly because a public pledging session would expose the flaw in the Vance-Owen plan: No U.N. member — not the U.S. and especially not the Europeans — will contribute its fair share of the necessary peacemakers.

Britain and France could each offer no more than about 5,000 on top of the several thousand they already have in Bosnia. With their budget cuts and other commitments, they have little more available. Germany won't contribute any soldiers, but might help with supplies. Russia could deliver about 10,000, but says it won't — and couldn't pay for them anyway.

Thus all other nations *might* contribute 20,000 troops at most. Neither Mr. Clinton nor Congress would dream of asking Americans to assume the rest of the load. Nor should they.

The Vance-Owen plan is a dream, and a false one. Yet the U.S. and its allies are now trying to tighten economic sanctions on the Serbs to make them say yes to it. They are embarking on yet another venture to keep that hopeless dream alive, to delay the day they will have to confront the real choices:

Either we should arm the Muslims, help them with air power and give them a fair fight for their lives; or we must propose carving Bosnia into three parts — let the Serbs join Serbia, the Croats Croatia and give the Muslims their own state. All else is pretense.

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WASHINGTON
ECONOMIC
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*A Digest of Development Policy Information*

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**SPRING 1993**
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Dear Readers:

Marking our fourth year in production, The Overseas Development Council is pleased to bring you the twelfth issue of the Washington Economic Watch: A Digest of Development Policy Information, a compilation of the recent U.S. policy debate concerning the developing world. ODC wishes to thank the World Bank, the U.S. Agency for International Development, and the Morgan Guaranty Trust Company of New York for their continued interest in this project.

This issue reflects the first 100 days of the new administration, including the debate over President Clinton's economic recovery plan for the United States, testimonies for and against the North American Free Trade Agreement, discussion of Western Aid to the Former Soviet Union, and analysis and commentary on privatization in developing countries and former centrally planned economies, among other issues.

As you know, institutions that receive the Washington Economic Watch have a reciprocal publications agreement with the American University in Washington, DC. ODC can continue to offer your institution complimentary subscriptions provided that you send publications to the American University in return. For institutions that publish often we ask that you send a publications list to the American University; the Librarian can then make selections from your list. In the case where an institution does not publish, or is unable to reciprocate due to financial difficulties, the American University requests written notification. Please direct publications and correspondence to: Acquisitions Librarian, The American University Library, 4400 Massachusetts Avenue, NW, Washington, DC 20016-8046, U.S.A.

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In the coming weeks you will receive a questionnaire to assess your institution's participation in the reciprocal publications agreement. ODC appreciates your institution's cooperation in this matter. We look forward to your correspondence and hope that you find this edition of the Washington Economic Watch to be a valuable resource for your institution.

Sincerely,

Christine Contee

Christine E. Contee
Director of Public Affairs
& Fellow

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John W. Sewell President

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TESTIMONY OF AMBASSADOR MICKEY KANTOR
UNITED STATES TRADE REPRESENTATIVE
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL TRADE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

March 11, 1993

Mr. Chairman, I welcome the opportunity to appear before the International Trade Subcommittee today to discuss the North American Free Trade Agreement (NAFTA) and President Clinton's plan to strengthen the NAFTA through supplemental agreements on worker standards, the environment and import surges.

In his speech at the American University on February 26, President Clinton laid out his vision of economic growth in America based on expanded trade and market opening: competing in, not retreating from, the global economy. This Administration's economic strategy begins at home with the President's economic plan--increasing investment, reducing the budget deficit. But it goes on to include NAFTA, strengthened by the supplemental agreements, a completed Uruguay Round, and far more balanced trading relationships with Japan and China.

Let me summarize why the President believes that NAFTA, if strengthened through these supplemental agreements, can help promote economic growth in the United States.

In this global economy, where capital and production are mobile, we face the challenge of creating high-wage and high-skill jobs here in the United States. We have already begun to see the benefits that the United States can gain as Mexico opens its markets. Our merchandise exports have grown from about $14.6 billion in 1987 to $40.6 billion in 1992. This export growth has reversed what was a $6 billion trade deficit in 1987 and turned it into a trade surplus of nearly $6 billion last year. These increased exports have come from every region in the United States. Mexico is one of the top ten overseas markets for 38 states, and 20 states each shipped roughly $250 million or more to Mexico in 1991.

Mexico is our fastest growing major export market, our second-largest market for manufactured goods, and our third-largest market for agricultural products. Seventy percent of Mexico's imports come from the U.S., and Mexicans already consume more U.S. goods per person than either the Europeans or the Japanese. The NAFTA will open still greater opportunites for U.S. exporters by eliminating Mexican tariffs (which average two and one-half times as high as U.S. duties), knocking down other forms of Mexican trade restrictions, and eliminating discrimination against U.S. providers of goods and services.

Today, more than 600,000 Americans owe their jobs to our exports to Mexico. This number is estimated to increase to

more than 1 million by 1995 with NAFTA. We know that U.S. workers in export-related jobs earn 17% more per hour than the average American wage. This agreement will be of particular benefit to small and medium-sized companies that are experiencing the fastest export growth. Unlike big companies, small and mid-sized firms do not have the resources to locate around high trade barriers. With trade barriers removed, U.S. firms will not have to move to Mexico to sell to Mexico.

I have emphasized, in a very abbreviated way, some of the potential economic benefits to the United States. But obviously, economic growth will not only make Mexico a better customer, but a stronger and more stable neighbor. The success of President Salinas' reforms is very much in his country's interest, but it is also, very much, in ours.

During the campaign, President Clinton concluded that while NAFTA carried with it the potential for real benefit to the U.S., that potential could be fully realized only through significant additional steps to enhance environmental quality and worker standards throughout North America. On March 17, our negotiators, led by Ambassador Yerxa, begin the process of negotiating the supplemental agreements to which the President is committed. We will not re-open the NAFTA, and we hope to see it enter into effect, as envisioned in the agreement, on January 1, 1994. But we will pursue these supplemental agreements



vigorously, we will not sacrifice substance for speed, and we will not ask you to vote on NAFTA implementing legislation until these negotiations result in full and effective agreements, with benefits that you can assess.

Through the supplemental agreements and related initiatives, we seek to strengthen NAFTA in five ways:

1. Border Cleanup. We will work with Mexico to address the serious environmental problems at the border. The NAFTA process has produced an intense focus on the depth of the problem and an unprecedented degree of cooperation in attacking it. As President Salinas told President Clinton when they met in January, Mexico has dedicated $450 million over three years to invest in environmental projects in Mexican border cities. The joint U.S.-Mexico Border Plan, which was formulated in the period leading up to the NAFTA negotiations, set up a number of working groups and projects -- including cooperation on enforcement -- to deal with border problems. Plainly, this must be a sustained effort, and it will be costly. USTR and the other agencies are studying the various options for funding critical border activities.

2. Stronger enforcement of national laws. Mexico has solid legislation on its books to protect the environment and its

workers. Mexico's environmental laws, regulations and standards are in many respects similar to those in the United States. Its comprehensive General Ecology law embodies principles similar to ours, and the regulations and technical standards implementing this law take an approach comparable to ours. The Mexican Constitution and subsequent legislation guarantees basic worker rights, such as the right of association and the right to strike, prohibits forced labor, and regulates the working activities of children. Mexico also has detailed laws and regulations governing occupational safety and health.

The issue, of course, is enforcement of the laws, to make the protections on the books a reality for those who live and work and do business in Mexico. President Salinas has taken significant steps, but much more remains to be done. I believe that we might use the negotiations on these supplemental agreements to discuss with the Mexican government ways to strengthen the enforcement of their laws. These initiatives might include changes in the administrative and judicial processes to increase access of citizens and non-governmental organizations.

In thinking about ways to improve enforcement, it is noteworthy that all NAFTA parties committed, in Articles 1714-16 of the NAFTA, to a significant set of principles and administrative and judicial procedures for the domestic



enforcement of intellectual property rights. We will review these provisions to assess their applicability for environmental and labor issues. Procedures like these to promote due process, judicial review, and citizen access to judicial and administrative bodies can contribute to improved enforcement of the law, as well as increased public confidence in the law.

3. <u>North American Commissions on environment and labor standards.</u> President Clinton is committed to the creation of two tri-national commissions -- one on the environment, and one on worker standards. This is one of the most challenging assignments facing us in the negotiations, but I believe that we can create commissions that break new ground in both these areas, and contribute to enhanced quality and improved worker standards in North America.

We envision the commissions as forums for discussing and analyzing environmental and labor issues on this continent. They would have independent, expert staffs and the authority to review complaints from citizens and non-governmental organizations. They would be able to request information from environmental and labor enforcement agencies in the three countries, and publicize the request and any failure by the governments to comply. The commissions could review and report publicly on the enforcement activities of the relevant government agencies, including the implementation of NAFTA's environmental



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provisions.

Our goal for the Commissions is the strongest possible improvements in environmental quality and worker standards throughout North America. At the same time, we have to bear in mind that the powers granted to the Commissions will apply to us as well as to our neighbors. The challenge is to create bodies which respect national sovereignty while accomplishing things that none of the nations in North America can do alone. From my consultations with this committee and others in Congress, I am acutely conscious of the depth of your concern that these Commissions have the requisite authority to make a real difference, and I expect the supplemental agreements will be judged accordingly.

4. Worker Adjustment and Retraining. We believe that NAFTA will create jobs in the United States and contribute significantly to economic growth. At the same time, we recognize that the agreement will undoubtedly cause some loss of jobs. This Administration recognizes that to those who lose their jobs, it is cold comfort to know that others are benefitting from expanded trade. We are committed to helping those who lose their jobs with an effective program of retraining and assistance. This is a priority of the President, and Secretary Reich is taking the lead in fashioning a comprehensive program to deal with those who lose their jobs, whether the cause is this trade



agreement, defense cutbacks, or corporate downsizing. We know that NAFTA will be judged in part by the effectiveness of that program, and it should be.

5. Import surges. In the area of import surges, we are not looking to change the mechanisms in NAFTA, but rather want to ensure that these provisions can be effectively and fairly used for all sectors. I know that there are concerns in certain industries about whether NAFTA's provisions could result in an import surge, and I want to address those concerns. At the same time, we should remember that our exports are a much greater share of the Mexican and Canadian domestic markets than are their exports in our much larger economy. So any new measures we press for may be more likely used against U.S. exports. As with labor standards and the environment, I will be looking to you and the private sector for guidance on these matters.

In conclusion, I want to assure the subcommittee that I am well aware of the concerns that many here in Congress, and around the country, have about NAFTA. I believe that the depth of the concern reflects, in part, doubts about our economic strength that grew understandably during a long period when our government did not address our fundamental economic problems. But we are beginning to attack those problems now. In conjunction with the President's economic package, I believe that NAFTA, if strengthened by the supplemental agreements, will come to be seen as a positive step for our nation, and an historic step for the North American continent.

**STATEMENT OF REP. JOHN J. LaFALCE, CHAIRMAN**

**COMMITTEE ON SMALL BUSINESS**

**HEARING ON THE NORTH AMERICAN FREE TRADE AGREEMENT**

**March 24, 1993**

This afternoon the Committee on Small Business is pleased to welcome one of America's most distinguished business leaders, Mr. H. Ross Perot, to further explore the potential impact of a North American Free Trade Agreement, or NAFTA, on the U.S. economy.

This 103rd Congress will have to consider the merits of a free trade agreement with Mexico that was negotiated by the Bush Administration. During the presidential campaign, Governor Clinton supported this free trade agreement on the condition that three supplementary side agreements--strengthening provisions for labor standards, environmental protection, and import surges--could be negotiated. We now understand that a fourth factor--the legal/judicial aspects of Mexico's enforcement process--may be included among these conditions. You, Mr. Perot, as one of three Presidential candidates, did not favor the agreement as negotiated; nor did you favor it conditionally; you denounced it. But neither Congress nor the American public has yet heard fully from you the specific reasons for your denouncement. I believe all--especially Congress and the American public--would benefit from having a full explanation of your views. And that is why you were invited to testify today.

The key question before Congress is whether this free trade agreement negotiated with Mexico can work and whether it is a good deal for America. I surely commend the Clinton Administration for trying to further refine and improve the work of the previous Administration; but I fear that no side deal, no additional monitoring commissions, can save this agreement.

We must not lose sight of the fact that NAFTA is a house that was built by Prime Minister Mulroney, President Bush, and President Salinas. President Bush is now gone, and Prime Minister Mulroney is resigning. President Clinton is trying to put some additions on that house. But I fear no matter how many additions, no matter how many coats of paint we put on that house, the foundation will remain the same. It is that foundation we need to investigate. For if the foundation is unsound, the whole house could come crashing down upon the American worker.

This Committee has held five previous hearings on NAFTA in an attempt to ensure that Congress hears all sides of the issue. Other Congressional committees also have focused on NAFTA, but their witnesses for the most part have supported NAFTA. The Small Business Committee has attempted to bring a modicum of balance to the review process. In addition to those from the business and academic communities who support NAFTA, we have heard from small-business owners, academics, labor, and human rights activists from both the United States and Mexico who expressed grave concerns.

Many issues have been raised about NAFTA:

- 0 During debate on extending fast-track authority for NAFTA negotiations, there was concern that the package might ultimately be approved primarily because of the time and effort already expended in negotiations.

- 0 There is concern that Congressional votes might be cast, not on the economic merits, but as a means of ensuring political stability in Mexico.

- 0 There is fear that U.S. jobs lost by plants moving to Mexico will not be replaced by newly created, comparable jobs in the same communities.

- 0 There is consternation about the leader of the democratic world joining economic hands with a Government whose electoral process is less than free; and whose record on labor and human rights is highly questionable.

- 0 There is skepticism whether this agreement will truly be an avenue to enhanced U.S. competitiveness, or whether it instead represents an ill-considered resort to a "low-wage option" for America that will neither improve the underlying conditions supporting competitive performance nor enhance the American worker's standard of living.

