UNITED NATIONS

ECONOMIC COMMISSION
FOR LATIN AMERICAN
AND THE CARIBBEAN

DISTR.
LIMITED

LC/WAS/L.33
8 March 1996

ORIGINAL: ENGLISH

INTERNATIONAL ECONOMIC HIGHLIGHTS

1995

22 MAR 1996

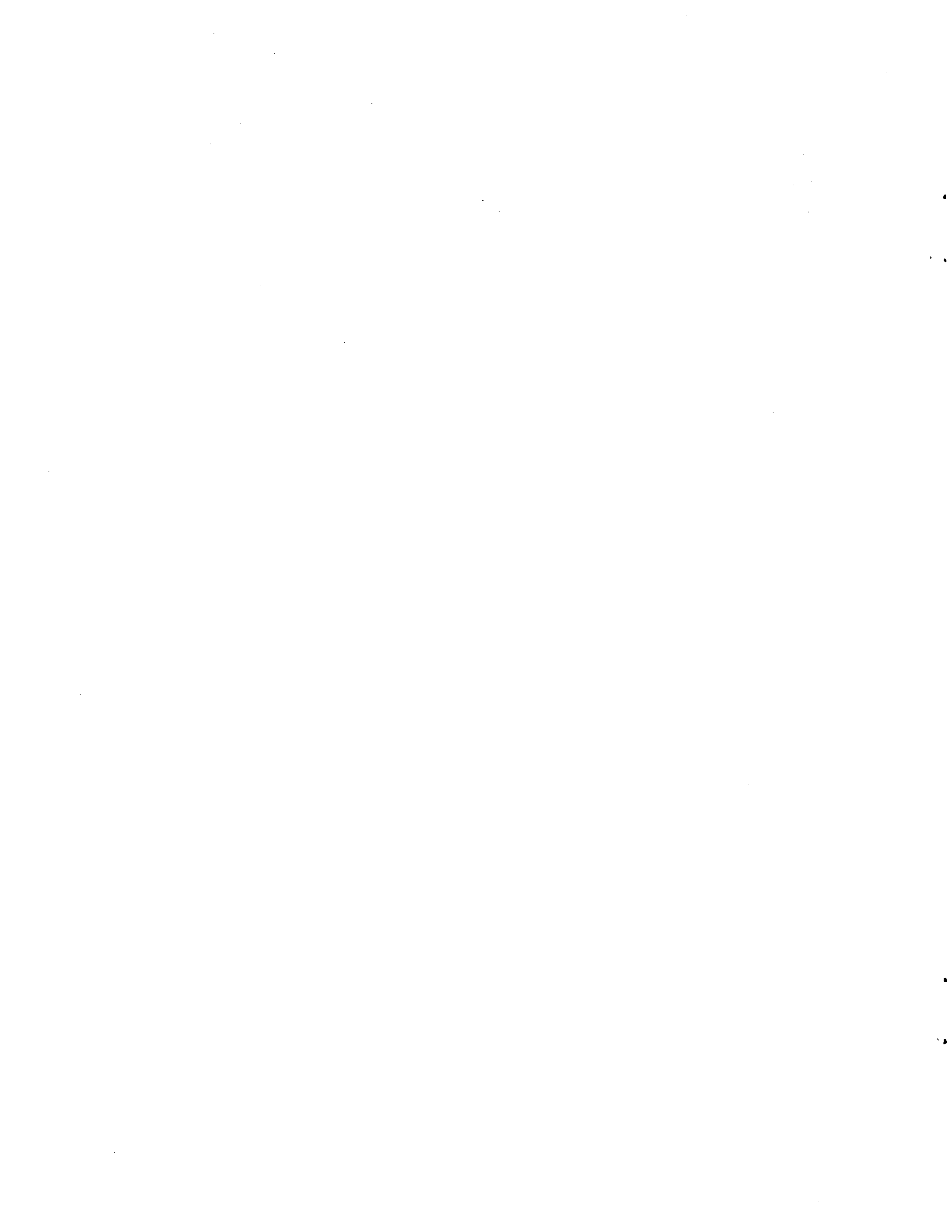


TABLE OF CONTENTS

PRESENTATION

I. THE WORLD ECONOMY

1. The IMF's First World Economic Outlook (WEO) 1
2. The Halifax Summit 3
3. Institutional Engineering in Halifax 5
4. Economic Globalization and Labor 6
5. Who Prevails, the Market or the Regulators? 8
6. Defiant Derivatives 10
7. The IMF's Second World Economic Outlook (WEO) 12
8. The Paranoia of Globalization 14

II. THE U.S. ECONOMY

1. Anxiety Amid Good News in 1995 17
2. The State of the Union: Searching For the Center 19
3. The Economic State of the Union 21
4. The Battle of the Budget 23

III. THE JAPANESE ECONOMY

1. Japan In Recession, Again? 25
2. Japanese Economic Reactivation 27
3. Can U.S. Revisionists on Japan Claim Victory? 28

IV. THE DEVELOPING ECONOMIES

1. External Finance for Developing Countries 31
2. Prospects for the Developing Economies 33
3. Latin American and Caribbean Economic Prospects 34
4. Institutional Investors in Emerging Markets 36
5. The Rise of the Capital Account in Emerging Markets 38

V. THE MEXICAN ECONOMY

1. The Mexican Package 41
2. Fallout From the Mexican Package 43
3. The Search For the Culprit in the Mexican Meltdown 44
4. Looking For a Lender of Last Resort 46
5. Factors Behind the Mexican Crisis, According to the IMF 48

VI. TRADE

1. The Clinton Administration's Trade Liberalization Policy 51
2. The U.S. Trade Policy Agenda for 1995 53
3. The Denver Ministerial 54
4. Brazil and the United States Review Their Trade Relations 56
5. The End of Consensus on U.S. Commercial Policy? 58

VII. MULTILATERAL FINANCIAL INSTITUTIONS

1. New President for the World Bank 61
2. The Spring Meetings of the Bretton Woods Institutions 63
3. The IMF's Annual Report 65
4. The World Bank's Annual Report 67
5. The IMF-World Bank Annual Meetings 69

PRESENTATION

This is the ninth year that the weekly dispatches transmitted during a year by ECLAC Washington, to ECLAC Santiago and other subregional offices, are gathered in a single document.[1]

For their presentation here, the dispatches are classified by subject and ordered chronologically within each chapter. The heading of each chapter indicates the relative saliency of these issues within the international economic agenda.

The three most important issues that dominated the international economic agenda, throughout the concluding year, are listed in this presentation according to what, avowedly, is a very subjective ordering of their relative importance.

1) The debate over economic policy and the role of government in the United States acquired extraordinary intensity, due to the control by the Republican Party of the legislative majority and the approach of this year's presidential election. Only time can tell how the outcome of this confrontation will affect the participation of the United States in the world economy.

2) The depression of the Japanese economy deepened, without immediate reactivation in sight. On the contrary, problems of bank solvency intensified, consumers remained reluctant to spend, land prices continued falling and the government was unable to come out with a credible reactivation package. In this context, the yen's appreciation, during the first half of 1995, only deepened the slowdown even more.

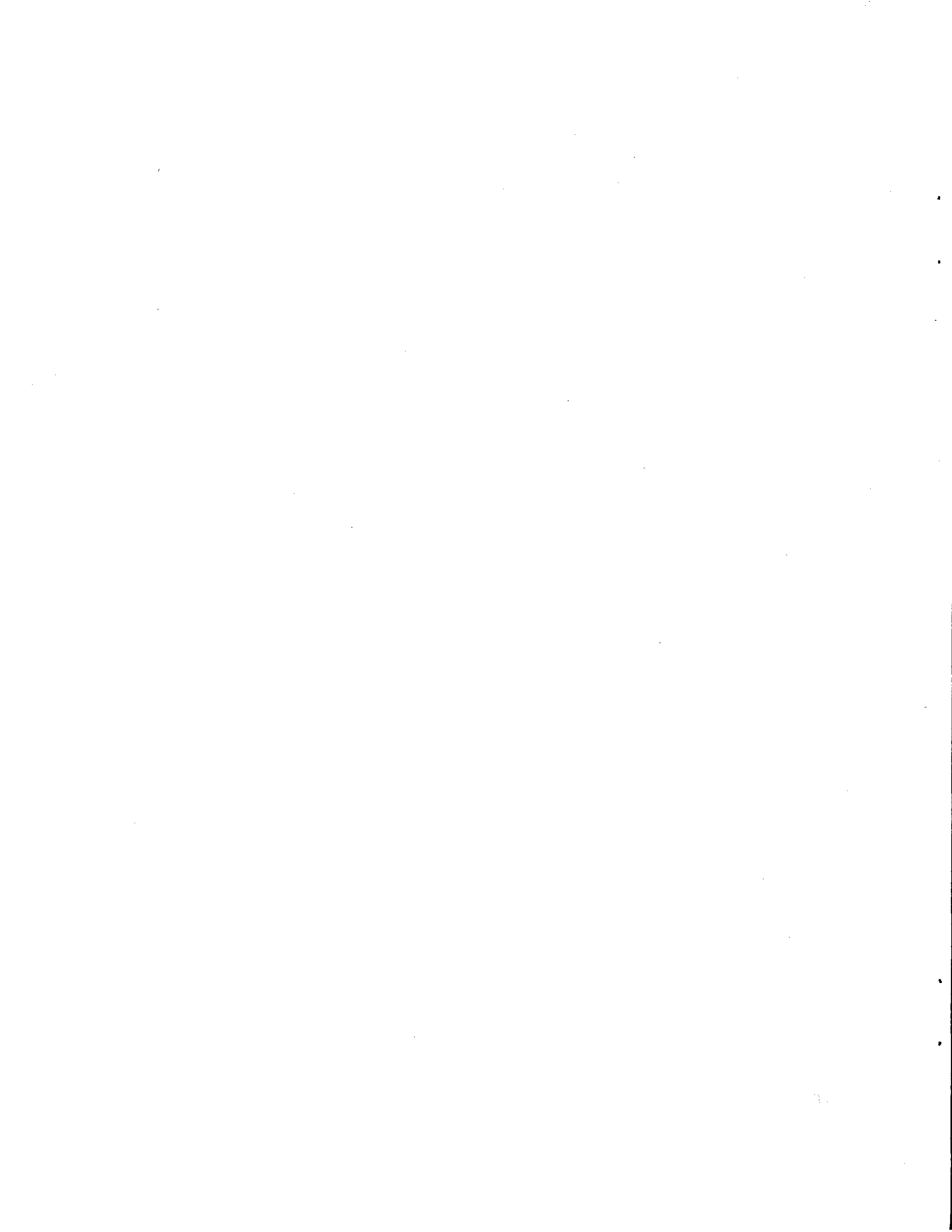
3) Finally, the Mexican financial crisis showed the vulnerability of most emerging markets to sudden capital movements, particularly among those low savers of the Western Hemisphere. Investors remained skeptical throughout the year about sending their money to these markets, which contributed to a slowdown in the regional average rate of growth of Latin America and the Caribbean for the year running.

Some of these issues were described throughout the year in the regular transmissions of this Dispatch. The purpose of gathering these dispatches is to make them available for easier consultation in a single document, in case the Washington D.C. vantage point they present still has some testimonial value.

Finally, those readers that are not familiarized with the dispatches should be reminded that they try to remain within a self-imposed limit of 750 words, because their purpose is only to bring an issue to the reader's attention.

---

[1] ECLAC Washington, International Economic Highlights, (LC/WAS/L.2) 17 August 1988; (LC/WAS/L.4) 17 March 1989; (LC/WAS/L.8) 15 March 1990; (LC/WAS/L.11) 22 March 1991; (LC/WAS/L.14) 11 March 1992; (LC/WAS/L.17) 11 March 1993; (LC/WAS/L.23) 30 March 1994; (LC/WAS/L.27) 21 February 1995.



I. THE WORLD ECONOMY

I. 1. THE IMF'S FIRST WORLD ECONOMIC OUTLOOK (WEO) (WDW/13/95 17 MAY 1995)

As every year, the advanced copy of the first WEO was released on April 23, just ahead of the annual Spring meetings of the Fund and the Bank (WDW/12/95, p.63). In two volumes, the first contains the main report and the second the supplementary analyses, excluding only the full statistical appendix, to be included in the final version due to be published sometime in May.

The main report contains the following chapters: I) economic prospects and policies; II) policies for sustained growth in industrial countries; III) policy challenges facing developing countries; IV) disinflation, growth and foreign direct investment in transition countries; and V) a special topic, saving in a growing world economy.

The second volume contains the following annexes: I) factors behind the financial crisis in Mexico; II) adjustment in Sub-Saharan Africa; III) structural fiscal imbalances in smaller countries.

The important progress experienced by the world economy in 1994, according to the staff of the IMF, shows that a new global expansion has started. After the slowdown of 1990-93, "world growth last year was in line with its long term trend of 3 1/2 to 4 percent while world trade expanded by an impressive 9 1/2 percent, well above its long term average."

Output in the industrial countries increased 3 percent in 1994, the highest rate of growth in five years, with buoyant economic conditions in North America and the United Kingdom, recoveries in continental Europe, and a modest pickup in Japan. Despite the turmoil in some emerging financial markets, in 1994, the developing countries experienced an average rate of growth of 6 percent, in line with the last three years. Finally, in the economies in transition the picture was mixed, with vigorous economic growth experienced by the radical reformers, while output declined in those countries that followed "a less comprehensive strategy."

However, two factors contradicted this positive performance. First, the loss of confidence by investors in some emerging markets, which began before the financial crisis in Mexico, and second, the turbulence in exchange markets caused by the principal currencies.

Still, world economic growth is projected "to remain fairly robust during the period ahead." The industrialized countries are expected to grow in 1995-96 at an average rate of

around 3 percent. The outlook for the economies in transition is also positive, if there will prevail sound financial policies and structural reforms, their rate of expansion can reach 5 percent or more over the medium term.

By contrast, growth in the developing countries is expected to "slow slightly in 1995-96." The Western Hemisphere will show the "most profound slowdown," while Asia will moderate its strong rate of expansion and Africa and the Middle East will experience "some strengthening of growth."

Because of the financial crisis in Mexico and its contagion effects, the projection for the developing countries of the Western Hemisphere was revised downwards by one percentage point to 2 1/4 percent in 1995. This downward revision of the regional average is accounted by Mexico's output expected to decrease by 2 percent in 1995, while growth in Argentina is expected to "slow significantly in 1995-96, to around 3 percent." Also, in 1995, Peru is projected to slow down to 4.5 percent, less than half of the spectacular rate of the previous year and Venezuela will experience another decline in output of 2 percent. Only Chile, Colombia and Brazil are projected to grow at around 5 percent in 1995, still not enough to counter the downward revision of the regional average.

The lessons from the Mexican episode are analyzed separately in an annex. To begin with, surges in capital flows to developing countries are blamed for excessive liquidity expansion, unsustainable external imbalances and excessive real exchange rate appreciation. In other developing countries of the Western Hemisphere, the sudden reversal of capital flows, particularly of portfolio investment, also exposed the fragility of banking systems.

Two specific policy lessons are drawn from the Mexican episode "for countries that are confronted with shifts in market sentiment." In the short run, to correct domestic and external macroeconomic imbalances, monetary conditions should be tightened through increases in domestic interest rates and fiscal adjustments, even if the initial imbalances originate in the private sector. In the medium term, the underlying causes should be addressed, such as low saving and relative price distortions.

The other policy lesson has to do with exchange rate regimes, particularly in those countries where the exchange rate is an anchor of a wider stabilization strategy. This deserves a full quotation. "The initial response to exchange market pressures should consist primarily of monetary tightening. However, under circumstances of sustained pressures, accepting a devaluation or abandoning a fixed exchange rate parity may be the only credible policy response." In such a case, "to limit the inflationary impact of the devaluation," it will be necessary to enforce a "tight monetary and credit policy, as well as a fiscal stance that is consistent with the new policy regime."

I. 2. THE HALIFAX SUMMIT
(WDW/18/95 21 June 1995)

The leaders of the seven most industrialized democracies met in the twenty-first summit, over the weekend in Halifax, Nova Scotia--"the poorest corner of Canada," according to Anne Swardson, from the Washington Post. This choice of venue was part of a deliberate attempt by the hosts, to avoid the usual extravagance and instead display some Canadian modesty and austerity. As characterized by Canadian Prime Minister Jean Chretien, the aim was a "Chevy" not a "Cadillac" summit.

The participating governments were asked to limit the number of delegates and the press contingent was smaller too. By contrast with last year's summit held in Naples, only one half of the government delegates and one third of the press correspondents were present in Halifax.

Also, the meetings took place in the empty floors of an office building and the meeting tables were those used last year at the Naples meeting. Finally, to keep costs under the US $25 million, spent seven years ago at the Toronto summit, the government this time allowed private sponsors to supply food and services in exchange for advertising.

A German veteran of every summit, quoted in the New York Times, declared that "he had never seen such a warm welcome," since the first summit held in Rambouillet, France in 1975. Even the final communiqué was leaked and circulated throughout the world a week in advance.

However, summits are not only symbols and ritual, there is always some substance hidden behind the lavish dinners, the fireworks and the cryptic language of the communiqué. As recalled by Michel Camdessus, Managing Director of the International Monetary Fund (IMF), at the third annual Sylvia Ostry lecture pronounced in Ottawa only a week before the Halifax summit, there have been "some landmarks." For instance, the support for multilateral trade, by the Bonn summit of 1985, opened the door, the following year, to launching the Uruguay Round. The Tokyo summit of 1986 supported the policy coordination required to enforce the Plaza agreement on exchange rates, as the Venice summit of 1987 endorsed the Louvre Accord. Finally, the Toronto summit of 1988 approved the granting of debt relief for the poorest countries.

The question is what landmark will be recalled from the Halifax summit. Perhaps Halifax will be remembered as the summit that launched the process of reform of the multilateral financial institutions (MFIs) (WDW/19/95, p.5).

This does not mean that there were not other more pressing issues, such as the confrontation between Japan and the United States over Japanese automobile imports, or the dollar's fall. However, these were removed discreetly by means of a preliminary press

conference held jointly by Prime Minister Murayama and President Clinton and by a brief mention in the final communiqué. Even the hostilities in Bosnia were adroitly set aside, in a statement drafted at the urging of the newcomer French President Jacques Chirac.

In the end, the final communiqué remained as the version that was previously leaked. It contains sections dedicated to growth and employment; meeting the challenges of the 21st. century; creating opportunities through open markets; economies in transition; nuclear safety; and concludes announcing that next year's summit will be held in Lyon, France, from June 27 to 29.

The section on the challenges of the next century is the most detailed and signals the kickoff for the process of institutional reform. The major challenge is characterized as the management of the world economy's "increased interdependence while working with the grain of markets and recognizing the growing number of important players."

At issue is the prevention of crisis, such as this year's Mexican episode, amid the increased globalization and integration of capital markets. The measures proposed include: more timely publication of key economic and financial data; creation of an "Emergency Financing Mechanism" at the IMF; to expand the General Agreements to Borrow by doubling the $28 billion presently available; to support the discussions on a new IMF quota review; mandates the IMF to review the role of the Special Drawing Rights (SDRs); and urges closer cooperation between regulators and supervisors of financial institutions and markets.

The communiqué also supports other shared objectives, such as promoting sustainable development, reducing poverty, safeguarding the environment and preventing and responding to disasters and other crises.

Finally, a specific section is dedicated to "reinforcing coherence, effectiveness and efficiency of institutions," including the MFIs and the United Nations. Mentioned specifically is the elimination of overlaps between the United Nations Conference on Trade and Development (UNCTAD) and the new World Trade Organization (WTO), and "the roles of certain institutions in light of evolving challenges, eg. Regional Economic Commissions and UNIDO."

Therefore, several experienced summit watchers concluded that these results were not as disappointing as could be expected from a meeting where five of the participants, except the host and the newly elected President of France, were experiencing exacting domestic political challenges.

I. 3. INSTITUTIONAL ENGINEERING IN HALIFAX
(WDW/19/95 28 JUNE 1995)

Extraordinarily, with the final communiqué of the Halifax summit (WDW/18/95, p.3), the leaders of the G-Seven released a background document titled Review of International Financial Institutions. With this unusual release, the G-Seven leaders deemed it necessary to present a lengthier explanation and clarification of their institutional reform proposals. Even so, the background paper contains less and more on institutional reforms than the cryptic final communiqué.