- 0 There is unease that we may be promoting an economic marriage too quickly, that, rather than go so far so fast, we should instead take the time to develop prenuptial conditions to ease into this union as the European Community did with Spain, Portugal, and Greece.

- 0 - Finally, there are warnings that the United States will encounter heavy long-term financial costs resulting from this union with Mexico; in fact, there is considerable concern that we will not even see a short-term export benefit should Mexico devalue its peso once NAFTA becomes effective, as many if not most economists expect them to do.

Mr. Perot, during your presidential campaign, you sought to educate the American people on economic issues. You brought the macro and microeconomic realities of the U.S. economy into the living rooms of Americans so they could understand the enormous economic perils that lie ahead for our country.

I view today's hearing as a continuation of that educational process you started--educating both the Congress and the public. Mr. Perot, as one of America's most prominent business leaders, I believe that we perform a public service by having you appear before this Committee. Your undisputed expertise in the business world makes your assessment of NAFTA, and particularly its impact on U.S. jobs, an important contribution to Congress' analysis of the agreement. We are delighted to have you here.

# TESTIMONY OF ROSS PEROT
# TO THE
# HOUSE SMALL BUSINESS COMMITTEE
# MARCH 24, 1993

The North American Free Trade Agreement must be carefully evaluated.

First, I suggest that we focus on our financial situation in the United States.

-- Our country is four trillion dollars in debt.

-- We have gone into debt an average of one trillion additional dollars during each of the last three Presidential terms.

-- President Clinton's forecasted plan will place us another one trillion dollars into debt.

-- We go an additional one billion dollars into debt each working day.

-- We have gone over $145 billion into debt just since election day.

-- Our manufacturing base is declining.

-- We exported over two million manufacturing jobs to Asia alone in the 1980's.

-- Factory workers making $440 per week who lost their jobs, are now making $270 a week -- if they have a job .

-- The standard of living has gone down for 4 out of 5 American families during the 80's.

-- In 1950, U.S. workers made 15 times as much as Japan and 4 times as much as Germany. Today, both countries are ahead of us.

-- In 1950, a dollar was worth a dollar. It is now worth 18 cents.

Businesses in our country carry a number of economic burdens.

-- We pay manufacturing workers ten times what they make in Mexico.

-- The minimum wage in the U.S. is $4.25. The Mexican minimum wage is 58 cents.

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-- The single most expensive item in making a car in the U.S. is health care.

-- Our companies spend a great deal on retirement, workers compensation, life insurance and many other benefits.

-- The recently-passed employee leave bill adds to the cost of manufacturing.

Our number of manufacturing workers is declining. We now have more people working in government at all levels than in manufacturing.

The top job growth categories in the 1980's in our country were janitor/cleaner, food preparation worker, and cashier -- none of these jobs pay enough to support a family.

We have a history of one-sided trade agreements, where our nation and our people are placed at a distinct disadvantage.

Entire industries have been lost overseas as a by-product of these agreements. Companies, cities and regions of the country have been damaged.

We cannot pay our bills, balance the budget, and pay down our debt if our worker income base is deteriorating. We need a growing, dynamic income base which gives us a growing, dynamic tax base -- instead, at this critical time, our job and our tax base are deteriorating, because of past poorly conceived trade agreements and an adversarial relationship between government and business in our country.

Our successful competitors have an intelligent, supportive relationship between government and business. Their trade agreements benefit their people.

Perhaps the core question is, "How does a company in the United States with all of the requirements and mandates placed on it compete with 58 cents-an-hour labor?"

The capitalist's or investor's view of this agreement can best be summed up by a prospectus of an organization called Amerimex, created by Nafinsa, Mexico's largest state-owned development bank and the Warwick Group of New York.

The plan was to raise approximately $50 million initially to buy U.S. companies that are labor intensive and marginally profitable.

-- The stock of these companies could be purchased at a very attractive price.

-- The company's manufacturing operations would then be relocated to Mexico to take advantage of the reduced labor costs.

-- To quote from the prospectus:

"We estimated that manufacturing companies that experience fully loaded gross labor costs in the $7-$10 range in the U.S. may be able to utilize labor in Mexico at a fully loaded gross labor cost of $1.15 to $1.50 an hour . . . This could translate into annual savings of $10,000 to $17,000 per employee, creating a dramatic increase in profitability."

-- The stock which had been purchased at a low price could then be sold at dramatically higher price, as a result of moving the labor to Mexico.

The characteristics of these companies are --

-- Low to mid-range technology manufacturing.

-- Moderate to good growth.

-- With sales in the range of $10 million to $100 million.

-- Excellent management and sales teams willing to remain with the company.

-- Proven products.

-- A labor component of 20%-30% of the cost of goods sold.

U. S. companies meeting these criteria employ 8.6 million workers. 5.8 million production workers meet these requirements.

The next question you might logically ask is when would these companies be sold?

To quote again from the prospectus, "It is anticipated that most investments will be limited from 3-8 years, but some investments may be realized early or later."

To me, this prospectus, which has now been withdrawn by Mexico because it so clearly summarized the impact of NAFTA on the U.S., is the most succinct summary one could make of the adverse impact of NAFTA on the U.S. workers, and the U.S. tax base.

Both Mexico, the U.S., and U.S. companies have waged a huge lobbying effort. An article in the New York Times, August 13, 1992, sums it up.

People in key positions on the 1992 Presidential campaign have been retained as Mexican lobbyists.

A former chief U.S. trade negotiator has been retained by the Mexican government and is being paid several hundred thousand dollars a year for his services.

To quote the New York Times:

-- The Salinas administration and its many lobbyists in Washington have fashioned what appears likely to be one of the most elaborate efforts at political persuasion ever undertaken in America by a foreign country.

-- A Mexican official said, "We are going to be launching a strategy of being in almost the entire United States, meeting with the editorial boards of local newspapers, meeting with business chambers and talking with other people", an official continued. "The intensity of our campaign will be much greater than it was with the "fast track"."

Let's look at a few facts:

Northern Mexico is rapidly becoming the newest American industrial belt. Nearly 600,000 jobs have been located in Mexico that in the past might have been in the United States.

Mexican workers can match the skills of 70% of the labor force in the United States.

To maintain the low wages that draw American companies to Mexico, President Carlos Salinas de Gortari has gotten commitments from business and union leaders to limit raises.

"It could be years before the gap with American wages narrows significantly", said John Pearlman, chairman of the Zenith Electric Corporation, which has 20,000 employees in Mexico.

An automobile engine plant's employees are a cross section of the new work force.

-- 100 are licensed engineers -- earning $1400 a month on average.

-- A U.S. engineer just out of college commands $25,000 to $30,000 a year as a starting salary. By comparison, a Mexican graduate engineer expects to earn $400 a month -- $4,800 a year -- at one of the factories upon graduation.

-- The 700 production workers are high school or technical school graduates, hired for the assembly line at $1.55 an hour. U.S. auto workers are paid $16.00 an hour.

-- Workers at an assembly for export plant in Juarez are paid 58 cents an hour, Mexico's minimum wage.

-- The Confederation of Mexico Workers (CTM) has been less aggressive in demanding raises for workers. Mexican workers' salaries fell 65 percent in real terms during the 1980's.

-- In one strike concluded in 1990, dozens of workers were shot and injured by State Police. The plant was shut down. 2,000 workers were fired, and those who remained had a 45 percent pay cut, from $2.64 to $1.45 per hour.

-- 14,200 plant workers were fired and the union dissolved, former union leaders signed a new contract, again without consulting the workers.

-- Assembly-line workers at this plant now make about 9 percent of the $16.12 hourly base wage of their American counterparts. Their daily wage of $11.60 does not cover food and housing costs for a family of five, estimated at $15 a day.

-- Mexican workers are in even worse trouble if they are injured on the job -- the law limits workers' compensation for injuries to $10,127.

-- Death benefits are capped at $6,720. In one situation, the life insurance policy paid $650 and a $23-a-month pension.

-- Four employees of a marine outboard engine plant were fired last April after they circulated a petition seeking better conditions.

-- All four, including a 10-year employee, earned Mexico's 58 cent an hour minimum wage.

-- Blue collar jobs now pay only 3.4 percent more than they did four years ago, while inflation was almost 12 percent in just the past year.

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-- A Mexican worker, employed by a major U.S. company, who suffers from skin lesions over most of her body, says the sores disappear whenever she takes leave from her job at an assembly plant. Her sick pay is $2.26 a day -- not enough to feed her two sons.

-- Many Mexican workers with U. S. companies cannot qualify for government housing credits and instead scavenge cardboard and trash to build homes. To buy a low-income house, a minimum wage earner would have to work 200 years.

We have heard a great deal of talk about creating jobs such as building factories and selling machine tools to Mexico.

Think it through. These are one-time jobs. Wouldn't we be better to have the factories here, employing people for several decades rather than having one-time jobs building factories?

The NAFTA Agreement was created before President Clinton took office. Our new President and his chief Trade Negotiator's challenge is to finalize the NAFTA Agreement that was presented to them when they took office.

As I understand it, the Congress is not allowed to make changes to the Agreement, and can only make an up or down vote. I am confident that both the President and Mr. Kantor will work to assure that the Agreement is fair and that the interests of the American people are protected. This has not been our pattern as a country in the past, and has resulted in significant damage to both our country and its people.

The core question is how do we work out the problems that are fundamentally driven by a huge gap in pay. Obviously, we cannot implode our job base and tax base at this critical moment.

-- We can either delay the NAFTA agreement or ratify it and try to work out these problems with supplemental agreements.

We lose all leverage once we have ratified the agreement. In all probability these basic problems will never be satisfactorily resolved, and will create stress between our countries.

I realize that this approach is not what Mexico would like. Mexico is our friend. President Salinas has done a brilliant job in rebuilding the country. We must continue to work closely with Mexico.

In doing so, we must be particularly sensitive not to impact Mexico's sovereignty.

A number of items currently being considered to be included in the supplemental agreements would be very unattractive to Mexico and should be avoided.

1) For example, one proposal to monitor Mexico's elections would create great stress between our countries.

2) Mexico has accurately pointed out that we are trying to subject them to much more scrutiny than our other trading partners.

3) President Salinas has warned that this current debate could damage U.S./Mexico relationships if our discussions do not respect Mexico's accomplishments and intelligence.

   He is right.

4) Some of our environmental demands include a trilaterial commission to inspect and make sure environmental standards are met. This will be offensive to Mexico.

President Salinas has promised the Mexican people that the sovereignty of the country will not be damaged in any way by free trade. We need to be very sensitive to this issue.

There is a great sense of urgency in Mexico to have the treaty ratified and put in effect before the Mexican Presidential elections next year. All of these concerns by the Mexican government and its leaders are legitimate.

We must weigh all of these issues and determine an appropriate course of action. The fail safe course of action would be --

-- To respectfully go to our friends in Mexico

-- Point out that we have a new President and a new government.

-- Explain that we need time to carefully analyze this complex agreement.

-- Tell them candidly, but respectfully, that we feel that it would be poor strategy to ratify the agreement and then try to correct its deficiencies with supplemental agreements which may or may not ever materialize.

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-- Openly explain the problem of losing wages and taxes in our country at this critical time.

-- Form a task force and intensively work together to fashion an agreement that will be in the best interests of both countries.

-- Propose a multi-year pilot phase to allow both countries to test this agreement to see that it works as planned.

-- Have provisions in the agreement that allow the agreement to be altered and improved based on the actual experience of this pilot program.

-- Have a clear understanding that either nation may decide to cancel this agreement, if in its judgement, the pilot program is not successful.

I realize that my testimony here will not be welcome by many in U. S. business, and our friends in Mexico.

Basically, Mexico has some of the least costly workers in the world. Our country has the world's most productive work force, but it is expensive. Our workers will lose, because of the wage difference.

Our country will also incur a tremendous loss in taxes at a time when we need a growing tax base.

Economic models have been developed showing that this is a good plan. These economic models make a number of unrealistic assumptions, such as --

-- Full employment assumption -- anybody losing a job immediately gets a new job.

-- That is not the way it works.

-- Just look at the 1980's.

In summary I would recommend that we proceed with care and work out the treaty to our mutual satisfaction before ratifying it.

Statement of Peter Hakim
Acting President
Inter-American Dialogue
before the
Committee on Foreign Affairs
United States House of Representatives
February 3, 1993
Washington, D.C.

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I greatly appreciate this opportunity to discuss US policy toward Latin America. Although I will be presenting my own views today, much of what I have to say will be drawn from the recently released policy report of the Inter-American Dialogue, Convergence and Community: The Americas in 1993, and an earlier report issued by a special Dialogue task force on Cuba. I have submitted copies of both reports for the record. As many of you know, the Inter-American Dialogue is an assembly of some 100 Western Hemisphere leaders who meet periodically to review and offer recommendations on US-Latin American relations.

Back in November, Bill Clinton said to a group of Latin American officials that he wanted to join with their nations to create a "Western Hemisphere Community of Democracies." This is obviously an ambitious goal--but it is the right goal for these times. The main challenge for the United States in Latin America today is not resolving old conflicts, although there are still some of these hanging about. Instead, it is effectively managing new opportunities for cooperation between the United States and the region.

To meet that challenge, President Clinton and his advisors have to accomplish three fundamental and interlinked tasks: the building of constructive economic partnerships with the nations of Latin America; the strengthening of democratic practice and respect for human rights throughout the hemisphere; and the fostering of social opportunities to reduce poverty and inequality. These are the essential building blocks of a democratic community, and each must be pursued in tandem with the others. The decisions made and actions taken on the following agenda of issues will be crucial.

## I. The North American Free Trade Agreement (NAFTA)

The North American Free Trade Agreement (NAFTA), designed to break down trade barriers between the United States, Mexico, and Canada, will be the first crucial test of the new administration's commitment to regional economic partnerships. After two years of negotiation, the NAFTA was signed by President Bush in December and now must be presented to Congress for ratification.

A great deal is riding on the NAFTA. Its rejection at this stage would be a devastating blow to US ties with Mexico, far and away our most important bilateral relationship in all of Latin America. The defeat of NAFTA would also gut the core of future inter-American trade arrangements. Approval, conversely, would set the stage for free trade negotiations with other Latin American countries and the eventual development of a hemisphere-wide trading system.

Clinton has consistently supported NAFTA. He must now invest the energy and political capital needed to win congressional endorsement of this still controversial accord. He is right, however, to demand that NAFTA be fortified by supplemental accords that adequately protect the environment and workers' rights. These would broaden US public and Congressional support for NAFTA, reduce negative spinoffs, and assure the benefits are more fairly distributed. In addition, while the NAFTA negotiations are helping to open up Mexican politics in a variety of ways, the United States should continue to work directly for a more democratic Mexico, free from electoral fraud and human rights abuses.

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## II. Building Hemispheric Trade Ties

Although NAFTA takes first priority, the Clinton Administration, together with the governments of Mexico and Canada, should move quickly to transform that agreement into a hemisphere-wide free trade area. Every Latin American and Caribbean nation should be welcome (and encouraged) to join--provided that it is willing to play by the rules, which should include a commitment to democratic governance. Some special consideration should be given to the countries of Central America and the Caribbean, which are likely to lose some of the benefits of existing US trade preferences when NAFTA enters into force.

Even prior to NAFTA's approval by Congress, the three North American partners should begin consultations with other regional governments to establish criteria, procedures, and timetables for building a full-fledged Western Hemisphere trade pact. An economically integrated hemishpere would enable every nation to become more productive and compete more effectively in the global economy. It will be particularly important to engage Brazil, which holds 40 percent of Latin America's population and produces more than 40 percent of its economic output.

## III. The Collective Defense of Democracy

President Clinton has vowed agressively to support the promotion of democracy and human rights worldwide, but has given little indication of how he proposes to carry out that pledge. In Latin America, the best way to proceed is to fortify the role of the Organization of American States (OAS) in mobilizing collective efforts to safeguard and advance democratic practice.

After years of irrelevance, the OAS has recently emerged as a significant actor in inter-American affairs and, for the first time ever, has established procedures for responding to violations of the democratic order.

Clearly, the OAS has not made much progress in Haiti or Peru--the first two tests of its new procedures. That does not mean that Washington should now give up on the OAS, however. The challenge for the Clinton Administration is to provide the leadership needed to reshape the Organization into a more vigorous and effective instrument of multilateral action. Most Latin American countries are prepared to join the United States in that effort. It will require such measures as bolstering the authority of the OAS Secretary-General, streamlining the Organization's decisionmaking, and expanding the mandate and resources of two key agencies--the Inter-American Commission of Human Rights and the Unit for Democracy--while trimming back the rest of the Organization. An equitable burden-sharing formula must be found to finance special OAS initiatives to safeguard democracy. In the short run, the United States should consider earmarking a portion of its payments on outstanding arrears for such initiatives.

In the specific cases of Haiti and Peru (and in other situations of constitutional breakdown that may arise in the future), the United States and other OAS members must keep sustained pressure on all sides to negotiate until agreement is reached to restore democratic rule. The Haitian generals, for example, should know that, if they refuse to negotiate seriously, end the widespread abuse of human rights, and ultimately agree to yield power, the currently limited embargo would be tightened and other sanctions imposed. But Aristide and his supporter cannot be allowed to block progress either. They must also be pressed to bargain in good faith. Over the longer run, the only way to stop the outpouring of refugees from from Haiti is to revive hope among the country's impoverished majority by ending repressive military rule and reconstructing a devastated economy.

## IV. Other Democratic Initiatives

There are several additional initiatives that the United States can and should take to strengthen democracy in Latin America. The new administration should review US military programs in Latin America and, where they are still considered necessary, make sure they are reinforcing, not weakening, civilian authority. All military aid should be channeled through elected civilian leaders, conditioned on respect for human rights, and avoid enmeshing armies in political tasks. Further, the United States should encourage national and regional dialogues among civilian and military officials to develop regionwide norms regarding the missions, size, and weaponry of armed forces.



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The United States can also expand nonpartisan assistance to strengthen legislatures and judicial systems, and provide similar help to non-governmental organizations (NGOs)--political parties, trade unions, human rights groups, business and consumer associations, and civic and community organizations--through which the demands of ordinary people are expressed. Indeed, collaboration with NGOs should become a major new ingredient in American foreign policy.

Finally, US initiatives can contribute to the struggle for social justice in the Americas--and there is much lost ground to be regained after a decade of debt crisis and economic restructuring. Given its domestic commitment to "put people first," the Clinton team will understand that progress toward democracy cannot be sustained as long as mass poverty and profound economic inequalities plague the hemisphere.

Through its own aid programs and its influence on the priorities of the global financial institutions, Washington should work to increase international support for broadening social opportunities and make common cause with those in Latin America who want to turn poverty reduction into a crucial national goal. The Clinton Administration should use US political and financial muscle in Latin America to lean against the political imbalances that exclude the poor from their nations' progress.

## V. The Old Issues that Refuse to Go Away: Central America, Cuba, and Drug Trafficking

Although the wars in Central America have largely ended, democratic rule and respect for human rights remain weak in every nation of the region except Costa Rica. Abject poverty remains pervasive, and most of the countries are economically distressed. The United States still maintains considerable influence in Central America and could contribute importantly to political opening, economic reconstruction, and the resettlement of large numbers of refugees and displaced persons. That, however, will cost money, and US economic assistance to the region has been sharply curtailed in the past few years.

The Clinton Administration could partially compensate for the reduced aid flows by providing some additional trade preferences and encouraging increased lending by the World Bank and Inter-American Development Bank. But the fact is that, to play a constructive role in Central America today, the United States will have to come up with more hard cash.

Like his eight predecessors, President Clinton will not be able to avoid dealing with Fidel Castro's Cuba. Nothing that Clinton has said so far suggests that his administration would be disposed to change current US policy, directed at squeezing Cuba

economically and isolating it diplomatically. Yet, that approach--which has been pursued for more than thirty years--is stale, unimaginative, and unproductive. It is time for Washington to set a new course rather than be guided by inertia. This past September, a task force of the Inter-American Dialogue put forth a sensible alternative that should be considered. It proposes combining continued economic pressure with new incentives for political opening, seeks a marked expansion of the flow of information and ideas to the island, and--most importantly--urges greater cooperation between the United States and Latin America in trying to encourage peaceful change in Cuba.

The choice for President Clinton is whether to pursue a fresh and more activist approach, involving an effort to mobilize an international coalition and to begin bargaining with Cuba--or whether to continue a policy of passively waiting for the Cuban authorities to take the first steps or for Fidel Castro to pass from the scene.

Decisions also have to be made about international drug policy. Now that the war against drugs has receded as an issue in US politics, there may be room for some significant policy changes--and these are justified on both substantive and financial grounds.

As conveyed in a series of private studies and government reports, the evidence is overwhelming that US anti-drug efforts overseas have had no impact on US drug problems at home and probably never will. Given the scarcity of foreign aid resources, funding for drug initiatives in Latin America should either be sharply curtailed or more effectively directed to helping Latin American governments to deal with their drug problems--not ours.

President Clinton has inherited a well-defined policy agenda for Latin America. With the end of the Cold War, a significant bipartisan consensus has emerged in Washington on what issues should be given priority attention in US-Latin American relations, and that consensus is, by and large, shared by most governments in Latin America.

But the fact that the agenda is set and the issues are familiar does not make the challenges confronting the new administration in Latin America any less difficult or important. The battle for democracy could still be lost; economic progress in the region is by no means assured; cooperation between Latin America and the United States, whether on economic matters or on other issues, remains incipient.

The task of the Clinton Administration is not to break new ground, but to consolidate and build on what has been accomplished, and seek to structure an enduring relationship that serves the best interests and values of both the United States and Latin America. By grasping the historic moment, the Clinton Administration would benefit all Americans, North and South. It would also establish a new standard for US leadership worldwide.

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GARY CLYDE HUFBAUER AND JEFFREY J. SCHOTT
assisted by
Robin Dunnigan and Diana Clark

# NAFTA
# An Assessment

INSTITUTE FOR INTERNATIONAL ECONOMICS
Washington, DC
February 1993

# 1

## Overview and Scorecard

On 17 December 1992, the United States, Canada, and Mexico signed a historic trade accord. The North American Free Trade Agreement (NAFTA) is the most comprehensive free trade pact (short of a common market) ever negotiated between regional trading partners, and the first reciprocal free trade pact between a developing country and industrial countries. The NAFTA is scheduled to enter into force 1 January 1994, after ratification by the three legislatures.

In the United States, the process of formulating implementing legislation will begin in the new Congress, which convened in January 1993. Because the NAFTA was signed before fast-track provisions of US trade law expired, there is no statutory deadline for submitting implementing legislation. However, as a practical matter, given the 90 session days allowed for congressional action and the political calendar in Canada and Mexico, US implementing legislation must be submitted to Congress by summer 1993 if the NAFTA is to enter into force, as envisaged, in January 1994.

Delay in US ratification of the NAFTA could complicate the timetable of parallel efforts in Canada and, to a lesser extent, Mexico. In Canada, the Mulroney government must stand for election by late November 1993, so it will likely seek to approve the NAFTA in advance of US action to preclude the pact from becoming the focal point of the election, as the Canada-US Free Trade Agreement (FTA) was in 1988. In Mexico, the Salinas government has a longer tenure but would like the NAFTA to enter into force before the ruling party (PRI) nominates its candidate in summer 1994 to succeed Salinas in December 1994.

In this book, we summarize the central provisions of the NAFTA text, evaluate the economic impact of the agreement, and score the results against the recommendations of our earlier book (Hufbauer and Schott 1992a). This assessment is not intended as a legal guide or a negotiator's memoir. We leave those books to other authors. Our purpose is to provide a road map so that legislators, businessmen, labor leaders, and environmentalists can get a quick handle on the agreement.

Much of our analysis focuses on issues related to Mexico's participation in the pact, and in particular, the labor and environmental concerns that have dominated the US debate on NAFTA during the 1992 election and that will be a central theme in the ratification debate. Since the NAFTA incorporates much of the existing Canada-US FTA, we have limited our analysis of US-Canada issues to those areas where the NAFTA modifies or augments FTA provisions.

## NAFTA Highlights

In essence, the NAFTA is a new, improved, and expanded version of the Canada-US FTA. In large part, the agreement involves commitments by Mexico to implement the degree of trade and investment liberalization promised between its northern neighbors in 1988. However, the NAFTA goes further by addressing unfinished business from the FTA, including protection of intellectual property rights, rules against distortions to investment (local-content and export performance requirements), and coverage of transportation services.

The NAFTA provides for the phased elimination of tariff and most nontariff barriers on regional trade within 10 years, although a few import-sensitive products will have a 15-year transition period. US-Canada bilateral tariffs will continue to be phased out according to the FTA schedule, that is, by January 1998. In addition, the NAFTA extends the innovative dispute settlement procedures of the FTA to Mexico (in return for a substantial revamping of Mexican trade laws that injects more transparency into the administrative process and brings Mexican antidumping and other procedures closer to those of the United States and Canada); contains precedent-setting rights and obligations regarding services and investment; and takes an important first step in addressing cross-border environmental issues.

The agreement contains notable commitments with regard to liberalization of trade and investment. First, the NAFTA establishes within 15 years free trade in agricultural products between the United States and Mexico. The accord immediately converts key US and Mexican agricultural restrictions into tariff-rate quotas and sets a maximum 15-year period for the phase-out of the over-quota tariffs—an impressive achievement considering the dismal track record of other trade talks in reducing long-standing farm trade barriers.

Second, the investment obligations of the NAFTA (and related dispute settlement provisions) accord national treatment to NAFTA investors, remove most performance requirements on investment in the region, and open up new investment opportunities in key Mexican sectors such as petrochemicals and financial services. The investment provisions provide a useful model for future GATT trade accords, despite the notable exceptions for primary energy and Canadian cultural industries.

Third, the pact sets important precedents for future regional and multilateral negotiations by substantially opening the financial services market in Mexico to US and Canadian participants by the year 2000 and by removing significant obstacles to land transportation and telecommunications services.

Finally, the NAFTA offers a schizophrenic result in textiles and apparel. On the one hand, the pact calls for the elimination of all tariffs and quotas on regional trade in textiles and apparel (except for a special US quota for Canadian apparel producers that do not meet the strict regional rules of origin). This is the first time in this heavily protected sector that imports from an important developing-country supplier have been significantly liberalized by the United States and Canada. However, the rules of origin established to qualify for duty-free treatment are highly restrictive. If not coupled with prospective GATT reforms, the cumulative result could be strongly trade diverting.

The NAFTA is a noteworthy achievement, but its implications for Mexico, Canada, and the United States should not be exaggerated. By widening the scope of the market and enlarging the range of available labor skills, the NAFTA enables North American firms and workers to compete more effectively against foreign producers both at home and in world markets. But the ability of the NAFTA partners to gain maximum benefits from the pact with minimum adjustment costs depends importantly on maintaining domestic economic policies that ensure growth. Firms will still look first and foremost at the macroeconomic climate in each country in setting their investment priorities.

## Implications for Mexico, the United States, and Canada

For Mexico, the NAFTA reinforces the extensive market-oriented policy reforms implemented since 1985. These reforms have promoted real annual growth of 3 to 4 percent in the 1990s and a falling rate of inflation. The NAFTA portends a continuation of the fast pace of change in the Mexican economy by extending the reform process to sectors such as autos, textiles and apparel, finance, telecommunications, and land transportation. Mexican exporters will also benefit in two distinct ways: the relatively unfettered access to the US market that they already enjoy

under various unilateral US programs will be sustained, and the few remaining US trade barriers will be liberalized.