For instance, while the paper deals exclusively with the financial institutions, the communiqué addresses the need for coordination with those United Nations bodies that deal with economic issues. Also, the paper recalls that the mandate to discuss institutional issues was approved at last year's Naples summit. However, both the paper and the communiqué recognize that the events that took place between the two summits have imposed a certain degree of urgency on the need to reform the institutional framework that presently prevails.

As recalled before Halifax by Michel Camdessus, Managing Director of the International Monetary Fund (IMF), three major monetary and financial crises have confirmed the wisdom of the institutional question asked by the Naples summit. The question, referred for its examination to Halifax, was "how can we adapt existing institutions and build new institutions to ensure the future prosperity and security of our people."

The three events, identified by Mr. Camdessus as imposing the urgency of institutional reform, are the Mexican episode, the failure of Barings and the dollar's fall. These issues, said Mr. Camdessus perhaps with a bit of hyperbole, made of Halifax "already a summit of the 21st century, dealing with the next century's challenges."

The following challenges are enumerated in the background paper: 1) "the global economy is more integrated"; 2) "world trade has grown steadily and direct and portfolio investments have increased sharply"; 3) "capital market liberalization, technological change, and financial innovation have transformed the global financial landscape"; 4) "there is greater consensus on the role of the market, economic incentives, and open policies, and much less faith in dirigiste solutions to economic problems"; 5) "a variety of global challenges have emerged in areas such as environmental stewardship and the importance of good governance"; 6) "the influence of developing countries in the world economy is growing, yet, a large portion of the world's population still lives in extraordinary poverty."

To deal with these challenges, the paper enumerates the following "interrelated elements." First, "an improved early warning system is needed to avoid financial shocks." Second, "ensure that the capacity exists to induce appropriate policy responses at an early stage." Third, "appropriate and adequate financial mechanisms." Fourth, "an effective system of cooperation among the major industrial countries and multilateral financial institutions is

needed, which allows a rapid and concerted response to external shocks." Finally, "there may also be a need to look at other mechanisms that might usefully be considered in situations of financial crisis."

The first institutional response asks the IMF to improve its surveillance activities in specific ways. The second institutional response aims at adopting policy responses that are "early and appropriate," through the creation of two financing mechanisms, a new "Emergency Financing Mechanism" at the IMF and the doubling of the General Agreements to Borrow (GAB) by the G-Ten and other countries. The third institutional response calls for strengthening financial market supervision and regulation, through the Basle Committee on Banking Supervision and the International Organization of Securities Commissions. The fourth institutional response asks the multilateral development banks to allocate resources more efficiently, emphasize poverty reduction and to reduce the debt burden of the poorest countries.

To strengthen "governance and management," two options are suggested about the functioning of the Interim and the Development Committees. In the first option, both committees would be merged into a "single joint Fund-Bank Committee to focus on global financial and development issues." The other option is to transform the Development Committee into a steering body for the World Bank Group, as the Interim Committee oversees the functioning of the IMF. In either case, Ministers would only attend the annual meetings, while the spring meetings would be attended only by senior officials.

Finally, more coordination is asked between the IMF and the OECD in the area of macroeconomic surveillance, while closer coordination is also asked from the WTO with the IMF, the World Bank, the OECD and "trade-related UN bodies to avoid unnecessary duplication in their activities." Anyway, all these institutions are asked to be more "cost-effective."

As described, the institutional proposal contained in the background paper does not entail profound transformations of existing institutions, neither the creation of new institutions. This is consequent with the premise, stated at the beginning of the paper, that "the international financial institutions have demonstrated an exceptional degree of flexibility in adapting to changing demands. Nevertheless, there remain a number of areas where improvements are both possible and desirable."

I. 4. ECONOMIC GLOBALIZATION AND LABOR (WDW/20/95 5 JULY 1995)

This time, the World Bank cannot be accused of avoiding controversy. This year's World Development Report (WDR), released on June 29, explores the highly controversial

issue of how the workers of the world are adapting to increased levels of international integration.

After eighteen successive issues, for several reasons, the WDR's yearly release is a well-established agenda setting exercise. First, because of the saliency of the topics discussed and second, for the influence these reports exercise on what still is the main source of multilateral development lending. Some previous reports were dedicated to less controverted issues, such as health and infrastructure, while other more quarrelsome topics, such as the environment, poverty, and development strategies, have also been analyzed.

As stated in a news release, the Report comes out against "doomsayers." Particularly those that see in the integration of the world economy, coupled to the impressive growth of the labor force in developing countries, "a source of falling wages and job insecurity." Also, as indicated in the foreword by President Wolfensohn, one goal of the Report is to "spark a broad and informed debate on these often contentious issues."

The Report's chapter headings illustrate this: 1) which development strategies are good for workers? 2) is international integration an opportunity or a threat to workers? 3) how should governments intervene in labor markets? 4) how can policy choices help workers in periods of major change? and 5) outlook for workers in the twenty-first century.

To begin, the Report presents some orders of magnitude about recent spectacular changes in the world's work force. In 1978, two-thirds of the world's laborers lived, one third each, under centrally planned economies, or sheltered behind protective barriers. By the year 2000, it is projected that only 10 percent of the work force will be isolated from the world market.

Amid these changes, the most successful development strategies come out of East Asia, in the form of labor-demanding growth, investment in people and infrastructure, support for family farms, high saving ratios and vigorous exports. True, the formerly centrally planned economies, by contrast, achieved "high degrees of equality," but, despite high levels of investment, labor incomes first stagnated and then collapsed. Also contrasting is the case of Latin America, where an attempt to bias investment against agriculture and sheltering industrial workers behind protective barriers, dictated wage increases and job creation in the public sector, but could not overcome highly unequal income distribution.

According to the Report, those who perceive as threatening the international flows of goods, services, persons and capital disregard some facts. First, where "exports have risen fast, so have real wages--by an average of 3 percent per year." Second, one third of the capital flows to developing countries are foreign direct investment that creates many new jobs. Third, migration "has usually brought income gains to those who move, higher remittances to those who stay, and increased production of goods and services in the host countries." Finally, a "small but vocal minority" in the industrialized countries, who fears competition from low-wage imports, is reminded that such imports represent only 3 percent of industrial countries' GDP.

The Report also supports public intervention to complement formal and informal labor markets. For instance, legislation is not enough to influence labor conditions in informal markets, "direct public action" is needed to influence "the working environment and the health of workers." In the formal sector, the government needs to set the rules for labor management interaction, "spelling out the rights of workers and firms, establishing dispute resolution mechanisms, and promulgating basic health and safety regulations." Decentralized collective bargaining is recommended, "to determine wages and working conditions." According to Michael Walton, the team leader that drafted the Report, unions "can be forces for productivity increase, better working conditions, and a better civic society." However, unions can also have "negative economic effects" when they "behave as monopolists" for the protection of minority groups. On labor relations, by contrast with wage and employment increases, the record of the East Asian economies "is less enviable." However, it is emphasized that poor labor relations are "not key to East Asia's success."

Additionally, "direct government intervention makes sense in dealing with child labor and in other cases where the market may produce adverse outcomes, such as discrimination against women."

On the linkage between labor standards and trade agreements, the Report recognizes that "there is a case for international concern over core standards," understood as "basic rights that do not directly raise labor costs." Nonetheless, "it is best to keep multilateral trade agreements confined to directly trade-related issues, to prevent protectionist interests from misusing such links to reduce trade."

To conclude, markets are asked to create opportunities, "taking care of those who are vulnerable or left out, and providing workers with the conditions to make their job choices freely, bargain over their conditions of work, and take advantage of better educational opportunities for their children."

I. 5. WHO PREVAILS, THE MARKET OR THE REGULATORS? (WDW/24/95 6 SEPTEMBER 1995)

On Monday, August 21, the Washington Post awoke the city with the news that the International Monetary Fund (IMF) blamed Mexican investors for the peso crisis and that the Fund supported using controls to regulate capital flows across national borders. This is hardly the kind of news capable of awakening a city where the Congress was in recess and the President and almost everybody were on vacation, while the barometer registered the longest stretch on record of temperatures above 90 degrees, without rain in sight.

Even so, what these news revealed in effect was that the IMF's annual report on the behavior of international capital markets can reach the Post's top right-hand column, but only in the stillness of the Washington summer.

The news did generate a stampede among journalists to obtain the advance copy of the report and some interesting reactions. For instance, an editorial in the Wall Street Journal said "this is roughly equivalent to the World Trade Organization coming out for high tariffs." While the Financial Times saw "a shift of position" by the IMF after the Mexican crisis.

Beyond the headlines, the report addresses two main topics: first, the turbulence in emerging markets and second, the supervisory and regulatory challenges confronted by the financial markets of the industrialized economies.

Both of these issues are a consequence of the profound transformations that are taking place in world financial markets. In the terms of Henry Kaufman, a prominent practitioner, the "new financial world" is characterized by significant deregulation; by widespread securitization of credit; by expanding use and complexity of financial derivatives; by the relative decline of traditional institutional lenders; by the ascendance of "hi-octane" portfolio managers with very near-term investment horizons; by corporate treasury departments attempting to become profit centers; and by the extraordinary expansion of mutual funds.

These are some of the changes that are generating turbulence in capital markets and that are testing the regulators from the industrialized and the developing economies.

The conclusions drawn by the report on the recent turbulence in emerging markets, particularly after the Mexican episode, are that, first, there is less margin of maneuver for policies that are not aligned with fundamentals. Domestic and foreign investors can simply vote with their feet against those polices. It is here that the report, based on data that "should be interpreted with caution," claims that Mexican investors initiated the stampede that led to the plunge of the Mexican peso.

Second, liberalization has also made these emerging markets more vulnerable to external events, to panics and to the spread of contagion.

Finally, by contrast to the early 80s, the decentralized nature of present capital flows, on account of the shift away from syndicated bank lending, are making more complicated attempts at voluntary debt restructuring.

Therefore, the authorities in emerging markets, that experience turbulence, need to deal with at least three kinds of risks.

The first is the macroeconomic risk derived from the impact of sudden capital flows on the exchange rate and on inflation. The policy response includes intervention, sterilization, fiscal consolidation and the heretical capital controls, which generated the Wall Street Journal reaction.

As stated by Stanley Fischer, the IMF's first deputy managing director, "we should not push developing countries and transition economies to liberalize the capital account too fast, for in the absence of macroeconomic stability, and a well-developed domestic financial system, liberalization can be problematic." Furthermore, the IMF report describes as positive examples the experience with capital controls of Brazil, Chile, Colombia, Indonesia, Malaysia and the Philippines.