The prospect of NAFTA implementation has already generated strong expectational effects, with capital inflows to Mexico estimated at about $18 billion in 1992 (of which about $5 billion was probably foreign direct investment).[1] These large inflows are the financial counterpart to the growing Mexican current account deficit generated by imports of machinery, equipment, and other capital goods—all essential ingredients for the sustained development of the Mexican economy.

However, a major cloud must be noted over Mexican skies: the government of Mexico seems determined to bring inflation down from its current rate of 10 to 15 percent to the US rate of 3 to 4 percent through stringent monetary policy, without permitting a significant devaluation of the peso. This approach could put the Mexican economy in a straitjacket, akin to the experience of the United Kingdom prior to the breakdown of the exchange rate mechanism in September 1992, and possibly compel Mexican policymakers to institute policies entailing high interest rates, low growth, and a burgeoning trade deficit for several years. Recognizing these risks, Mexico altered its exchange rate policy on 20 October 1992 and doubled the pace of permitted depreciation of the peso against the dollar from 2 percent to 4 percent per year (*Wall Street Journal*, 21 October 1992, A13). Further steps in this direction may be needed.

For the United States, the NAFTA reforms should enhance an already-important export market. US exports to Mexico have grown sharply since 1986 and now run at an annual rate of about $42 billion. US suppliers of intermediates, capital goods, and high-technology products should continue to reap large benefits as prime suppliers of the growing Mexican market. Over time, the NAFTA should impel industrial reorganization along regional lines, with firms taking best advantage of each country's ability to produce components and assembled products and thus enhancing competitiveness in the global marketplace.

In addition, the NAFTA meets key US foreign policy objectives. The US debate often ignores the foreign policy dimension, blithely taking for granted that Mexican steps toward economic reform and political pluralism are irreversible. But Mexico's economic reforms are still vulnerable to political and financial shocks, and democratic reforms are still in their infancy. The NAFTA should anchor achievements already made in Mexico and reinforce efforts to promote economic growth and political pluralism in that country.

1. Investment has anticipated trade reforms in Mexico, just as it did in Europe after passage of the Single European Act in 1986, which presaged the internal market reforms of the EC 1992 process.

For Canada, the NAFTA reinforces, and in some cases strengthens, its FTA preferences in the US market. Canada achieved many of its specific objectives in the negotiations, such as clarifying the method used to calculate the regional content for autos and retaining the Canada-US FTA provision that exempts Canadian cultural industries from external competition. In addition, the NAFTA improves Canada's access to the Mexican market. Although Mexico is a relatively small export market for Canada (under $1 billion at present), the NAFTA will expand export opportunities for Canadian firms in several key sectors, such as financial services, automobiles, and government procurement.

## NAFTA "Lowlights"

Despite its attractions, the NAFTA does contain warts and blemishes. For example, basic energy remains immune to free trade, progress on labor and environmental issues proceeds in half steps, and the accession clause is no more than a hortatory statement.

But the main area where the NAFTA is open to criticism is its enunciation of restrictive rules of origin. These arcane trade provisions have been aptly labeled "tools of discrimination": they are used to determine which goods qualify for preferential treatment under the NAFTA and to deny NAFTA benefits to those goods that contain significant foreign-sourced components.

Rules of origin are an integral part of all free trade pacts, but the NAFTA provisions pose two distinct dangers. First, to an undue extent, they penalize regional producers by forcing them to source from less efficient suppliers located in the region, thereby undercutting the global competitiveness of the buying firms. Second, the NAFTA rules could establish an unhappy precedent for other preferential trading pacts, which may choose to emulate the restrictive practices articulated in the NAFTA to the disadvantage of the original perpetrators.

The impact of rules of origin in limiting trade liberalization is suggested by comparing actual and hypothetical duty collections on US imports from Canada.[2] Based on 1991 data, duty collections from Canada will eventually drop to about 18 percent of the most-favored-nation (MFN) duty rates rather than the zero level that would occur without rules of origin. In other words, about 18 percent of US imports from Canada will not benefit from the FTA. Obviously, the stricter the rules of origin, the higher this residual percentage will be.

In general, the NAFTA adopts a standard rule that goods containing foreign components qualify for preferential treatment only if they un-

2. This exercise was carried out by Tom Dorsey (1992) of the Office of Management and Budget.

dergo a "substantial transformation" in the region that results in a change in tariff classification of the product. In addition, however, the NAFTA rules of origin for several key sectors have been encumbered by complex value-added tests and requirements that products not be contaminated by key components sourced abroad.

Our concerns about restrictive NAFTA rules of origin arise most prominently in two sectors: textiles and apparel, and autos. In textiles and apparel, the agreement establishes a triple transformation test that makes the already-protectionist rules of origin in the Canada-US FTA seem liberal by comparison. For most products, the NAFTA establishes a "yarn forward" rule, which requires an item to be produced from yarn made in a NAFTA country to qualify for regional preferences. The impact of this rule is somewhat softened, however, by the exemption of a small number of fabrics that only need pass a single transformation test to qualify for preferential treatment and by special quotas under which products that do not meet the origin requirements still qualify for preferential tariff treatment. The intense lobbying that prompted these restrictive NAFTA rules presages the industry's counterattack against the proposed global reform of the Multi-Fiber Arrangement in the Uruguay Round of GATT negotiations. The reform would phase out all quotas over 10 years.

For autos, the NAFTA adopts a "net cost" approach for origin calculations. By itself, this method is an administrative improvement.[3] However, the NAFTA value-added test (62.5 percent for autos, light trucks, engines, and transmissions; 60 percent for other vehicles and parts) is much higher than, and supersedes, the 50 percent requirement of the Canada-US FTA. Moreover, the NAFTA includes tracing requirements to ensure that the foreign component of engines, transmissions, and other specified parts is subtracted when determining whether a vehicle meets the new content requirements. Together these rules substantially raise the overall regional-content requirements for preferential trade in automotive products.

Foreign concern about the potentially adverse trade effects of these provisions will diminish if:

- The three NAFTA partners cut their MFN tariffs substantially in the Uruguay Round (thereby reducing the surviving margin of preference between the NAFTA zero rate tariffs and the MFN rate);
- The three countries move toward the adoption of a common external tariff, especially in autos, thereby mitigating the legitimate worries about potential transshipment of foreign components from one NAFTA partner to another.

3. The net-cost approach subtracts specified administrative expenses from the transaction price to determine the base for calculating the ratio of foreign to regional content.

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In contrast to the textiles' and autos' rules of origin, a constructive precedent was set in the rule of origin for computers. The rule is relatively simple: computers qualify as a North American good if the circuit board is made in the region and is further transformed so as to change the tariff classification (e.g., from a circuit board to a partly assembled computer). In contrast to textiles and autos, the NAFTA establishes a common external tariff for computers and related products among the three countries: US and Canadian MFN tariffs (3.7 percent or 3.9 percent, depending on the product) will remain the same (subject to Uruguay Round cuts), but Mexico's external tariff will be reduced from rates of 10 and 20 percent, down to the US and Canadian levels over 10 years (annex 308.1).[4]

## NAFTA Ratification: The Clinton Scenario

From the moment NAFTA negotiations were contemplated, US critics focused on environmental and labor provisions. These issues served as lightning rods for the congressional debate prior to the start of NAFTA talks in 1991. At that time, President Bush promised Congress to include environmental safeguards both in the agreement and in parallel bilateral initiatives with Mexico and to ensure that adequate programs address the adjustment needs of US workers dislocated by the NAFTA reforms.

While the NAFTA and the parallel US-Mexico side agreements arguably meet Bush's commitments, they clearly have not satisfied the critics. Even though the NAFTA is probably the "greenest" trade pact ever negotiated, the accord contains far less in terms of rules and enforcement than US environmental interests demanded. Similarly, the NAFTA drew sharp objections from US labor groups because it does not contain "hard" obligations in the area of workers' rights and related labor issues. In both cases, the critics complain that the consultative commissions are of the "meet and greet" variety, rather than forums for progressively upgrading standards and enforcement.

In October 1992 Governor Clinton delivered a major address in which he endorsed the NAFTA, rejected any renegotiation of the text, and enumerated important qualifications (Clinton 1992). With Clinton's election, these qualifications now provide a guide for the requirements for US ratification of the NAFTA.[5]

4. In addition, duty drawback benefits will be phased out over seven years for the maquiladoras, where most Mexican-made computers are produced (US Chamber of Commerce 1992, 32).

5. At a news conference held on 19 November 1992, President-elect Clinton affirmed that the NAFTA is a priority and that while "there are other things that have to be done before the treaty should be implemented by Congressional legislation," he looks forward to working with President Salinas to resolve the outstanding issues (*Washington Post*, 20 [illegible]

In broad terms, Clinton sees NAFTA and other trade accords as part of a larger national economic strategy, including changes in the US tax system (i.e., investment tax credits), developing a "conversion plan" for the defense sector, and controlling health care costs. The NAFTA is accordingly regarded as a part of the overall US competitiveness strategy. Moreover, Clinton views the NAFTA as the first step toward developing stronger regional ties, as the United States "reaches down into the other market-oriented economies of Central and South America."

Clinton has enumerated five unilateral measures that the United States should enact in the context of NAFTA implementing legislation. The unilateral steps require worker adjustment assistance (training, health care benefits, income supports, and assistance to communities to create jobs); environmental funding (to ensure environmental cleanup and infrastructure investments in the United States); assistance to farmers (strict application of US pesticide requirements on food imports, plus help in shifting farmers to alternative crops); assurance that NAFTA "does not override the democratic process" (i.e., Clinton would give US citizens the right to challenge objectionable environmental practices in Mexico or Canada);[6] and assurance that foreign workers are not brought to the United States as strikebreakers.

In addition to these unilateral steps, Clinton stated his intention to negotiate three supplemental agreements that would be submitted to Congress in parallel with NAFTA implementing legislation. His proposal was ambiguous as to whether these pacts would be solely with Mexico or trilateral in nature. However, it clearly was motivated by political demands to strengthen US-Mexico provisions.

The first agreement would create an Environmental Protection Commission. The commission, which would be headed by Vice President Gore, would have "substantial powers and resources to prevent and clean up water pollution" and would "encourage the enforcement of the country's own environmental laws through education, training, and commitment of resources, and provide a forum to hear complaints" (Clinton 1992).

A second supplemental agreement would create a Labor Commission that would have powers similar to those of the environment commission to protect worker standards and safety. "It, too, should have extensive powers to educate, train, develop minimum standards, and have similar dispute resolution powers and remedies."

Finally, a supplemental safeguards agreement would be negotiated to deal with instances where "an unexpected and overwhelming surge" in imports from a partner country required temporary protection beyond that provided by the "snapback" clauses enumerated in the NAFTA text. The rationale for such a provision would be to provide an additional avenue for temporary import relief to deal with the aftershocks of regional integration. It does not encompass, however, the innovative safeguards mechanism that we advocated for sectors such as autos, textiles, and agriculture.

President Salinas has reacted positively, if not warmly, to these proposals. Indeed, he reportedly suggested that the agenda of these supplemental negotiations be expanded to include a special economic support fund for Mexican development (*Wall Street Journal*, 8 December 1992, A11).

In the relevant chapters that follow, we examine these proposed supplemental agreements in more detail. As with the completed NAFTA text, we offer recommendations regarding the scope and content of the prospective labor and environment pacts.

## NAFTA Accomplishments: A Scorecard

In the remaining chapters of this assessment, we examine the accomplishments of NAFTA measured against the yardsticks set out in our 1992 book. When we drafted that book, we regarded our recommendations (which serve here as yardsticks) as the outer limits of what might be accomplished in a long process of integrating the economies of Canada, the United States, and Mexico. We have never viewed the NAFTA text as the final word on economic and social convergence within the huge North America market. Rather, we see the NAFTA as a very large first step, with the implication that further steps will be taken in later years.[7]

What follows are detailed assessments of the key provisions of the NAFTA text, both in terms of individual sectors and in terms of cross-cutting rules. Readers who want a succinct appraisal should turn to the appendix, which summarizes our recommendations, the main elements of the NAFTA text, and the contrast between recommendations and results. For readers who want a very short scorecard, in table 1.1 we have assigned grades for achievements in each area. In this scorecard, a gentleman's B indicates that the outcome just met our recommendations (which demand a high standard of accomplishment), an A indicates an outcome that surprised us for the exceptional progress made toward a free regional market, and a C indicates that the outcome was disappointing.

6. This subject, of course, raises issues that could require negotiated commitments with US trading partners.

7. In a sense, the NAFTA for North America is akin to the Treaty of Rome, signed by European Community members in 1957. The parallel is far from exact, however, in that the Treaty of Rome announced as its destination a common market with a major institutional superstructure. By contrast, the NAFTA has as its destination a free trade area with little institutional superstructure.

**Table 1.1 Scorecard: How NAFTA rates against the recommendations**

| NAFTA results | Grade |
|---|---|
| Market access by sector | |
| Energy | C+ |
| Automobiles | B |
| Textiles and apparel | B+ |
| Agriculture | A |
| Financial services | B+ |
| Transportation | A |
| Telecommunications | B+ |
| Trade rules | |
| Rules of origin[a] | C+ |
| Safeguards[b] | C |
| Subsidies and dumping[c] | B |
| Dispute settlement[c] | A |
| Government procurement[d] | B+ |
| New issues | |
| Investment | A− |
| Intellectual property | B |
| Environment | B |
| Labor adjustment[e] | A |
| Maquiladoras[d] | B |
| Average grade | B+ |

a. Rules of origin are discussed in chapter 1 and in the automobiles and textiles and apparel sections of chapter 3.
b. Safeguards are discussed in chapter 2.
c. Subsidies and dumping are discussed in the dispute settlement section of chapter 4.
d. Government procurement and maquiladoras are not addressed separately in the assessment but are included in the appendix.
e. Labor adjustment is discussed in chapter 2. The grade of A assumes that President Bush's proposed labor adjustment program, or a better program, is adopted.