Other risks are associated with the banking system becoming vulnerable to the effects of the policy response and to liquidity risks, mainly caused by the reliance on short-term debt finance indexed in foreign currency.

For the capital markets of industrialized countries, present difficulties come from the challenge posed to regulators by the failures experienced by global derivative markets. The growth figures of derivative markets presented in the report are staggering. For instance, all outstanding derivative contracts increased "from $2 trillion at the end of 1986 to more than $20 trillion at the end of 1994, an average annual growth rate of 140 percent."

The challenges are mainly that while "capital markets are becoming increasingly global, the rules under which these markets and institutions operate remain largely national." In other terms, the regulators are running behind the markets, therefore, there is an urgent need for increased international cooperation among regulatory authorities.

In conclusion, the response to the question of who prevails in these increasingly globalized circumstances is that both liberalization and regulation should prevail. Because neither the market by itself, nor the regulators alone will be sufficient to avoid present volatility.

I. 6. DEFIANT DERIVATIVES
(WDW/28/95 5 OCTOBER 1995)

Several incidents of spectacular losses, surprising most observers, have renewed the debate about the regulation of derivative contracts. The recent collapse of Barings, one of the oldest investment banks established in 1762, was preceded by other spectacular losses by the treasurer of the affluent Orange County, in California and by MG Corporation, a U.S. subsidiary of the German Metallgesellshaft AG.

All these losses, attributed to transactions in derivative contracts, revealed that it took a while before supervisors and regulators became aware of them. Such slackness was evidenced again only last week, when it was revealed that a bond-trader from the Daiwa Bank in New York lost $1.1 billion, over the last eleven years, without generating suspicions among internal auditors and supervisors, or external inspectors.

These incidents have brought to the forefront the debate about the degree and kind of regulation required by the spectacular growth experienced by derivative markets in the present decade. As defined in a newsletter for economic educators, published by the Federal Reserve Bank of Chicago, a derivative is "a financial contract with its value and payments based on another asset." One of the oldest and best known derivative is a futures contract, transacted in the Chicago Board of Trade, founded in 1848. Besides commodity futures, modern derivatives include futures and options on interest rates, on currencies and on stock market indexes.

Transactions in these instruments have led to the "spectacular growth of derivative markets," described in the last report on international capital markets released by the International Monetary Fund (IMF) (WDW/24/95, p.8). The IMF estimates that the value of "all outstanding exchange-traded and over-the-counter derivative contracts increased from less than $2 trillion at the end of 1986 to more than $20 trillion at the end of 1994, an average annual growth rate of 140 percent."

One aspect of this rapid expansion is considered "worrisome" by the IMF, since it is mostly banks that have become involved in these transactions. The IMF's concern is based on the experience that "rapid expansions in certain types of financial exposures" have led to "major losses during periods of consolidation." Furthermore, there is evidence that transactions in derivative contracts are concentrated among a small number of major commercial banks. For instance, a paper in the Federal Reserve Bulletin of September 1995, reveals that in the United States "the number of banks involved in derivatives has risen since 1990." However, the number is "still relatively small--about 600 as of March 1995," while "the top fifteen banks hold more than 95 percent of the derivatives contracts."

Amid this impressively concentrated expansion, several regulatory initiatives have been adopted, some of them aimed at increasing the "transparency" of these transactions. At issue is the assessment of the "safety and soundness" of the financial institutions involved in derivative contracts, to avoid the risk that incidents of heavy losses, as those mentioned above, may endanger the whole financial system. However, the IMF recognizes that there is no consensus about the need for transparency. Some participants refuse to disclose information about the methods they use, because their competitors may benefit from such disclosures.

The adoption of different regulatory initiatives shows that at least there is consensus that traditional methods for evaluating risk, such as capital requirements, have become less relevant. This is also the case of accounting standards, or of the practice of reporting performance annually or semiannually.

Some initiatives proposed address the need for disclosure and they have originated in the private sector, by the prestigious think-tank known as the Group of Thirty and by the Institute for International Finance (IIF), to which belong almost 200 commercial banks from all over the world. In the United States, the Federal Accounting Standards Board (FASB) increased the required disclosures about derivatives for 1994 reports in a Statement of

Financial Accounting Standards Number 119, known as SFAS 119. Internationally, the central banks of the Group of Ten organized a working group of the Euro-currency Standing Committee, chaired by Peter Fischer, Executive Vice President of the Federal Reserve Bank of New York. The Fischer group made recommendations about the disclosure of quantitative information on market and credit risk exposures.

Finally, the most radical departure from traditional methods of risk assessment is being circulated by the Basle Committee on Banking Supervision. This new approach is based on using the banks' own internal risk-management models to estimate capital adequacy requirements. However, when this method is adopted, as expected by the end of this year, it will coexist with the rules approved by the Commission of the European Union on capital requirements for financial institutions, which are not based on internal models.

In dealing with the spectacular growth of derivatives, supervisors and regulators appear running behind the market. The "good news" is, according to the IMF, that the existing arrangements have thus far contained potential systemic spillovers.

I. 7. THE IMF'S SECOND WORLD ECONOMIC OUTLOOK (WEO) (WDW/29/95 11 OCTOBER 1995)

This year's second WEO was released by the IMF staff, as usual, a week before the inauguration of the annual meetings of the World Bank and the Fund, held this year in Washington, D.C.

The world economy, according to the IMF, has "proven quite resilient" to recent turbulence in financial markets. This turbulence was mainly caused by corrections in the misalignment of major currencies and by the adjustment of portfolios in the so-called emerging markets of the developing countries.

Despite the turmoil, the rate of expansion of the world economy is expected to reach 3.7 percent in 1995, a slight revision downwards of the projections made last May. The revision was due to a correction in the projected growth of the industrial countries, of half a percentage point for 1995. By contrast, growth in the developing economies remains at a robust 6 percent, despite the downward revision of the May projections on growth in Latin America, because of the performance of Mexico and Argentina. Finally, growth in the transition economies is projected to be stronger among those that achieved stabilization earlier.

Within this "relatively positive" picture, in the terms of the Fund's Research Director Michael Mussa, the major exception among the industrialized economies remains Japan. According to the WEO, the Japanese economy "has yet to show convincing signs of recovery

from the deep and protracted downturn that began in late 1991." Therefore, the forecast for Japan in 1996 is revised downwards from 3.5 percent to 2.2 percent.

Japanese policy makers face what is characterized as "a unique policy challenge," posed by spreading price declines, labor market slackness and continued weakness of asset prices. Additionally, there is the wide pressure exercised by the strong yen and many disruptions among financial institutions, such as recent failures of credit unions and the heavy loan losses that appear in the portfolios of bigger and smaller banks.

An attempt to confront some of these challenges has taken the form of a stimulus package, approved on September 20, amounting to 14.2 trillion yen, or 3 percent of GDP. The package includes mainly expenditure increases, such as public investments amounting to 1.5 percent of GDP, to stimulate activity in the real estate market through land purchases. Consequently, in 1995, Japan's public sector structural deficit will increase to 5.5 percent of GDP and to 6.25 percent in 1996.

Among the developing economies there were some contrastingly positive performances, with those of Asia expected to continue growing at more than 8 percent, for the fourth consecutive year. Meanwhile, average performance of the developing economies of the Western Hemisphere was affected by the Mexican crisis and its effect on Argentina.

Even so, the global projections for 1996 are more optimistic. Since world output is projected to increase at more than 4 percent, growth is thus expected to be positive across the board in 1996.

The industrialized economies are projected to grow moderately at 2.4 percent. The developing economies will continue growing at a strong 6.3 percent, including those of the Western Hemisphere, which are projected to grow 4 percent. Even the transition economies will grow positively in 1996. After consecutive negative performances in the last three years, the economies in transition are projected to grow at a rate of 3.4 percent.

A main conclusion, drawn in the WEO from these figures, is that the performance of some developing countries is no longer fully synchronized, as it used to, with that of the industrialized countries. In Asia and in the Western Hemisphere, between 1990-93, growth continued despite the slowdown in the industrialized economies. By contrast, Africa and the Middle East "have continued to be closely influenced by developments in the industrial countries."

The chapter dedicated to the developing economies celebrates their increasing openness, because the robust growth rates that prevailed among them have been associated with their integration in the world economy. Nonetheless, the benefits from openness have reached unevenly all of the developing economies.

While the Asian economies have increased spectacularly their relative shares in world export markets, the relative participation of the Latin American economies has stagnated at low levels. For instance, the relative participation of Argentina and Brazil, together at 1.3 percent, is almost the same as that of Thailand, at 1.2 percent, that is among the smallest shares for Asian economies.

Released in a single volume, on October 4, 1995, the advanced copy of the WEO contains the following chapters: I) economic prospects and policies; II) the world economy in 1995-96; III) financial market turmoil and economic policies in industrial countries; IV) increasing openness of developing countries--opportunities and risks; and V) policy challenges facing transition countries. The volume also contains several boxes and one annex dedicated to the exchange rate effects of fiscal consolidation.

The WEO's final version will be released by the end of October, including the complete statistical appendix which does not appear in the advanced copy released to the media.

I. 8. THE PARANOIA OF GLOBALIZATION (WDW/32/95 1 NOVEMBER 1995)

Several indicators confirm that there exists a trend toward the increased globalization of the world economy. Among the most often quoted are the $1 trillion in daily foreign exchange transactions, or the $20 trillion outstanding in derivative contracts. Also mentioned, is the 125 percent growth of international trade in the last decade, although the spectacular growth in cross-border financial transactions is more revealing of increased globalization.

As described by the Chairman of the Federal Reserve Board Alan Greenspan, in the last decade, the stock of cross-border assets held by banks increased 3 1/2 times; while the annual issuance of international securities was four times greater, over the same period. Technological change and ideas, according to Chairman Greenspan, have "significantly altered the nature of output so that it has become increasingly conceptual and less physical."

All these trends, says the Vice Chairman of the Federal Reserve Alan Blinder, have now made it "chic" to assert that the global economy is already here. Correspondingly, the national economies are perceived as gradually losing the capacity to control their own destinies.

However, there are also indications that the globalized economy is not quite here yet. If only because some indicators of globalization are used to justify the adoption of protectionist measures and isolationist postures. This reaction is described by University of Michigan Professor Marina von Neumann Whitman as causing a "national paranoia about globalization."

It is this reaction that is feeding the belief that the trade deficit and foreign investment are causing unemployment. There is even a formula to quantify their impact. For instance, the Republican candidate for president Patrick Buchanan has used this measure in a Wall Street Journal op-ed, titled "An American Economy for Americans." In his terms, if the trade deficit reaches $200 billion this year, based on the estimate that $1 billion in exports equals 20,000 jobs, this will mean a net loss of four million jobs.

Professor Whitman counters that the increase in the trade deficit is "statistically associated" with lower unemployment, because more imports result from higher levels of income.

Another assertion challenged by Whitman is that free trade agreements are associated with flights of investment, from high-wage to low-wage countries, to produce cheaper exports that flow back to the investing country. Professor Whitman responds that only 11 percent of the production of U.S. firms abroad gets back to the U.S. market, with 3 percent of the total originating in developing countries.

Additionally, in the last quarter century, the United States has not lost ground in export markets. According to the IMF, the relative participation of the United States in world exports was 12.1 percent in 1970 and this figure increased to 13.3 per cent in 1994. The economies that more than tripled their relative participation in world exports are those of East Asia. For example, in the last 25 years, China has moved from 0.8 to 2.4 percent; Hong Kong from 1.0 to 3.5 percent; and Thailand from 0.3 to 1.1 percent. Meanwhile, some European and Latin American countries have lost ground.

Other indicators reveal that the trend toward globalization has yet to make a dent in investor preferences. The IMF has estimated that domestic ownership exceeds 90 percent in the three largest stock exchanges--Japan, the United Kingdom and the United States. Also, despite an impressive growth in capital flows to emerging markets, these investments represent only 1 percent of the total assets held by institutional investors from the United States.

Consequently, the figures still do not support the anxiety about the loss of national control, allegedly caused by the globalization of the world economy. Paraphrasing Churchill, the Fed Vice Chairman Alan Blinder concludes, "open, competitive markets in which participants seek profits is the worst way to allocate capital--until you consider the alternatives."

Vice Chairman Blinder also warns that "the voices of protection that you still occasionally hear in this country and others are not only counsels of despair, bad economics, and often the worst kind of special pleading. They are also relics of a past that, I am pretty sure, will never return."

Paradoxically, this paranoia caused by the trend toward globalization comes at a time when representatives of the developing economies are preaching the benefits of free trade.

At the inauguration of the last summit meeting of the non-aligned countries, for instance, the President of Colombia called on the participants to fight against protectionism and to work toward true free trade. At the same meeting, held in Cartagena, Colombia, the President of Bolivia said "let's start trading among ourselves instead of complaining about the developed world." And the President of Indonesia urged the members of the non-aligned movement to give top priority to economic issues.

The paranoia, generated by some indicators of economic globalization, is the equivalent of believing that, at its fiftieth anniversary, the United Nations is close to achieving enough power to dominate the world.

II. THE U.S. ECONOMY

II. 1. ANXIETY AMID GOOD NEWS IN 1995 (WDW/1/95 18 JANUARY 1995)

Paradoxically, the strong performance and low inflation of the U.S. economy in the last quarter of 1994 has generated anxiety among forecasters. Since very few anticipated the last quarter's more than four percent in GDP growth, this year's predictions are anxiously wondering how long will the good times last. The question is not if the economy will slowdown in 1995, but when and by how much.

As admitted by Alan Greenspan, the Chairperson of the Federal Reserve Board (FED), in a statement to the Joint Economic Committee of Congress on December 7, "there is very little evidence throughout this economy of any degree of slowdown." Also, this strong performance was accompanied by a moderate increase in the consumer price index (CPI) of 2.7 percent for the year as a whole, the same as in 1993. The core index, excluding food and energy prices, increased only 2.6 percent, the smallest increase since 1965. Moreover, in its third year of recovery, the economy created 3 million jobs pushing unemployment down to 5.8 percent.

These indicators showed how hazardous it was to try to forecast the performance of the U.S. economy in 1994. For instance, out of the 59 economists that participate in the semiannual Wall Street Journal survey, of June 1994, only two predicted the strong performance of the U.S. economy during the second half of the past year. One of them was the former governor of the Federal Reserve Wayne Angell, now chief economist at Bear, Stearns & Co., the other was Gail Fosler of the Conference Board.

That Mr. Angell foresaw in June annual economic growth at 4 percent or more, for the rest of the year, even raised some eyebrows. Mr. Angell's accuracy, in predicting some decisions adopted by the FED, led House Banking Committee Chairperson Henry Gonzalez (D-Tex) to ask the Securities and Exchange Commission (SEC) to investigate if Mr. Angell was using inside information from his previous position. As reported, an internal FED investigation did not reveal wrongdoing.

By contrast, there is wider consensus among this year's forecasts, issued by the economists surveyed in the Wall Street Journal. The consensus is that this year will witness the effects of the six interests rate increases approved by the FED last year, including those of the increase that the FED is expected to approve by the end of this month.

Consequently, optimists expect the FED to achieve the "soft landing" that it is seeking, by slowing down the economy real GDP growth close to the noninflationary rate of 2.5 per cent.

Most economists agree that, during the first half of 1995, the economy will grow at an annual rate of 2.9 percent and of 2.5 percent in the second half of the year. This represents a slowdown from the rate of growth of more than 4 percent of 1994. Even so, in 1995, most forecasters surveyed do not see a recession and expect inflation to remain moderate.

Government economists agree with some of these projections. The Chairperson of the President's Council of Economic Advisors, Laura D'Andrea Tyson in 1995 foresees a rate of real growth of 2.7 percent, with unemployment climbing to 6.2 percent and an inflation rate of 3.2 percent. Also, the vice-chairman of the FED, Alan Blinder expects that growth will slow down in 1995 to between 2.5 and 2.75 percent.

The expectation that the recession will happen in early 1996 is seen as hurting both the Republican Congress and President Clinton. It used to be that a recession was supposed to hurt the incumbent. Thus, the fact that the last recovery initially was not strong enough explained why it hurt President Bush's reelection. However, that the recovery only gained strength last year did not help the incumbents to retain their control of the Congress.

As Sylvia Nassar said in the New York Times, "blessed with some of the best economic numbers in a generation, President Clinton cannot seem to communicate the good news." The conclusion drawn by Keith Bradsher, also in the New York Times, from these contradictory signals is that recessions hurt incumbents, while recoveries help them much less.

Be it as it may, the most decisive influence on the performance of the economy does not reside in the Executive or in the Congress. It is the control exercised by the FED on interest rates that will determine the onset and the deepness of the recession, if any.

Nobody knows if last year's interest rate increases will slow down the economy earlier, to the point of starting a recession by the end of this year. For the politicians from both parties the question is who will be blamed, the Republican Congress or the Clinton Administration.

Meanwhile, the debate now consists of guessing if the FED can engineer the "soft landing," by bringing down the rate of growth to the proverbial 2.5 percent, consistent with a steady unemployment rate. Or, if the FED overshoots, by stepping on the brakes too harshly, it will cause a "crash landing" that will sink the economy into recession.

No wonder, James Glassman concluded in the Washington Post that "there is no future in foretelling the economy." Instead, in 1995, all time and energy are dedicated to "the joy and anguish of FEDwatching."

II. 2. THE STATE OF THE UNION: SEARCHING FOR THE CENTER (WDW/3/95 1 FEBRUARY 1995)

Last week, President Clinton delivered the longest State of the Union address of his mandate. During eighty-two minutes, of what some saw as a long but masterful delivery, the President explained his vision of what he called a "New Covenant." This "covenant" is based on "an old idea: That all Americans have not just a right, but a responsibility to rise as far as their God-given talents and determination can take them, and to give something back to their communities and their country in return."

The New Covenant should serve as the foundation for the accomplishment of three basic objectives: a new economy, a new government, and leadership abroad. These three objectives give content to President Clinton's vision of the center.

The new economy reaches out to the middle class, to help "hard-working families" meet the costs of raising and educating their children, obtain training for higher paying jobs, buy a first home, save for their retirement. The new economy also reaches out to lower-income workers by proposing a controversial increase in the minimum wage. While promising to continue "vigilance on the deficit," the new economy offers to protect social security and oppose Medicare cuts. Finally, in recognition of past frustrations, the path to "health security" will be undertaken step-by-step.

The new government will be smaller and more effective, "less costly and smarter--leaner not meaner." For this purpose, the President called for the approval of lobbying and campaign reforms and the continuation of cuts in the federal bureaucracy and in unnecessary spending, particularly through the line-item veto. Some of these proposals were applauded by the opposition, such as the reform of the welfare system, into a system of work and responsibility, securing the borders against illegal immigration, and the fight against crime. While others were not applauded, such as keeping the ban on assault weapons or building on the success of the Americorps national service program.

Finally, the exercise of leadership abroad reaches out to the internationalists from both parties. In the President's terms, "security depends upon our continued world leadership for peace, freedom, and democracy. We cannot be strong at home without being strong abroad."

The first item in the international agenda was the financial crisis in Mexico, the only Latin American issue mentioned in the speech. The President explained that it was necessary to act promptly, "for the sake of millions of Americans whose livelihoods are tied to Mexico's well-being." Additionally, the President repeated "this is not a loan, this is not foreign aid, this is not a bail-out." To help "put Mexico back on track," the President said, "we'll be giving a guarantee, like co-signing a note with good collateral that will cover our risk." Finally, "together with the bipartisan leadership," the President called on Congress to pass "quickly" the legislation containing the Mexican package.

Other items in the international agenda were the approval of the START II treaty to eliminate 5,000 nuclear weapons; to lead the world into the extension of the Nuclear Non-Proliferation Treaty; to intensify the fight against international terrorism; and to maintain "the best equipped, best trained and best prepared fighting force on Earth."

How close the President came to find the center of the political spectrum may be answered by the fact that the speech was severely criticized by both liberals and conservatives.

For instance, the Washington Post editorialized that the speech "tried too hard to fulfill too many political imperatives at once." Republican strategist William Kristol saw the address as the "most conservative . . . ever delivered by a 20th century Democratic President." Not so, said Richard Cohen, for whom "the embrace was too wide and too thin."