The overall grade we assign the NAFTA text is a B+. In most subjects, the agreement met our recommendations. In several areas—such as investment, agriculture, transportation, dispute settlement, and labor adjustment—the NAFTA text exceeded our recommendations and receives an A. However, in some areas—energy and rules of origin—the agreement falls short and earns only a C.

# SUITING UP FOR COMBAT ON TRADE PACT

BY ELIZA NEWLIN CARNEY

Alarmed by an increasingly visible grass-roots campaign to kill the North American Free Trade Agreement (NAFTA), business interests are fighting back.

About 400 major trade associations, corporations and business coalitions have joined a new umbrella group dubbed USA*NAFTA that plans to invest heavily in defending the recently signed agreement, which—if approved by Congress—would join the United States, Mexico and Canada in a single commercial market. The group, spearheaded by Rochester (N.Y.)-based Eastman Kodak Co. and American Express Co. in New York City, has set out to raise $2 million for a national public education and grass-roots lobbying drive, though some NAFTA supporters say it will cost far more than that to counter mounting opposition.

"Clearly the groups that support NAFTA realize that we've got a fight on our hands," said Robert J. Morris, senior vice president for the Washington office of the New York City-based U.S. Council for International Business. After a year and a half of heavy anti-NAFTA lobbying by a coalition of labor, environmental, family-farm, consumer, church and civic groups, industry NAFTA backers say that they are beginning to catch up. The Mexican government already is well into a high-dollar public relations and lobbying campaign. *(See NJ, 9/19/92, p. 2122.)*

WASHINGTON INC.

USA*NAFTA has already sought advice from the Wexler Group, a Washington lobbying firm headed by former Carter White House aide Anne Wexler that has had close ties to President-elect Bill Clinton. Coalition leaders recently met with Mexican President Carlos Salinas de Gortari, and the group is hosting twice-monthly meetings to help pro-NAFTA forces share intelligence and coordinate strategy.

Coalition members, which include such major players as the National Association of Manufacturers, the Business Roundtable and the U.S. Chamber of Commerce, are pulling their weight by producing white papers showing NAFTA's positive effects and by talking up the agreement among their members.

A USA*NAFTA member, the U.S. Council of the Mexico-U.S. Business Committee, recently commissioned a pro-NAFTA study by Paula Stern and Paul A. London, her husband, of the Washington consulting firm the Stern Group Inc. (London and Stern, who's a former chairwoman of the International Trade Commission, have been advisers to Clinton.) In conjunction with USA*NAFTA, the council has also released 50 detailed (and largely optimistic) summaries of how the agreement would affect each state in the union.

NAFTA supporters have been spurred on in part by the growing visibility of a broad anti-NAFTA coalition led in Washington by Ralph Nader's lobbying group, Public Citizen Inc. Led primarily by labor unions and environmental



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groups, the coalition has drawn together such diverse bedfellows as the Sierra Club, the AFL-CIO, the National Family Farm Coalition and the National Rainbow Coalition. *(For details, see this issue, p. 47.)*

Recently renamed the Citizen Trade Campaign, the coalition in mid-December announced that it was redoubling its efforts against the free-trade agreement in conjunction with another Washington-based anti-NAFTA group, the Alliance for Responsible Trade.

Among other moves, the two groups persuaded 52 national organizations to sign a letter to Clinton detailing problems with the agreement. The letter, sent to every Member of Congress, contends that the agreement will degrade the environment, jeopardize worker health and safety and threaten U.S. jobs by encouraging companies to cross the border.

"The basic premise of our campaign is pretty simple, which is that once people understand what [President] Bush's NAFTA means for their lives, for the environment, for their food safety, they can't help but be opposed," said Lori M. Wallach, staff attorney and director of trade programs at Public Citizen's Congress Watch.

The Citizen Trade Campaign has already spent nearly $200,000 on radio, television and newspaper advertising against the agreement. Labor groups, which contributed heavily to Clinton and to the Democratic Party, have also paid for anti-NAFTA newspaper ads.

NAFTA supporters counter that the agreement will create jobs in the United States and will improve environmental conditions by boosting Mexico's economy.

But NAFTA opponents apparently have had an easy sell so far. Several surveys have found that the majority of Americans who are familiar with the trade agreement oppose it. A CBS News-*New York Times* poll in July found that respondents considered free trade with Mexico a "bad" rather than a "good" idea by 2-1.

And the Citizen Trade Campaign and its allies have struck a nerve among Americans increasingly worried about jobs and the economy. Hundreds of people have turned up at rallies, protests, press conferences and town meetings that the coalition has held all over the country during the past 18 months.

"We think Clinton is going to have a hard time getting this through, and he is going to need all the help he can get," said Betty Ann Kane, a federal relations adviser with the Washington law firm of Miller & Holbrooke who recently was hired to be executive director of a Laredo (Texas)-based group called Pro-NAFTA. Headed by Laredo Mayor Saul N. Ramirez Jr., Pro-NAFTA represents the mayors of several cities along the Mexican border who support the agreement.

Determined to turn grass-roots organizing to their advantage, USA*NAFTA officials are setting up state coalitions throughout the country. Though groups on both sides say that they want to be heard by Clinton and by Mickey Kantor, his choice for U.S. Trade Representative, Congress is the real focus of the NAFTA battle. Clinton has said that he backs the agreement, which Bush signed on Dec. 17, so long as supplemental pacts are provided to protect the environment, worker safety and American jobs.

The next step is to hammer out the details with Congress. And both sides want to make sure that Members, particularly freshmen, hear from their constituents.

Supporters and opponents agree that the NAFTA fight has taken trade lobbying to a new pitch. "Trade policy is becoming the overarching conceptual framework for a lot of other issues," said Don Wiener, the Citizen Trade Campaign's Chicago-based field director. "Trade policy informs or affects labor policy, human rights policy, environmental policy."

Willard A. Workman, a Chamber of Commerce vice president, concurred. "This is the first time in recent memory that a trade issue has been given this kind of national attention," he said. ■



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The New York Times March 24, 1993

# American Rules, Mexican Jobs

By Jagdish Bhagwati

Supplemental agreements are being negotiated with Mexico to raise and enforce environmental and labor standards as conditions for Congressional approval of the North American Free Trade Agreement. But the proposals being canvassed are, at best, debatable. Better suggestions can be made.

Because these proposals are largely driven by fear that we will lose jobs to the cheap Mexican labor, they seek to impose excessive environmental standards and have effectively become instruments for indirectly raising Mexican costs. The demands for tougher Mexican standards could be legitimately read as a ploy to undermine Mexico's ability to join the trade agreement and thus to kill the accord itself.

Demands that commit Mexico's scarce resources to improve environmental and labor standards are, however, not the end of the matter. Many Congressmen and lobbies would go further. They would have Mexico also make similar commitments by each industry, matching them up to levels of regulation in corresponding industries in the U.S. This would presumably yield level playing fields for our industries in the trade agreement; otherwise, it is reasoned, Mexico would reap unfair advantage in free trade with us.

But surely the manner in which Mexico divides its overall effort to meet environmental objectives among different industries and regions must reflect its own priorities just as ours reflect our own interests.

## Apply strict labor standards to U.S. companies in Mexico.

Demands on Mexico to do exactly what we do are therefore not sensible. Since we would properly not submit to them if made by others, they are also unreasonable.

But we can address the chief concern of U.S. labor unions that our investments will flow to Mexico in industries where standards are lower than our own. For U.S. companies in Mexico, whether fully owned subsidiaries or joint ventures, we can legislate, not just exhort, that they act entirely up to our standards. Since our standards are often not uniform across different states, perhaps we might even overlegislate and make the toughest standards mandatory on our companies in Mexico. A rationale for this Draconian policy would be that industries in the states with the toughest measures are most likely to be influenced into moving to Mexico.

Such a policy, reminiscent of the Sullivan Principles urging U.S. companies in South Africa to comply with American laws against racial discrimination, would respond to the fears of the unions about the loss of jobs to Mexico. It would thus strengthen the ability of the Clinton Administration to reject the outlandish demands that Mexico, despite its poverty, do much more for the environment and labor than it can currently afford and that it replicate our regulations and standards on each industry.

This policy is in our jurisdictional powers: our industries should be subject to our legislation, especially as no conflict with Mexican laws is at stake.

Proponents of tough environmental and labor standards, who desire them as good values that should apply to Mexican citizens, should also realize that the presence in Mexico of our companies adhering to the higher standards would serve as a demonstration for Mexican industries and would encourage Mexican nongovernmental organizations to agitate for an extension of such standards to all Mexican companies eventually. □

*Jagdish Bhagwati, professor of economics at Columbia University, is author of "Protectionism."*

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PERSPECTIVE ON NAFTA

# An Agenda for Clinton and Salinas

**They have two months to settle such side issues as environmental protection if free trade is to win Congress' vote.**

By BILL RICHARDSON

When President-elect Bill Clinton and Mexican President Carlos Salinas de Gortari conclude their first face-to-face meeting today, let's hope that they have made progress in two vital areas. First, they need to forge a strong personal relationship, essential for the leaders of two neighboring countries often at odds over a host of bilateral issues. They also need to agree on a strategy for winning Congress' approval of the North American Free Trade Agreement.

In a nutshell, the two leaders should explore potential side agreements to the negotiated NAFTA treaty to confront congressional fears over job dislocation, environmental protection and worker safety rights that have been left largely unattended by the Bush Administration.

To his credit, candidate Clinton endorsed NAFTA despite enormous pressure against doing so, while adding a firm commitment to address concerns about the environment and U.S. jobs. He will have to enlist Salinas' support in resolving these concerns if NAFTA is to pass Congress and function effectively.

In politics as well as in economics, timing is critical, and NAFTA needs to be completed as soon as possible during Clinton's honeymoon with Congress, preferably by early summer. A delay could weaken both U.S.-Mexican relations and U.S. efforts to increase its competitiveness in world markets. From Mexico's perspective, it would be a serious slap in the face for the Salinas government, which has invested so much of its political capital in closer economic and political ties with the United States. It could also undermine the reformist agenda of the Salinas government and aggravate Mexico's economy just when it needs a jolt of confidence.

Years of hateful stereotyping, mutual distrust and nationalistic sentiment have kept the United States and Mexico from forging stronger relations. These historic problems have prevented closer cooperation on important issues such as trade, immigration, drugs and environmental protection, all of which impact the United States profoundly. NAFTA presents both countries with the opportunity to overcome the limitations of the past.

The foreign-policy implications of NAFTA cannot be overlooked. Political and social stability in Mexico is central to stronger U.S.-Mexican relations. While President Salinas has moved Mexico toward that possibility with amazing alacrity, the free-trade agreement is an insurance policy against a possible Mexican retreat to economic isolationism. The rest of the Western Hemisphere—Latin America and the Caribbean—is already nervous about the outcome of NAFTA and will doubt our commitment to trade expansion in the region if NAFTA falters. Clinton needs to achieve a quick and positive outcome on NAFTA to establish a credible and successful foreign policy toward our hemisphere neighbors.

On the economic front, NAFTA has benefits for both countries. For Mexico, it means jobs and foreign investment for a more secure future. For the United States, it represents a real opportunity to combine our economic strengths with Mexico and Canada to match the production-sharing strategies of Japan and the European Community and to assure economic and job growth at home. More significant than increasing U.S. exports to Mexico is the boost that NAFTA will give to U.S. competitiveness in world markets. If the United States expects to compete with Asia and Europe, we need an economic partnership with Mexico that allows our country to capture the same economic synergies enjoyed by our competitors, who have already joined with developing countries in their regions to gain competitive advantage.

With the stakes so high, Clinton and Salinas should direct their negotiators over the next 60 days to develop side agreements to address the environmental and labor issues that have made congressional support for NAFTA tenuous. After completion of these agreements, NAFTA should be ready for formal submission to Congress.

This process will test Clinton's deftness at bilateral diplomacy. While Salinas must recognize Clinton's political needs to side agreements, Clinton must also recognize Salinas' sensitivities to sovereignty concerns that may arise from the agreements.

As for fears about the impact of free trade on American labor, Ross Perot had it wrong. The "giant sucking sound" is being caused by American job losses to Asia and Europe, not to Mexico. Mexican exports to the United States are less than 5% of our total imports. Clinton's response to fears of job loss should be to provide generous resources to retrain workers and improve our competitiveness. If he does this, as he has promised, he will have established a considerable measure of security for the future of the American work force. Such an initiative will need to be fleshed out and presented to Congress before a final vote on NAFTA.

RAESIDE, Times-Colonist, Victoria, Canada

As for the environment, the problems of air pollution, water contamination and necessary infrastructure along the border need to be addressed now. A U.S.-Mexico binational environmental commission could pave the way for a breakthrough on environmental protection. Such a commission would need the power to coordinate compliance with environmental laws and to guarantee bonds for infrastructure projects. U.S. and Mexican taxpayers should not have to foot the entire bill for environmental cleanup. Multinational corporations with operations in North America and in the border *maquiladora* zones should take a strong and innovative leadership role to find solutions and contribute financially to resolve these problems. So far, multinationals and *maquiladoras* have not done their fair share—have even shirked their corporate responsibilities to protect the environment in their communities. A solution along these lines would make NAFTA the "greenest" trade agreement in history.

Clinton and Salinas share striking generational similarities, in that both are pragmatic problem-solvers who have focused their energies on economic growth and development. Their mutual objectives can be met by developing a personal chemistry and by making some tough decisions on NAFTA early on.

*As chief deputy whip, Rep. Bill Richardson (D-N.M.) will be active in shepherding NAFTA through the House.*

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# Free Trade Pact Is Shaky

*Tough US demands dim trade prospects across borders*

**By Christopher Whalen**

AS American and Mexican negotiators begin formulating "side agreements" to the North American Free Trade Agreement (NAFTA), the weight of political opinion in Washington is quite pessimistic about the agreement's chances for congressional approval.

That sentiment on NAFTA in the House of Representatives is currently at least 2 to 1 against shows that the Clinton administration's renewed support for free trade is only the initial down payment on a very expensive political tab. Will President Clinton pay the price?