Robert Novak agreed that the speech "often sounded more conservative than any pronouncement by a Democratic president in this century, but it was regularly interspersed with liberal caveats." For David Broder it was "a speech about everything, and therefore about nothing. It was a huge missed opportunity."

In the end, the speech revealed how difficult it will be for the President to find the proverbial center by agreeing with the Republicans on certain issues, while reassuring his own party that he will continue supporting other issues that belong to the traditional Democratic agenda.

As described by R.W. Apple Jr., in the New York Times, "the months ahead will center around a battle for the symbolic high ground: are the Republicans the agents of change and the Democrats the defenders of the bureaucratic status quo? Or are the Democrats the agents of change and the Republicans the reactionary champions of trickle-down economics?"

Be it as it may, after the speech and for the first time in more than six months, the President's job approval rating increased nine percentage points to 54 percent, according to a Washington Post - ABC News poll. By contrast, House Speaker Newt Gingrich's approval rating rose five percentage points, to 40 percent, while the disapproval rating of his performance increased by eleven percentage points, to 48 percent.

As E.J. Dionne Jr. commented in the Washington Post, "however you cut it, the voters were a lot less rough on the president than the analysts were."

II. 3. THE ECONOMIC STATE OF THE UNION (WDW/6/95 22 FEBRUARY 1995)

In this year's letter of transmission to the Congress of his Economic Report, President Clinton describes 1994 as a year of outstanding performance for the economy of the United States. In his own terms, "today there is no country in the world with an economy as strong . . . as full of opportunity, as full of hope."

For 1995, the prospects described by the President are just as good, based on the execution of the Administration's economic strategy. The aims of the strategy are to continue reducing the federal fiscal deficit; preparing the economy for competition in the next century; expanding opportunities through free and fair trade; carrying out health care and welfare reform; and reinventing government.

In the short-term, the Administration's forecast "expects the economic expansion to moderate in 1995 as the effects of increases in interest rates to date spread more broadly throughout the economy." The growth rate in real Gross Domestic Product (GDP) is expected to reach 2.4 percent and the rate of inflation to remain roughly constant at 3 percent. Thus, in 1995, the economy will achieve a "so-called soft-landing."

The annual report of the Council of Economic Advisers (CEA), that follows the President's message of transmission to Congress, expands on each of the economic strategy's elements mentioned above. It contains the following chapters: 1) implementing a national economic strategy; 2) the macroeconomy in 1994 and beyond; 3) expanding the nation's productive capacity; 4) public and private sector initiatives to promote economic efficiency and growth; 5) improving skills and incomes; and 6) liberalizing international trade.

Deficit reduction, the first chapter explains, is not an end in itself, it is a means to increased national savings and investment in an economy that globally is performing well, but where "real median family income in 1993 is about at the same level it was in 1973." Furthermore, "this stagnation of incomes has been accompanied by a growing inequality, with larger and larger shares of total income going to the top fifth of the income distribution." Therefore, the President, with the release of the Economic Report, also sent to Congress initiatives proposing the increase in the minimum wage and a "Middle Class Bill of Rights," to provide tax relief to "the people who need it most." In President Clinton's terms, "an America that, in our finest moments, has always grown together, now grows apart."

The proposal for further deficit reduction and the proposed middle class tax cut are contrasted, in the following chapter dedicated to the macroeconomy, with the recent tax and expenditure proposals contained in the Republican "Contract with America."

The Administration's forecast for the economy is also discussed in this chapter, including some risks to the forecast. Some of these include the risk of overshooting, the possibility of stalling in international economic growth, particularly because of the cut in exports that will result from the slowdown in the Mexican economy. Finally, among the risks, the Report mentions the "substantial uncertainty about future congressional action in matters that can influence the paths of output, deficits, and interest rates over the medium run."

To expand productive capacity, the Report focuses on the sustainable growth rate of the economy and on the trend in productivity growth. The role of government in boosting the sustainable growth potential of the economy is two pronged. First, to promote a high level of saving through the most direct means, such as the reduction of its own deficit and second, to promote additional investment in both human and physical capital.

Government is expected to contribute to the improved performance of markets, through the promotion of competition, remedying harmful externalities, such as pollution, and the provision of public goods, such as security, education, research and development. Also, to correct its own inefficiencies, government should "reinvent" itself, for instance, through the streamlining of purchasing practices, expected to generate more than $50 billion in savings. Finally, government can stimulate economic growth, accelerating private investment in sectors such as telecommunications and investing in science and technology.

To sustain rapid growth in employment and wages, the Administration is carrying out "an ambitious agenda of lifelong learning," that includes transforming the unemployment system into a reemployment system.

Finally, the Report describes an agenda for liberalizing international trade, based on the Administration's previous achievements, such as the approval of the Uruguay Round, the entry into force of the North American Free Trade Agreement (NAFTA), the Summits of the Asia-Pacific Economic Cooperation Forum (APEC) and of the Americas, and the Framework for a New Economic Partnership with Japan. The Administration's trade policy is based on mutually supportive objectives pursued in negotiations at the multilateral, plurilateral/regional and bilateral levels. The "final component" of the Administration's trade policy is domestic policy, because "trade adds to the opportunities and dynamism of the economy, and to the adjustments required over time."

II. 4. THE BATTLE OF THE BUDGET (WDW/34/95 15 NOVEMBER 1995)

In an approaching election year, the standoff between Congress and the Executive, over how to deal with the U.S. federal budget deficit, could be easily dismissed as normal posturing among politicians. After all, the present is the tenth "shutdown" experienced by the federal government since 1981.

The markets have not reacted to the confrontation yet, perhaps because they are assuming that in the end there will be a last minute agreement that avoids the worst. Even so, the contenders have been admonished about the perils of failing to come to an agreement.

For instance, the Chairman of the Federal Reserve Alan Greenspan has written to the Senate Banking Committee Chairman Alfonse D'Amato (R-N.Y.) that the borrowing authority of the Treasury "need not be part of the process." Chairman Greenspan also declared that failure to agree "would signal that the United States is not capable of putting its fiscal house in order," which would have "serious, adverse consequences for financial markets and economic growth."

Also, Standard & Poor's Corporation, the most prestigious credit rating agency, has declared that it is "increasingly concerned about the global financial market ramifications of the current U.S. budget impasse." Therefore, there is a risk that U.S. bonds could be rated below the triple-A rating, as those of other less fiscally responsible governments.

However, beyond the immediate consequences and the political bickering, recent studies reveal that to dismiss the confrontation as mere political posturing, this time, would be superficial.

A recent study, by the heads of the research department of the International Monetary Fund (IMF), concludes that the fiscal deficits that prevail today in all the industrialized countries are due to profound and complex causes. The IMF's director and the assistant director of research Michael Mussa and Paul Masson presented the study to a symposium on "budget deficits and debt," organized by the Federal Reserve of Kansas City, in Jackson Hole, Wyoming, on August 31-September 2, 1995.

Among the main conclusions presented by Mussa and Masson is that, traditionally, budget deficits were a response to extraordinary circumstances, such as the two world wars and the Great Depression. Therefore, the return to normalcy meant also a return to budget balance. The exception has only happened in the last two decades, during which the industrial countries have exhibited "persistent budget deficits" and "substantial increases in debt/GDP ratios," without experiencing major emergencies.

Mussa and Masson also conclude that the causes of these persistent deficits cannot be found in the change in the role of government that followed the Great Depression, neither in the Keynesian prescription for deficit spending to compensate for cyclical downturns. For one thing, because "sizable and persistent deficit spending only started in the 1970s, when the influence of Keynseanism was waning."

The culprit, starting in 1975, are the "large increases in social security spending," turned into "entitlements . . . increasingly divorced from the normal budgetary process." Furthermore, present levels of debt to GDP ratios are not sustainable, because of demographic trends, such as the increase in lifespans and the decline in birthrates; the substantial increase in health care costs; the slowdown in economic growth; and the inflationary pressures of the last five decades.

Some of these conclusions were used as inputs in a recent study on saving, investment and real interest rates, released by the Deputies of the Group of Ten (G-10)--Belgium, Canada, France, Germany, Italy, Japan, The Netherlands, Sweden, Switzerland, United Kingdom and the United States.

The first conclusion presented by the G-10 deputies is that "there appears to have been a trend increase in the real interest rate of around 100 basis points in most G-10 countries over the past 35 years, to about 4 percent presently." The study also highlights that "national saving rates have declined by nearly 5 percent of GDP." The cause of this decline is found in "a reduction in the saving rate of the public sector." In all, the G-10 deputies conclude, "the secular rise in the real interest rate is due to a decline in the saving rate--driven largely by fiscal deficits--which has outweighed a parallel reduction in desired investment."

Therefore, "a reduction in public deficits will unambiguously raise national saving" and fiscal consolidation will "put downward pressure on interest rates." Additionally, fiscal policy "should aim to reduce the debt-to-GDP ratio in times when the economy is not subject to adverse shocks."

For the peace of mind of the developing and the transition economies, the G-10 study asserts that their "capital demands" are not "a major source of secular upward pressure on global interest rates." Also, they are advised not to repeat the industrial economies' past mistakes and miscalculations.

For the reasons found both in the IMF and the G-10 studies, the confrontation over balancing the budget in the United States should be closely followed. Particularly because of its anticipated influence on the fiscal discipline of the industrialized economies.

III. THE JAPANESE ECONOMY

III. 1. JAPAN IN RECESSION, AGAIN?
(WDW/21/95 12 JULY 1995)

Behind the barrage of news about the trade confrontation between the United States and Japan and about the dollar's fall, it was seldom noticed that, in the first quarter of 1995, the Japanese economy barely escaped falling again into a recession.

Had it not been for the announcement by the Japanese government, last June 20, that in the first quarter of this year gross domestic product grew by a meager one tenth of 1 percent, technically, the Japanese economy would have fallen into a recession. According to the accepted definition, if this year's first quarter weak performance would have been negative, followed by the slump of 3.9 percent in GDP registered during the last quarter of 1994, the economy would be in recession after two successive quarters of negative growth.

However, if gross national product (GNP) is used, the economy registered, in the first quarter of 1995, negative growth of 0.2 percent, followed by a contraction of 3.7 percent in the last quarter of 1994. Technically, this places the Japanese economy in recession.

Beyond the technicalities, as described by Tomoko Fujii, an economist from Salomon Brothers in Tokyo quoted in the Wall Street Journal, the paltry rate of growth of this year's first quarter is "a slump." Furthermore, since the last negative growth figures date only from the last quarter of 1993, some observers have concluded that the Japanese economy may be experiencing the longest downturn of modern times.