Roughly three-fourths of newly elected members of the House and Senate explicitly opposed NAFTA in their campaigns. In a series of surprisingly candid interviews, United States Trade Representative Mickey Kantor concedes that NAFTA is in trouble politically. But he also asserts that he can satisfy the objections of members of Congress.

Mr. Kantor's optimism and seeming willingness to commit publicly to deliver on innumerable promises may be part of the larger problem facing NAFTA.

When former Trade Representative Carla Hills began the long and difficult NAFTA process, one of the first rules she established was that the negotiations would occur in private. She correctly acknowledged that the talks could not succeed if the particulars of the US agenda were discussed with members of Congress and the press before they were presented to the Mexican and Canadian representatives at the bargaining table.

Kantor, on the other hand, seems happy to discuss details of the three-sided agreements in appearances before Congress and with the press, apparently as part of a larger strategy to manage the process through the media. In general, he has conducted one of the most frank and open discussions of US-Mexico relations given by an American official in many years. But his candor troubles always-reticent Mexican government officials and NAFTA supporters, who rightly wonder what Kantor really has in mind if he is so willing to discuss the US shopping list for the side agreements.

Ms. Hills was charged with negotiating an agreement, which would then be sold to Congress by President Bush.

Kantor's assignment is much broader and arguably far more difficult, if not impossible. In practical terms, he must hold difficult talks with Mexico and Canada while conducting detailed negotiations with members of Congress, environmental groups, labor organizations, and hundreds of state and local entities.

The scale of the task facing former lawyer/lobbyist Kantor is illustrated by his calls for basic changes in Mexican law and legal procedures. A number of members of Congress have demanded major alterations in Mexican legal practices in order to ensure that both NAFTA and side agreement provisions are enforceable.

Significantly, Kantor has already backed away from an earlier pledge to give the trilateral commissions envisioned in the trade agreement supra-national authority to resolve disputes and enforce rules. He apparently understands that the issue of how Mexico's legal system works (or fails to work) inevitably leads to political questions that cannot be answered within the narrow confines of NAFTA.

But without the fundamental changes that House Leader Richard Gephardt (D) of Missouri, other members of Congress, and even Kantor himself have called for, there can be no effective enforcement of any NAFTA provisions that require specific action on the Mexican side of the border. If these concerns are not dealt with, astute observers believe, NAFTA is dead.

THE reasons behind such pessimism are more complex than the question of simply enforcing labor and environmental rules. One of the more revealing developments in the NAFTA process has been the emergence of the term "upward harmonization," which essentially means that Mexico must change its laws and regulations in order to raise its internal regulatory environment to the same level as that prevailing in Canada and the US.

The term "upward harmonization" is pejorative and suggests, some say correctly, that Mexican regulatory standards are inadequate, a fact which is causing much friction inside the Mexican government. Most observers, even Mexicans, would agree that our southern neighbor needs to make significant changes in its legal system, yet the tone of the American demands is condescending and even inflammatory. The drive for "upward harmonization" originates with the environmental movement, which is unlikely to be mollified by pretended "solutions" to Mexico's basically dysfunctional legal system.

The fact is that Kantor has promised to include in the side agreements basic legal and political changes inside Mexico that he simply cannot deliver. "We are going to insist that we have some changes in the Mexican judicial system to make sure people have access to that system, that due process is followed, and that administrative decisions can be appealed in court," Kantor has said. No American can fulfill this promise, say sources in Mexico.

One Mexican politician with close ties to the government of President Carlos Salinas de Gortari says Kantor "is promising what he cannot deliver, what no one can deliver. How can Kantor publicly tell members of Congress that he will produce changes in Mexican law when we cannot possibly begin such a process now? The [Mexican] president's term is effectively over now, and we have elections next year. Thus, I cannot imagine when Salinas could make the legal changes that Kantor requires, even if he were inclined to do so."

Kantor will not be able to obtain and/or demonstrate the changes necessary to satisfy Congressional critics, and the agreement will either be shunted aside or voted down the House, Senate, or both. Aides in the Clinton White House confess their worry that the president may not be willing or able to see NAFTA through Congress.

By September, when supporters of NAFTA hope to see the agreement moving toward a positive vote in Congress, Mr. Clinton may be on the defensive politically and embroiled in a many-sided legislative fight. In these circumstances, the White House might prefer to see the trade agreement go down to defeat rather than spend dwindling political capital and presidential popularity to attempt to rescue it.

Kantor and other members of the Clinton administration have said repeatedly that they will walk away from NAFTA unless the necessary changes are made. Putting aside their reassuring rhetoric about supporting free trade with Mexico, perhaps letting NAFTA gradually fail was always Clinton's intention.

■ *Christopher Whalen is a Washington-based consultant and edits The Mexico Report, a fortnightly newsletter.*

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OPINION/ESSAYS

# NAFTA Agreement Is Good US Economics

By Peter Hakim

THE Greeks have a saying: "Milk turns sour when shaken too much."

That is what may be in store for the North American Free Trade Agreement (NAFTA) unless the Clinton administration moves forward quickly to nail down the details of this accord and presses hard to gain its approval in Congress.

Throughout his presidential campaign, Bill Clinton consistently supported NAFTA and its goal of eliminating trade barriers between the United States, Mexico, and Canada.

A month before the election, he devoted an entire speech to endorsing the 2,000-page NAFTA pact negotiated and subsequently signed by then-president George Bush – although signaling his intention to seek supplemental accords on a few issues like the environment and labor rights that were not adequately addressed.

Since taking office, however, the Clinton administration has done little to build public and Congressional backing for the agreement.

The president's few statements on NAFTA, although supportive, have been brief and lacking in enthusiasm. US Trade Representative Mickey Kantor has been energetically promoting the agreement, but swelling criticism has put him on the defensive.

If the president wants a NAFTA agreement, he and his advisers must now take the initiative. They need to communicate a clear and comprehensive rationale for proceeding, linking NAFTA to the administration's strategy for revitalizing the American economy. Until that is done, NAFTA's critics will have the field to themselves. They have been effective in galvanizing the opposition, so much so that doubts are emerging on whether NAFTA can gain approval.

In contrast, the president's allies on the issue remain on the sidelines, finding it difficult to join the debate without direction from the White House.

The president has to make a convincing case for NAFTA, not by responding to its critics, but by fully explaining how this agreement serves US interests. Time is running short. Here are the key arguments that should be advanced:

■ Every credible study has concluded that NAFTA will be a decisive economic plus for the US, creating good jobs for American workers and making the US economy stronger.

■ Exports to Mexico will expand significantly in response both to lowered trade barriers and increased Mexican buying power, as that economy prospers. Every dollar Mexico spends on imports, more than 70 cents ends up in the US. Nowhere else do we enjoy that advantage. In the last five years, as Mexico has emerged from its economic slump, its purchases from the US have soared by nearly 150 percent to almost $40 billion in 1992 and could eclipse our sales to Japan.

**The Clinton administration should press Mexico to open its politics, keep elections honest, and end human rights abuses.**

■ The promise of closer economic cooperation has already contributed to a sharp decline in the suspicion and distrust that traditionally characterized Mexican attitudes toward the US, and is opening the way for more effective cooperation on such other vital issues as drugs, immigration, and the environment.

■ NAFTA will produce improvements in environmental conditions within Mexico and along the US border. Mainstream environmental groups acknowledge that NAFTA already includes sound ecological provisions.

These should be further strengthened by the proposed supplemental accords.

■ Although NAFTA will lead to a net gain in US employment, it will also put some American workers out of jobs. The administration has to make clear that it will address the needs of displaced workers through improvements in US labor legislation.

■ The administration should recognize it is concluding an economic pact with a nation that is not genuinely democratic, and commit itself to pressing Mexico to open its politics, keep elections honest, and end human rights abuses.

■ Finally, NAFTA should be promoted as a crucial first step toward building a hemisphere-wide free trade area. Although struggling to shake off a prolonged economic depression, Latin America spent some $60 billion on US exports last year, more than either Japan or Germany. In recent years, the region has been our fastest growing export market.

By boosting Latin America's economic prospects and opening further its markets, free trade arrangements would spark new demands for US goods and services.

Every 1 percent of added growth in Latin America increases US exports by about $5 billion, compared with only $1 billion for the same rise in Japan's growth rate. And, as in the case of Mexico, stronger US-Latin American economic relations are the essential basis for stronger political ties and expanded cooperation on many shared problems.

NAFTA is good trade policy, good economic policy, and good Latin American policy.

■ *Peter Hakim is acting president of the Inter-American Dialogue in Washington.*

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# TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

ADDRESS BY LAWRENCE H. SUMMERS[1]
UNDER SECRETARY-DESIGNATE OF THE TREASURY AND
TEMPORARY ALTERNATE GOVERNOR FOR THE UNITED STATES
AT THE ANNUAL MEETING OF THE
INTER-AMERICAN DEVELOPMENT BANK
HAMBURG, GERMANY
MARCH 30, 1993

Distinguished Governors, Mr. President, delegates and friends: I am extremely pleased to be here in this historic city of Hamburg and among so many friends of the Americas. I want to thank our German hosts for their gracious hospitality which has added so much to the quality of our deliberations. I also want to offer our warmest congratulations to President Enrique Iglesias on his recent reelection as President of the Inter-American Development Bank.

Together, we look to the Inter-American Development Bank to be a catalyst for sustaining and deepening the truly historic social and economic trends in the Latin American region that have occurred over the last several years. We look to the IDB as an institutional commitment of our hemispheric partnership for prosperity.

As President Clinton's nominee to be the Under Secretary for International Affairs at the Department of the Treasury, I welcome this opportunity to underscore the commitment of President Clinton and Secretary Bentsen to this strong and growing relationship with Latin America and the Caribbean. Presidents from Roosevelt to Clinton have understood the shared destiny of our peoples. The new Administration in Washington sees Latin America as a partner, and we are working closely with our Congress to shape the many dimensions of our partnership.

Our countries and cultures have much in common. We are a young, vibrant hemisphere with an optimistic outlook. We believe in markets, yet we also believe that governments have an appropriate role to play. We have common interests in the areas of trade, investment and debt. We share similar views of problems and solutions. We are not plagued by the negative aspects of nationalism, and we believe in the promise of the modern state. Our hemisphere has a new generation of post-Cold War leaders, leaders committed to democratic principles.

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[1]As presented by James H. Fall, Deputy Assistant Secretary of the Treasury.

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For both Latin America and the United States, the early 1980s were marred by high interest rates and record debts; the 1990s offer the promise of the opposite, low interest rates and reduced debts. The 1980s saw regional disputes over contras, commandantes, and human rights; the 1990s will be devoted to promoting greater regional integration. The early 1980s witnessed protectionism, government-led growth and burdensome regulation in Latin America, but the 1990s can be a decade of mutual accord over hemispheric growth, political plurality, and environmental sustainability.

There is a distinct echo in the reform efforts underway in Argentina, Chile, Mexico, and elsewhere in Latin America and President Clinton's economic plan for domestic renewal. Each effort was thought to be politically impossible, but each actually has received a broad base of public support. President Clinton's program and the Latin American reform plans also share an activist approach to economic policy, with a two-pronged approach marrying pro-growth and anti-poverty measures.

The President's plan has a number of critical components. First, the President proposed the most serious deficit reduction package in the history of the United States. By 1997, when the provisions of the plan are fully phased in, the annual deficit will be reduced by $140 billion. Second, the package includes short-term stimulus measures to sustain and push forward the nascent recovery. Third, the package includes an investment component to start shifting the composition of the federal budget from consumption to investment. Finally, the President's plan includes a broad-based energy tax. This will not only help cut the deficit but will promote environmental standards by effectively taxing pollution.

The domestic economic plan will advance American foreign policy. By restoring fiscal responsibility and promoting long-term investment and growth, the United States is setting a strong economic foundation for the 21st century.

The President's plan was designed to create jobs and spur growth at home, but there are powerful benefits in its adoption for all the Americas. The plan will be good for Latin America in several important respects. It will secure financial stability and growth in the United States economy, offering larger markets for Latin exports. United States imports from Latin America and the Caribbean were $70 billion for 1992, with the prospect of reaching $100 billion by the end of the century. A one percent increase in U.S. GDP would boost regional non-fuel exports by $1 billion, and the secondary effects of that export growth would boost regional GDP by a further $2 billion.

Lower long-term world interest rates will have a major impact on Latin America. A one percentage point reduction in interest rates would reduce annual debt service by at least $1 billion on the $430 billion in Latin American and Caribbean debt. The economic plan has already had a significant impact on long-term rates.

A new focus on our national infrastructure and a promotion of high-tech, high-wage industries, sharpens U.S. competitiveness and strengthens our trade. This Administration is committed to the maintenance of a free and fair trading system among the Americas, and elsewhere, that will promote global export opportunities for all. We believe in the benefits of an open trading system. Where barriers to trade exist, we will work vigorously to enforce existing agreements or, where necessary, negotiate new ones.

In his recent speech at American University in Washington, D.C., the President stated his desire for a strong Uruguay Round agreement that will not only eliminate tariffs on goods, but will also secure financial market liberalization on a global scale. And we will work to ensure that just as our market is generally open to foreign friends that wish to invest in America, foreign markets should also be open to American investment.

The President has also pledged his strong support for the new North American Free Trade Agreement. To finalize NAFTA, we are working with Canada and Mexico to reach key understandings in the areas of environmental quality and workers' rights. And we hope to be able to negotiate and extend the benefits of NAFTA to other nations as well.

The President's vision of a new economic prosperity will reinforce and accelerate three positive trends in Latin America: 1) a redefined role of the state; 2) financial stability; and 3) political openness. Let me touch on each of these:

**Redefined role of the state:** There are serious efforts now underway to de-regulate for higher productivity, a willingness to abolish tariffs, a desire to accept technology and allow market access to foreign firms, a drive towards privatization and a commitment to regional integration. These are mutually reinforcing actions that imply and mean less state intrusion in economies.

**Financial stabilization:** This is a crucial ingredient for regional economic growth. Latin America's finance ministries have rationalized government spending, cut deficits, improved tax collection, and, in some cases, introduced fairness into the tax code. Exchange rates

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are now more responsive to market forces. Inflation has been cut. As a result, real GDP growth rates in 1992 are up by roughly 10% in Chile, Argentina, and Venezuela, and up by 3% in Mexico.

**Political openness**: A new political process is ascendant in Latin America. Popular, democratic elections and institutions are the rule rather than the exception. The entire region is more open -- politically, culturally, socially and commercially. In the last two years, intraregional trade has exploded. As both democracy and capitalism are under siege in the former communist states, the appeal and credibility of these ideas depend importantly on whether Latin America continues to succeed. The revolution in economics in Latin America is no less sensational than the revolution in Russia, and the immediate prognosis is far better in Latin America.

There has been profound progress and revolutionary change in Latin America and the Caribbean over the last several years. The Enterprise for the Americas Initiative (EAI) reflected a bipartisan U.S. approach to help speed these changes. We continue to support its goals in the areas of debt, investment and trade. The IDB's Investment Sector Loan Program has made a major contribution to the reform effort across the hemisphere. The foreign debt problems affecting the region have been reduced to manageable proportions with the help of the IDB. The IDB has played a major role in the EAI and will continue to do so in developing investment sector loans and administering the Multilateral Investment Fund.

Indeed, much remains to be done. Many countries' physical infrastructure is deteriorating, and in several countries the extent of poverty and suffering has increased. Millions still struggle to scratch out a living on less than $1 a day. Distorted income distribution remains a potential source of serious social conflict. In some places, the richest twenty percent of the population controls over twenty-five times the wealth of the poorest twenty percent. And inflation continues to pose a threat, having refused, even in the best cases, to drop back to single digits. Political and social inequality persists where economic reforms have not been accompanied by the modernization of political institutions.

Several important countries in the region, including Brazil and Peru, face serious political and economic challenges. If the fledgling market reforms are to be sustained, Latin leaders must address critical issues, including the alleviation of poverty, human rights, environmental protection, and removing government impediments to innovation and growth.

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To redress these problems, some would call for a return to state ownership and a massive redistribution of wealth. But statist economies and government-dominated enterprises are a thing of the past. The fact is that over time, state control has done more to damage their people than fair, efficient and open markets ever did. The legacy of state economies is a series of failed governments, repressed democracies, damaged environments, economic stagnation and poverty. We cannot go back. Governments clearly have a necessary role to play in ensuring economic vitality and realizing human potential. But governments must get out of those areas where markets and the private sector work better.

Look at a success story. Chile is an excellent example of a country that has implemented far-reaching macroeconomic reforms, encouraged the development of the private sector and markets, in part through an aggressive privatization program. Now the government can concentrate its resources on the social sector. As Minister Foxley stated here in Hamburg on Sunday, the Alwyn Administration will spend $6 billion on social programs this year, a thirty percent increase over 1991. Chile's wide-ranging reforms have led to a substantial increase in economic growth. Chile has demonstrated the political will to make social programs a priority. This is a good example for other countries and it is a good example for the Bank.

We believe the Bank must now play a far more aggressive role in advancing human welfare by supporting better programs in basic education, health and sanitation. The Bank can be in the vanguard in ensuring that education is broadly available, especially to the poor. A vibrant private sector can assume greater responsibility for university education, freeing scarce public resources for primary education. We believe the Bank also has a critical role in advancing health care: there are too many big hospitals that benefit the elite in Latin America and too few primary health care facilities for the poor and in rural areas. The Bank can help address judicial reform and important issues such as land tenure.

For the Eighth Replenishment, the United States is asking the IDB to advance the quality of its lending program. We are asking the Bank -- and more importantly its member governments -- to maintain a strong commitment to structural reform and the private sector. We are also asking the Bank to strengthen its commitment to environmental protection and to support social programs. There is no reason why structural adjustment and environmental integrity cannot go hand in hand, and the U.S. will work closely with member countries and Bank officials to help realize this potential.

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We are asking that the Inter-American Development Bank become a leading force for transparency and accountability in public finance. We ask the Bank to seek public participation in all its development activities and decisions, especially among the people who will be affected. We believe that the Bank should be an institutional leader in providing prompt public access to project information in donor and borrowing countries.

We are also asking the Bank Group to further rationalize its lending practices, streamline its management operations and increase the professionalization of its staff. We believe the Multilateral Investment Fund must remain a lean operation and the Inter-American Investment Corporation should restructure its management to achieve cost savings. We believe the Bank itself can reduce overhead expenses, and we encourage the Board of Directors to lead the way in reducing its own costs. Finally, we believe that the Bank and its members, both within the Western Hemisphere and beyond, should change the way they view the Bank and the allocation of its resources. Notions of fixed allotments and lending targets, along with inappropriate use of concessional and grant funds should be retired once and for all.

Governors and Friends, we believe this Bank can move to the forefront of social, environmental and economic development for the region. We depart Hamburg with full confidence that Latin America and the Caribbean are on a path to sound social and economic development.

I thank you again for your warm hospitality, and I look forward to working with you all in a spirit of close cooperation in the months and years ahead.

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# U.S. Investors Find That Chile Has a Lot to Offer

*By Julie P. Doherty*
*Chile Desk*
*U.S. Department of Commerce*

Chile's remarkable economic growth and political stability make it one of the most promising markets in Latin America. The accompanying surge in trade and enhanced attractiveness for foreign investors suggest Chile as an economic model for most developing countries. In the last two years, foreign investment inflows constituted 4 percent of Chile's gross domestic product, a rate matched by few countries in the world.

Chile's Minister of Finance, Alejandro Foxley, recently noted that the country is open to any type of initiative, including investment, that liberalizes its marketplace. Since the beginning of President Aylwin's administration in 1989, approved investment has risen to $13.9 billion, of which $5.3 billion is from the United States. Actual foreign investment put in place during 1992 exceeded $1.4 billion, a record.

In December 1992, Standard and Poor issued a "Double A" credit rating for Chilean internal debt instruments. Four months earlier, it had issued a "BBB" credit rating to Chile, making it the first country in Latin America to achieve an investment grade rating in the wake of the Latin American debt crisis.

The United States and Canada currently hold 40.5 percent of all foreign investment already in place in Chile. The European Community has approximately 28 percent. In 1992, the United States, Canada, and Finland were authorized the highest amount of direct investment in Chile. The United States accounted for $320 million, Canada $1.2 billion, and Finland $600 million.

Since 1982, about 45 percent of foreign investment in Chile has been in mining, but it has recently begun to diversify. New sectors include manufacturing, services, and agriculture. Total approved investment to date in mining is $8.1 billion, services $3.4 billion, and agriculture $130 million.

U.S. firms are major investors in Chile's mining sector. The U.S.-Japan $1.5 billion Phelps Dodge/Sumitomo joint venture in the "La Candelaria" copper mining project was recently approved. Another large U.S. project is a $40 million investment project by Bell South to upgrade Chile's telecommunications company (CIDCOM).

Japan and Australia have been given approval for a joint venture involving ENDESA (Chile's National Electrical Company), COMALCO Aluminum (Australia), and the Marubeni Corporation (Japan). Total investment in the project should reach $1.5 billion.

Chile encourages foreign investment under its Decree Law 600. This provides national treatment for all foreign investors. Further, there is free access to capital markets and economic sectors in Chile, and minimal government intervention in investor activities. The policy also provides for liberal profit and capital repatriation regulations. The free exchange system sets no time limit on remittance of profits and dividends. Investors should note that there is a non-interest bearing cash reserve requirement or deposit (ENCAJE) of 30 percent, for a period of one year. The ENCAJE is a monetary tool used to control excess liquidity, and is not designed to discourage foreign investment.

Individuals and businesses established in Chile, except foreign subsidiaries, are subject to a tax on income received from Chilean as well as non-Chilean sources. It is likely that tax agreements will be negotiated with some countries in 1993 to avoid this double taxation burden.

Foreign investors have two income tax options—either the general regime applicable to all Chilean-owned businesses, or the special regime solely for foreign investors. The *general regime* has a corporate tax rate of 15 percent on accrued income. If repatriation occurs, however, there is an additional tax of 35 percent, but accompanied by a 15 percent credit on corporate taxes paid.

The *special regime* currently features two alternate methods of taxation—an overall income tax rate of approximately 44.3 percent and a 40.0 percent rate with variable surtax. Pending legislation, expected to pass in 1993, will likely reduce the 44.3 percent to 42.0 percent, and eliminate the 40 percent option entirely. The same investment legislation should also include a reduction in the waiting period for capital repatriation from the current three years to one.

The Capital Goods Corporation of Chile predicts that between 1992 and 1997 there will be $26 billion invested in Chilean projects. Sectors with the most projects should be private sector mining with $3.5 billion, state mining with $1.3 billion, and industry and services with $4 billion. Other projects involve forestry, energy and fuels, parts, tourism, real estate, and public works.

A May 1992 law enables the government-owned CODELCO, the world's largest copper producer, to establish joint ventures with private firms to develop mining projects to improve CODELCO's profitability.

The telecommunications sector expects to continue its explosive growth of the last five years. Proposed legislation designed to speed up development in the telecommunications sector will be presented to the Chilean congress in May.

Chile's government is expected to continue encouraging foreign direct investment, including joint ventures of small- and medium-sized firms, to foster economic expansion and generate increased foreign trade.



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THE REGION

CAPITAL MARKETS

# Latin America's spectacular comeback

*But investors still need convincing*

*By James W. Conrow*

Latin America's rapid and large-scale return to the international capital markets has surprised most informed observers. Even more dramatic is the growth in the region's equity markets.

Both developments bode well for Latin America's drive to raise the investment capital it needs to modernize its industries and make them globally competitive. But while congratulations are in order, we cannot forget that the region's renewed attractiveness to investors has not come easily, nor is the process complete.

Latin America was absent from international debt markets for six years—from 1982, when Mexico suspended payment on its debt, until 1988, when Chile, Mexico and Venezuela completed small Euro-issue placements. Mexico's $100 million offering in 1989 signaled market acceptance for the region's full-fledged reentry. Other developments followed:

- Argentina and Brazil joined the list of countries whose paper is finding a good reception on the international markets.
- Top-quality private Latin American issuers as well as sovereign and agency credits are now rountinely funded in international markets.
- Spreads narrowed, from 900 basis points over U.S. Treasury notes in the market's early stages to around 300 basis points today.
- Maturities lengthened from two or three years to ten.
- The amounts of capital increased dramatically, from negligible levels in 1988 and 1989, to $5.4 billion in 1991, and an estimated $4.5 billion for the first half of 1992.

Equity investors have also found the continent a new land of opportunity. Teléfonos de Chile in 1990 became the first Latin American share offering to be listed on the New York Stock Exchange. Teléfonos de México's $2.35 billion secondary share offering in 1991 was by far the largest ever from an emerging market country. The spectacular run-up in share prices attracted investors, who enjoyed the best returns anywhere in the world—400 to 500 percent in some cases.

*The region's capital markets have an inner strength based on a commitment to a stable economic environment.*

The more recent correction in equity prices resulted not just from internal factors, but also in part from international events that provided fewer choices for high returns. But still, the Latin American markets have developed their own inner strength. This strength is derived from the policies of the region's new governments, which recognize that private sector growth requires a steadfast commitment to a stable and predictable economic environment.

Latin America's good economic prospects should ensure the region's continued access to international capital markets. At the same time, certain features of the region's economic turnaround give some cause for concern and present specific challenges that must be addressed.

One challenge is that the period of explosive growth and extraordinary returns for investors is largely behind us. Investment returns from now on will tend to settle into a long-term relationship with company earnings and the real pace of economic growth. As competition for international capital grows, investors will scrutinize returns from Latin America even more carefully.

Another concern is an apparent lack of investor diversity. The great majority of investors in the region are individuals who have repatriated part of the estimated $190 billion of flight capital to make these investments. Now, the region must improve its credit ratings to attract the more risk-adverse institutional investors from within and without the region.

Another problem is that the equity and bond markets in Latin America are still thinly traded, making them especially vulnerable to changes in investor preferences. A very high percentage of market capitalization and trading volume is concentrated in a few shares on most exchanges. And shares are still closely held, limiting information available to outside investors as well as opportunities for them to influence management.

The region also lacks sufficient capital committed to market making. In part, this reflects a residual lack of trust among major participants in the marketplace. For example, if securities companies are allowed to trade for their own ac-

*This article was adapted from an address given by IDB Executive Vice-President Conrow before the 1992 Financial Times Conference on Latin American Capital Markets, held in London, October 5-7.*



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*It has not been easy to attract investors to the region, and some must yet be convinced.*

counts, who will ensure that they don't abuse the interests of their retail and institutional clients? The existence of powerful economic groups that trade on insider information does not inspire confidence on the part of minority shareholders.

Latin America's return to the international capital markets represents a well-earned vote of confidence. Still, the amounts raised on the international markets must remain relatively small. The great bulk of the region's capital needs must be met by mobilizing domestic savings.

The level and growth of domestic savings within most Latin American countries is impressive, but the record of transforming them into domestic long-term investment has not been good. Long-term institutional investors, with few exceptions, either did not exist or have been driven abroad through a combination of excessive regulation and high inflation. The activities of the banking sector have been distorted by high reserve requirements, directed credit and interest rate control, creating an inability to meet investor needs. In some countries, the banking system merely funds government deficits with no real attempt to foster productive investment. But gradually this is changing, and institutional investors are returning to the market.

The development of Latin America's domestic capital markets is a foremost IDB priority. The Bank has used three main instruments in its work in this field.

One instrument is the IDB's investment sector loans. A government receives such a loan in exchange for a commitment to implement policy reforms designed to eliminate barriers to private investment and strengthen investor confidence. Such reforms have been carried out in the areas of legal and regulatory systems governing trade, taxes, commercial codes and foreign and domestic property rights. Other measures include lifting import restrictions, privatization, the protection of intellectual property rights, ensuring freedom in collective bargaining and eliminating unnecessary state intervention.