Several other indicators support this conclusion. Prices continue to fall down at record rates. The GDP deflator fell 0.8 percent in the first quarter of 1994, the largest drop in prices since the third quarter of 1958. This figure is also the third successive quarter of deflation, "the longest stretch of price declines in postwar Japanese history." Some analysts fear that the economy may fall into "hyperdeflation," and therefore, into a "depression," defined as "a recession that policymakers can't stop despite aggressive monetary and fiscal stimulus."

Another indicator that has registered unprecedented records is unemployment, which, at 3.2 percent in May, is still low by contrast with other industrialized economies. However, in March, the unemployment rate among young persons under 24 years reached 7.5 percent.

Meanwhile, the Nikkei 225 stock price index reached the lowest point in almost three years. Last Tuesday, before regaining some strength the following Friday, the Nikkei

average closed at 14599.68, the lowest point in two years and ten months. Such low performance by stock prices, dropping by two thirds since 1989, added to a steep fall in land prices, which have fallen by half since 1991, hurt the commercial banks, in whose ranks are found the five largest banks in the world. As Paul Blustein reported in the Washington Post, Fuji Bank's portfolio, the third largest in the world, breaks even at a Nikkei index of 14,371, while other more exposed banks, such as the Hokkaido Takushoku Bank breaks even at 15,088.

In the Japanese press, the most common interpretation of these events is found in what is called the "super high yen," or the 16 per cent rise of the yen against the dollar. According to the Nihon Kezai Shimbun (Nikkei), one reason for the weakness of Japan's recent economic recovery can be found in the levels of private sector capital investment. Due to the "super high yen," reports the Nikkei, corporations are moving their production bases overseas, or "hollowing out" Japan's industrial base. This has also led to several cancellations by large assembly manufacturers of their capital investment plans in Japan.

The prevailing concern about deflation is also attributed to the yen's appreciation and the consequent availability of lower priced imports. According to the Nikkei, this is equivalent to "prosperity without profit," whereby production increases while profits are decreasing. Additionally, concern over unemployment is leading to strict tightening of purses among households, particularly among youngsters, the hardest hit by unemployment.

Even Japan's legendary trade surplus, measured in yen, is disappearing rapidly. In volume terms, for instance, import growth has outstripped export growth for nearly three consecutive years. Also, as a percentage of GDP, Japan's current account surplus has been shrinking from its peak of 3.2 percent in 1992. As reported in the Wall Street Journal, the Organization for Economic Cooperation and Development (OECD), by next year, projects a fall in Japan's current account surplus to 2.2 percent and Salomon Brothers in Tokyo projects that it will fall to 1 percent by early 1997.

Therefore, the Nikkei informed that several private think tanks had reviewed downwards their estimates of real economic growth, for fiscal year 1995, to "about 1 percent in March, anticipating that the economic recovery would slow further."

The Japanese government's response to these unprecedented circumstances was the adoption of two packages. First, on May 20, the Diet passed a supplementary budget for fiscal year 1995, amounting to $32 billion. Second, on June 8, a rescue package containing few details, aimed at restoring confidence in the financial system, recognized that the banking system's bad debts amounted to $470 billion. Other estimates say this last figure could be as high as $1 trillion.

III. 2. JAPANESE ECONOMIC REACTIVATION (WDW/22/95 19 JULY 1995)

The reactivation of the Japanese economy is evidently linked to the rescue of the Japanese banks. This conclusion can be drawn from the components of both recently approved supplementary budgets for fiscal year (FY) 1995 and a rescue package for the banks (WDW/21/95, p25).

The supplementary budget, approved by the Diet on 19 May, appropriated additional spending of $32 billion, out of which $16.8 billion for the reconstruction of the damage caused by the Kobe earthquake of 17 January; $9.3 billion for disaster prevention measures; and $5.3 billion for measures to cope with the "super" high yen.

According to Tsutomu Tanaka, vice minister of Japan's Economic Planning Agency (EPA), total additional spending for FY 95 will amount to $82.4 billion, including additional loans amounting to $38.8 billion to be granted by government financial institutions. More than half of the total, or $49.9 billion will have a direct impact on economic growth, while $32.5 billion will be spent to acquire land for public works. In these terms, for FY95, the government forecasts real GDP growth of 2.8 percent.

The package to rescue the banks is less detailed, although the Finance Ministry recognized that problem loans in the banking system amounted to $473 billion. Other analysts consider this official figure too conservative and estimate that the amount is closer to $ 1 trillion. However, even the official figure is staggering. For instance, the amount of taxpayers money used in the United States to bail out the savings and loans institutions reached $200 billion.

The immediate cause of Japan's ailing banks is usually found in the steep slide in the stock and real state markets, or what is commonly known as the burst of the speculative "bubble" that prevailed during the second half of the last decade. An Occasional Paper (No. 124), released by the International Monetary Fund (IMF), titled Saving Behavior and the Asset Price "Bubble" in Japan indicates that, in the second half of the 1980s, Japan's stock prices tripled and land prices doubled. This surge was followed by a collapse in the stock market amounting to a 58 per cent reduction in the Nikkei index of 225 stocks, from its peak of 1989. Also, commercial land values have plunged by half, since they peaked in 1991.

These figures fit the definition used in the IMF study of a speculative "bubble," as "a continuous market overvaluation followed by a collapse." However, as stated by Juha Kahkonen in one of the papers contained in the IMF's Occasional Paper No. 124, "fundamentals also played a significant role" besides the speculative "bubble." Among these fundamentals, Kahkonen mentions, first, that the prices of stocks and real state "reflected the growth in the economy, in the second half of the 1980s real GDP increased by 25 percent,

and corporate profits rose by 69 percent." Second, easy monetary policy also contributed to the inflation in asset prices, through a decline in interest rates. Third, there was "excessive risk taking" due to expectations of higher growth opportunities. And fourth, the land tax system also stimulated the rise in land prices.

The rescue package announced by the Finance Ministry, on June 8, consisted mainly of an authorization given to the central bank, during the next five years, to make special loans to bankrupt lenders under strict conditions. These special loans are conceived as a temporary mechanism, while the incipient Deposit Insurance Corporation is expanded and strengthened. Presently, the Corporation is funded by the banking industry and it has assets of 870 billion yen, representing only less than 1 percent of all deposits.

The Finance Ministry did not allocate public funds for the banks' rescue, because the use of taxpayers money for such a purpose is still highly controversial. In the terms of a software salesperson, quoted in the Wall Street Journal, "I can't stand the idea of those well-to-do people getting rescued by tax money." Also, the present mayor of Tokyo was elected because he opposed the bailout of two credit unions. Furthermore, there has not been a bank failure in Japan since the end of the last war and the worst crisis in the banking sector dates from the 1920s.

For these and other reasons, recent discussion by the Finance Ministry of the possibility of bank failures is rightfully seen as extraordinary and has generated all kinds of speculation. For instance, the rescue package contains the following indication that the days may be over when the state was willing to rescue financial institutions in distress. "The Ministry shall prepare a framework in which the principle of self-responsibility can be fully applied to Japanese depositors as soon as possible, within five years at the latest."

All this indicates that the problems presently affecting the Japanese banking system will be around for a while and they will slow down the reactivation of the economy. Additionally, the implications of such a situation for the international economy cannot be underestimated, particularly because the fifteen largest banks in the world are from Japan. As declared in the Washington Post by Toyoo Gyohten, the internationally well-known chairperson of the Bank of Tokyo, "it's a very hypothetical question, but if the Japanese stock market were to collapse, it would have rather far-reaching repercussions on Japanese institutions which are large holders of U.S. securities."

III. 3. CAN U.S. REVISIONISTS ON JAPAN CLAIM VICTORY? (WDW/23/95 26 JULY 1995)

Observers of the debate on U.S. policy toward Japan are having trouble keeping a score. On one side, the "revisionists" are claiming points for the outcome of the last

confrontation on Japanese imports of automobiles and auto parts. On the other side, opponents point to the bleak performance of the Japanese economy (WDW/21, 22/95, p.25-28) as evidence that the long awaited correction of the Japanese trade surplus is under way, through conventional economic measures. Meanwhile, the debate has spilled over into the security sphere.

Clyde Prestowitz, a member of the so-called "gang of four," the group of scholars and commentators known in the United States as "revisionists," claims that the outcome of the most recent confrontation means victory for their camp. Besides Mr. Prestowitz, a former U.S. trade negotiator, the other members of the revisionist group are James Fallows, former correspondent of The Atlantic in Japan and now its Washington editor; Karel van Wolferen author of the Enigma of Japanese Power and a longtime resident of Japan, as correspondent for a Dutch newspaper; finally, Chalmers Johnson, considered the dean of the revisionists, a political scientist formerly at the University of California, San Diego.

According to Mr. Prestowitz, president of the Washington based think-tank Economic Strategy Institute, even if the outcome of the automobile talks in Geneva left unanswered the most important questions, "U.S. gains may be more than are immediately apparent."

First, the revisionists believe that Japanese capitalism is "different" and does not respond to ordinary remedies. Thus, the use of numerical benchmarks on the number of dealers and purchases of autoparts, according to Mr. Prestowitz, are not "meaningless" and "the numbers are not completely without teeth." Second, the benchmark will be useful in monitoring progress, as they have in other cases cited as revisionist favorites, such as the semiconductor and flat glass agreements. Finally, the deregulation of the car inspection system is considered the most important part of the agreement.

Still, Mr. Prestowitz asserts that the most important issue in U.S. Japanese trade relations remains unanswered, whether "cartelistic Japanese business practices are compatible with the principles of free trade." Mr. Prestowitz concludes, "the issue on the table was really the rules of trade in the 21st century. Which will govern mercantilism or free trade?"

Evidently, these are profound questions that demand proportionate answers. Meanwhile, economists argue that the Japanese trade surplus is in the process of being corrected through conventional economic adjustment, because of the "super" high yen. Therefore, more important than the skirmishes that periodically erupt between the United States and Japan, the opponents of revisionism argue, is the prolonged sluggishness that has afflicted the Japanese economy for the last four years (WDW/21/95, p.25). The major concern, at the present juncture, is the influence the prolonged tailspin of the Japanese economy will have on the rest of the industrialized economies and, ultimately, on the world economy as a whole.