Multisectoral credit programs are a second IDB instrument to spur private investment. Unlike traditional credit programs, which were designed to benefit a single sector, the new programs strengthen the private sector by letting the market decide where credit is to be used. An important complementary aim of the programs is to encourage banks to become a source of long-term financing.

*The countries are undergoing a fundamental change in attitude in favor of market forces and private ownership.*

In past years, it has been nearly impossible for businesses to get medium- and long-term credit. The reason is simple: if banks can only capture short-term deposits, they will understandably be unwilling to risk long-term lending. Consequently, a five-year investment project may have to be financed with loans rolled over every 90 days. Not surprisingly, loans to related groups and the largest clients generally receive preferential treatment.

In an IDB multisectoral credit program, the Bank lends to a wholesale public banking institution that in turn rediscounts loans to commercial banks that have been selected on the basis of solvency, experience and ability to provide long-term credit.

By preselecting a fairly homogenous group of banks with good credit ratings, the IDB has been able to experiment in allocating credit via an auction mechanism. In Bolivia, voluntary long-term lending has grown at prices comparable to the auction rate.

The IDB's third mechanism to spur the development of capital markets in Latin America is technical assistance.

In Mexico, for example, the Securities Exchange Commission asked the IDB for help in establishing a second tier stock market that would provide listing opportunities to smaller and emerging companies. In the past, smaller firms were discouraged from participating on the existing stock market by high costs, the reluctance of brokers to risk capital in shares that may trade only a few times a month, and lack of information on small companies.

With IDB support, the Mexican authorities are developing a call auction trading system in which orders can be combined and matched periodically rather than continuously, thereby saving money. Measures are also being considered to simplify financial reporting and distribute information inexpensively to a broader group of investors.

Latin America is undergoing a fundamental change in attitude towards market forces and private ownership. Admittedly, it is easy to adopt market principles when the results are as spectacular as they have been. But what happens if returns begin to weaken? The political pressure to return to the old ways of paternalism, protectionism and statism would undoubtedly increase if there were a prolonged period of stagnation. But we are confident that Latin America will continue its present policy course, and this will underpin future economic growth.

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IDB EXTRA

GROWTH WITH EQU

Supplement to *The IDB* • Publication of the Inter-American Development Bank • 1993

DAVID MANGURIAN IDB

*City residents tap into a broken water pipe. Throughout the region, demand for services far outstrips their supply.*

# Latin America's social imperative

A nation's economy, political system and level of social development are like the three horses of a Russian troika. Unless all three advance together, progress comes to a halt.

Once again, the economies of Latin America and the Caribbean are on the move. After a decade of economic crisis, the region has emerged as a stunning showcase for economic reform.

These same winds of change have also breathed new vitality into the region's democratic institutions. Today, nearly all of the region's peoples are governed by constitutionally elected leaders.

But these impressive gains rest on a fragile social foundation. Great segments of Latin American society remain shut out of the growing prosperity. Many millions of people feel they have no real voice in the decisions that affect their lives.

Particularly worrisome, the region's otherwise successful economic reforms have cost the jobs and livelihoods of millions of people. For many, the cure has been even worse than the illness.

**Eroding expectations.** The sobering fact is that Latin America today has more poor people than at the beginning of the past decade. The problem is heightened by inequitable distribution of wealth and a growing perception by the people of Latin America that the future will hold fewer opportunities for them and their children.

"Expectation and hope are eroding," says Maritza Izaguirre, head of the Bank's Social Development Subdepartment, "and with them the essential ingredients in human dynamism and creativity."

*"Today there are more economic reasons than ever for concluding that improved social conditions are the principal prerequisite for growth."*

*Enrique V. Iglesias, President*
*Inter-American Development Bank*

**The challenge.** The region's overarching goal must now be to reverse past patterns of social and economic exclusion. More than an ethical imperative, a policy of inclusion is also a precondition to a modern, competitive economy, which relies on the creativity and commitment of all its participants.

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# Latin America's social imperative

Poverty is not new to Latin America. Indeed, its roots can be traced back 500 years, to the implantation of colonial-era social structures that set the region on a historical path of inequitable development.

But there is something new about poverty in the region today. Despite steadily improving economic performance in most countries and hopeful prospects for the long-term future, overall living standards remain stagnant. In this era of economic recovery, the majority of the region's population is, in economic terms, worse off now than 20 years ago.

Ironically, the economic reforms that governments have carried out with such success bear some responsibility for the deteriorating social conditions. Conversely, the persistence of poverty threatens the prospects for sustaining the reform policies.

In this crucial period, policymakers are taking a new look at ways to address the issue of poverty. Many of them will gather at IDB headquarters in Washington, D.C., in mid-February for the first Forum on Social Reform and Poverty. The event is being held jointly by the IDB and the United Nations Development Programme. (See article page 8.)

**Invest in people.** The problem of poverty dovetails with other key social and development issues that, to be addressed effectively, must be addressed together. For example, as Latin America becomes increasingly integrated into the world economy, the region faces a growing need to invest in human capital and promote broader social participation in the development process.

In addition, the very success of market-based policies depends on the ability of economic participants— employees, entrepreneurs and investors— to put their talents and energies to work. To do so, they require a stable legal, institutional and sociopolitical environment.

*The persisting problem of poverty threatens prospects for sustaining the region's economic reform policies.*

While no single solution can address all these issues at once, a consensus is forming on priority areas of action. One task of particular importance is that of strengthening the state's ability to carry out its new responsibilities.

Closely related to this is the task of broadening and intensifying the participation of civil society— including community-based groups and the private business sector— in the development process.

Also of high priority are policies and programs designed to reverse the historical patterns of inequitable distribution. This means devising strategies for alleviating poverty in the short term and progressively reducing it in the future, specifically targeting services and opportunities to previously disadvantaged groups.

Specific measures to promote equity would include:

- ▶ Providing credit and investment in technology to further the development of both the informal and formal entrepreneurial sectors.
- ▶ Reorganizing the government budgeting process to increase efficiency and to ensure that expenditures are targeted equitably.
- ▶ Reorganizing systems for the delivery of public services, particularly in education, health, housing and sanitation, and developing new forms of cooperation between civil society and the state.
- ▶ Strengthening the ability of the state in the social area and promoting the kind of "good government" that is deserving of society's support.

The success of all these efforts must be founded on a commitment to use natural resources responsibly, and to eliminate discrimination based on gender and ethnic and racial groups. The final product of successful social reform will be both the fuller realization of each human being's potential and the blossoming of Latin American society as a whole.

*— Maritza Izaguirre*

WORLD BANK NEWS

WBN February 11, 1993

# Preston Calls for Stronger Attack On Poverty in Latin America

World Bank President Lewis Preston said that as Latin American countries move beyond the debt crisis, they must attack poverty more directly and aggressively. "The greatest challenge now is to improve the coverage and efficiency of social services," Preston told a conference on social reform and poverty organized by the Inter-American Development Bank and the United Nations Development Programme on February 10.

"If growth is to be sustainable, and if it is to have real meaning for the people of the region, their governments must do a better job of providing education, health and nutrition for the poor," Mr. Preston said.

He added that Latin America had traditionally spent less on social services than some other regions—East Asia, for example—and that economic reform and growth should help governments find more "fiscal space" for social services. But some basic budgetary reallocation is also required, he noted, and "rationalizing military and other non-productive expenditures would be a useful place to start."

Lewis Preston

The World Bank President also emphasized that there was considerable scope for governments to improve the efficiency and impact of social service expenditures—by better focusing programs on the poor and increasing cost recovery from people who can afford to pay for services. He gave the example of food subsidies that are available to all, regardless of income level. These subsidies could be "effectively replaced by more carefully targeted programs that reach those most in need." He added that "it requires political will to make the necessary reforms."

Preston said that external aid agencies must assist the countries of Latin America in stepping up their poverty reduction efforts. He noted that the World Bank's lending for human resource development in the region in 1993 is projected to be four times greater than five years ago.

IDB Photo/Carlos Conde

Students in Ecuador work on writing assignments.

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# President-Elect Clinton Tells Haitians "Leaving By Boat is Not the Route to Freedom," Urges Return to Democracy

PRESIDENT-ELECT CLINTON'S RADIO BROADCAST TO THE HAITIAN PEOPLE, JANUARY 14, 1993 [3]

Ladies and Gentlemen, Greetings. This is President-Elect Bill Clinton.

I speak to you today, before I take office, to express my strong support for the return of democratic government to Haiti, and to help prevent the tragedy of injuries and death coming from boat departures from your country.

I speak out of my deep concern about the situation in Haiti, and my strong desire to promote freedom, human rights, and progress to the Haitian people.

Several years ago, I saw personally the beauty of your land. I felt the warmth of your people and ever since then, I have wanted you to have freedom and democracy and economic opportunity.

The United Nations and the Organization of American States, with the full support of the United States, are now working with energy and determination to promote agreement among all Haitian parties on a political solution for your nation. I spoke with President Aristide just last night and expressed my full support for the negotiations seeking a political solution, which he also welcomes.

Progress toward a settlement will improve the human rights situation for all Haitians and create a brighter future for your country. That is why, as we work to restore democracy in Haiti, I urge Haitians to remain in Haiti and not to leave by boat.

Many hundreds of Haitians, including women and children, have already lost their lives in dangerous sea voyages. Just this week, some 400 Haitians, packed aboard one ship, are reported to have died at sea. President Aristide has told me that he also is deeply concerned about the dangers of leaving Haiti by boat. He believes, as I do, that it's better for Haitians to stay in Haiti, to participate peacefully in building a better future for your country.

For Haitians who do seek to leave Haiti, boat departure is a terrible and dangerous choice. I have been deeply concerned by reports that many of you are preparing to travel by boat to the United States, and I fear that boat departure in the near future would result in further tragic losses of life.

For this reason, the practice of returning those who flee Haiti by boat will continue, for the time being, after I become President. Those who do leave Haiti for the United States by boat will be stopped and directly returned by the United States Coast Guard.

*The practice of returning those who flee Haiti by boat will continue, for the time being, after I become President.*

To avoid the human tragedy of a boat exodus, I wanted to convey this message directly to the Haitian people: leaving by boat is not the route to freedom.

I also want to remind you that you do not need to risk your life to apply for refugee status and entry into the United States. You can apply from within Haiti, through the United States Embassy in Port-au-Prince. More than 7,000 Haitian citizens have already done so over the past year.

And when I become President on January 20, I will immediately begin to make it easier and safer for Haitians to apply for refugee status within Haiti. In particular, I will substantially increase the numbers of United States officials in Haiti, so that we can speed up the application process and make it easier for those who live outside of Port-au-Prince to apply.

I will also work with the United Nations and the Organization of American States to bring substantial numbers of observers into Haiti to help prevent human rights abuses in Port-au-Prince and in other parts of the country.

I hope that all these measures convince Haitians not to leave Haiti by boat.

Because of my deep concern about the dangers of boat departure, let me repeat, once more, what I said earlier:

The practice of returning those who flee Haiti by boat will continue, for the time being, after I become President.

Those who leave Haiti by boat for the United States will be intercepted and returned to Haiti by the U.S. Coast Guard.

Leaving by boat is not the route to freedom.

Restoring democratic government is the best hope for the people of Haiti, and I want to tell you again I am committed to working toward that goal.

In the weeks and months to come, I will seek additional ways to help Haitians who fear persecution in Haiti, and to treat all of them with fairness. But whatever future actions I take, my policies will continue to promote the return of democracy to Haiti, to discourage the dangerous practice of boat departure, and to expand opportunities for the people of Haiti to make applications for refugee status from within their own country.

We all have new hope that the negotiation effort of the United Nations and the Organization of American States will improve the human rights situation in Haiti and eliminate the reasons for boat departures.

To all Haitians, I urge you to work with me and with President Aristide to bring democracy back to your country.

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1 Statement at Department of State daily press briefing by Department Spokesman Richard Boucher, January 6, 1993.

2 Mr. Christopher testified before the Senate Foreign Relations Committee, January 13 and 14, 1993. The complete transcript of the hearings will be published by the committee and will be available from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20420.

3 Text provided by the Office of the President-Elect and Vice President-Elect, Little Rock, January 14, 1993.



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## Panel To Examine Truth Commission Report On El Salvador

*Statement by Secretary Christopher released by the Office of the Assistant Secretary/Spokesman, Washington, DC, March 24, 1993.*

Today, I have appointed a panel to examine the implications of the UN-sponsored El Salvador Truth Commission report for the conduct of US foreign policy and the operations of the Department of State. The panel will be co-chaired by retired career Ambassadors George Vest and Richard Murphy.

Acting as academic advisers to the committee will be Professor I.M. Destler of the University of Maryland and Professor Carol Lancaster of Georgetown University. Professor Destler has authored several books and articles on the foreign policy process, including a seminal work on the subject titled *Presidents, Bureaucrats and Foreign Policy*, Princeton University Press, 1972 and 1974. Professor Lancaster is a noted scholar and has authored numerous articles on development and Third World issues.

The atrocities committed during the long civil war in El Salvador are well documented in the Truth Commission Report. Although the report contains no explicit criticism of the US Government or its representatives, its publication does have implications for the conduct of US foreign policy and the Department of State's operations. Respect for human rights is a cornerstone of US foreign policy, and when questions arise that challenge our commitments, we have an obligation to seek answers.

Accordingly, I have asked this panel to review the Truth Commission's Report and examine the activities and conduct of the Department during this period. The panel's review will include responsiveness to congressional and public inquiries, human rights reporting, and the degree to which we encouraged State Department officers to conduct a full and independent inquiry of abuses by both sides in the civil conflict. The panel is to report its findings to me and make recommendations on steps the Department can take to ensure that the Department functions in a manner consistent with the highest professional and ethical standards and our nation's values. ❑



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