Additionally, this is perceived as fertile ground for the coming of what the Wall Street Journal characterizes as a "nastier new era" in U.S.-Japan relations. Because the end of the Cold War has "shattered restraints on economic rivalries."

Anyhow, a debate is already under way in the United States about how to deal with this "new era." In the July/August issue of the prestigious Foreign Affairs, Joseph Nye, Assistant Secretary of Defense for International Security Affairs, supports "the case for deep engagement" in East Asia. On the other side, the dean of the "revisionists" Chalmers Johnson describes Nye's proposal as "the Pentagon's ossified strategy."

According to Assistant Secretary Nye, there are at least five major strategic options for the United States in East Asia. These go from withdrawal, to balance-of-power politics, the creation of loose regional security institutions, a regional alliance, or to exercise leadership. The last is the strategic option advocated by a recently released Pentagon report, supervised by Assistant Secretary Nye, on United States Security Strategy for the East Asia-Pacific Region. This strategy of "deep engagement" has three components: first, to reinforce existing alliances; second, to maintain the presence of 100,000 U.S. troops; and third, to develop regional institutions.

Professor Chalmers Johnson counters that such a strategy assumes "that nothing has changed in East Asia and that U.S. policy should be to freeze relations in the Pacific indefinitely." By contrast, Professor Johnson advocates more self-reliance and less dependence by Japan, even to the point where the Japanese should finance and develop their own military capabilities.

Whatever the outcome, the revisionists have scored an important point when they hold that, with the end of the Cold War, U.S.-Japan relations have entered a new era. However, it remains open if this will be a "nastier" era, where trade skirmishes will become major confrontations and Japan will end up developing its own autonomous security capabilities.

IV. THE DEVELOPING ECONOMIES

IV. 1. EXTERNAL FINANCE FOR DEVELOPING COUNTRIES (WDW/2/95 25 JANUARY 1995)

This is the subtitle of the two volumes of World Debt Tables released on January 22, 1995 by the World Bank. The title of this publication is a legacy of the eighties. The first volume even contains a section dedicated to "the twilight of the commercial debt crisis." By contrast, the subtitle is more in tune with the times, since the indebtedness of developing countries has become, for almost all of the middle income countries, a matter of access to international capital markets.

The first volume recognizes this by focusing on recent developments in international finance for developing countries. Part I of Volume one is dedicated to external finance for developing countries, with chapters on financial flows; developments in external debt; and the debt of severely indebted low-income countries.

Part II contains the following appendices: 1) debt burden indicators; 2) external debt restructuring, from October 1993 to September 1994, including a summary of multilateral debt relief agreements, from January 1980 to September 1994; 3) portfolio investment in developing countries, including a list by country of international bond issues, commercial paper issues, equity issues, and close-end entry funds, all from January 1993 to September 1994; 4) external financing through privatization, including a list of privatization transactions between 1993-1994; 5) trends in foreign direct investment (FDI); and 6) debt conversion programs.

Finally, Part III contains summary statistical tables for selected regional and analytical groups comprising 154 developing countries.

The second volume contains statistical tables on the external debt of each of the 137 countries that report public and publicly guaranteed debt under the Bank's Debtor Reporting System (DRS).

Two "messages" were highlighted by Michael Bruno, the Bank's Chief Economist and Vice President, at the press briefing held for the presentation of the Tables. On private capital flows, he said, "the big story has been the four-fold increase in these flows mainly to the middle-income developing countries." However, in 1994, "there has been a sharp slowdown in the growth rate of these flows and most recently the developments in Mexico have very dramatically illustrated the volatility of some types of private capital flows." Vice President Bruno concluded, "notwithstanding these recent difficulties our analysis continues

to suggest that the factors underlying the private capital flows are structural and therefore there is no reason for them to be reversed in the aggregate." He also recognized that those countries "that depend heavily on short term portfolio flows to meet large current account deficits, may well experience year-to-year volatility even as the overall level of flows remains stable."

The second message from Vice President Bruno was that "although private flows have become the main source of external financing for an increasing number of mostly middle-income countries, the low-income countries (with the notable exceptions of China and India) continue to rely on official sources of financing, much of it on concessional terms."

Vice President Bruno singled out the case of the severely indebted low-income countries (SILICs). He concluded, "despite considerable efforts of multilateral and bilateral creditors to ease the debt burden of these countries," their debt stocks "remain unsustainable high."

During the press briefing, Sudarshan Gooptu, identified as "the principal author of the report" from the Bank's International Economics Department, described several reasons for the Bank's conclusion that "a general reversal of capital flows is unlikely."

First, "more than 40 percent of private capital flows are in FDI which is driven by changes in the world economy that are structural rather than temporary."

Second, "most debt-creating flows are no longer in the form of commercial bank loans, as in the 1970s, but in the form of bonds issued by a limited number of developing-country issuers."

Third, "emerging-market securities remain 'underweighted' in the asset portfolios of foreign institutional investors relative to the size of these markets." For instance, "while the market capitalization of emerging stock markets is now in excess of $1 trillion, accounting for 12 percent of world stock market capitalization, U.S. pension funds invest only about 1 percent of their financial assets in these markets."

Fourth, "the sources of flows to developing countries have become more diverse with greater participation by institutional investors, performance oriented traders of securities, managed funds and non-resident citizens. This diversity reduces the risk of a simultaneous drying up of flows as happened with commercial bank loans in the early 1980s."

Fifth, "the probability of a further large and prolonged increase in international real interest rates appears low in the next two to five years."

Therefore, Mr.Gooptu concluded, "the overall composition of aggregate resource flows to developing countries by income group has now become a function of access to international capital markets."

IV. 2. PROSPECTS FOR THE DEVELOPING ECONOMIES (WDW/15/95 31 MAY 1995)

"The global outlook is bright, but masks wide differences," says Michael Bruno, vice-president and Chief Economist of the World Bank, in the recently released Global Economic Prospects and the Developing Countries 1995. Besides medium-term projections (1995-2004) for the developing countries, the main theme of this year's report is globalization, "the most significant feature of the world economy." It covers the following chapters: 1) developing countries in an integrating world economy; 2) wider markets for trade: the Uruguay Round; 3) more to trade: the internationalization of services; 4) reverse linkages: growing together.

Globalization is driven by the following factors: "a near-universal push toward trade and capital market liberalization, increasing internationalization of corporate production and distribution strategies, and technological change that is fast eroding barriers to the international tradability of goods and services and the mobility of capital."

The report's "central message" is that integration of the developing economies into the globalized economy "represents a major--perhaps the most important--opportunity for raising the welfare of both developing and industrial countries over the long term."

This "central message" includes five main points. First, the global economic environment is "better than it has been since the 1960s." Second, access by the developing countries to the global capital market brings important benefits and it also requires "stricter discipline in economic management," as showed by the recent crisis in Mexico. Third, the Uruguay Round achieved significant results, "but a sizeable agenda for reform remains." Fourth, the internationalization of services "will likely lead the next stage of economic globalization." Finally, the industrialized economies derive major benefits from integrating with the developing economies, but this also entails adjustment costs and the "difficult but crucial challenge of carrying out the transition successfully."

The baseline projections for the decade 1995-2004 incorporate "significant revisions" of previous projections. 1) World trade will be "a major engine of growth," with merchandise trade growing at more than 6 percent a year and trade in services growing even faster. 2) For the developing economies, the rate of merchandise trade integration--measured by the difference between output and trade growth--was negative in 1970-85, it soared to almost 7 percent in 1991-94 and it is projected to average over 2 percent in the next decade. 3) If policy reforms "stay on track," output for the developing countries is expected to accelerate from 2.2 percent in 1981-94 to 4.9 percent in the next decade. Therefore, their share of world output will increase from 21 percent in 1994 to 25 percent in the next ten years, with their exports expected to grow 1 to 1.5 percent faster than those of the industrialized countries. 4) Growth in the industrial countries is projected to average 2.8 percent throughout the decade, with a low rate of inflation of 2.7 percent. 5) Volatility in

capital flows to developing countries will persist, but as confidence in emerging markets is regained moderate growth in these flows can be expected, if interest rates remain "moderately high, near current levels of 4 to 4.5 percent." 6) The long-term outlook for commodity prices, despite their recent cyclical surge, "remains unfavorable."

Within this positive global environment, "the baseline projection sees GDP growth in the developing countries accelerating from an average of 2.2 percent since 1980 to 4.9 percent over the coming decade." This means that average per capita GDP growth in the developing countries "will rise to a little over 3 percent a year in the next decade from virtual stagnation in the last."

This aggregate outlook "masks significant differences." East Asia remains the fastest growing, with "regional growth expected to ease to a still remarkable 7.7 percent in 1995-2004." If reforms are carried out in South Asia, "output growth is forecast to average 5.4 percent." Latin America and the Caribbean remain vulnerable, but "regional growth in the longer run could rise by 0.5 to 1.0 percentage points above the 3.5 percent average projected for 1995-2004." In Europe and Central Asia "long-run potential growth could move toward 5 percent a year." In the Middle East and North Africa, "average regional growth may improve to more than 3 percent." Finally, Sub-Saharan Africa is "projected to strengthen to 3.8 percent a year in 1995-2004 from 1.7 percent in the preceding decade."

An alternate scenario, based on a "boom-bust outcome," identifies significant risks in the "broadly favorable baseline outlook," such as higher interest rates in industrial countries and policy slippages in the developing countries. The risk derives from "higher-than-anticipated growth in 1995-96," generating "a global boom that reduces incentives to adjust and induces policy slippages in both industrial and developing countries, leading to a bust." By the year 2000, according to this alternate scenario, GDP in the developing countries would be 3.5 percent below the baseline. Another risk is a "mini-debt crisis," similar to the recent Mexican episode, caused by an accelerated loss of confidence resulting from policy slippages among other major recipients of private capital flows.

IV. 3. LATIN AMERICAN AND CARIBBEAN ECONOMIC PROSPECTS (WDW/16/95 7 JUNE 1995)

All the forecasts about this year's performance of the Latin American and Caribbean economies, issued before the Mexican crisis, have been revised downwards. The International Monetary Fund's World Economic Outlook (WDW/13/95, p.1), optimistically, projects that the developing countries of the Western Hemisphere will grow this year at an average rate of 2 1/4 percent. The World Bank's baseline scenario for Latin America and the Caribbean, presented in the last Global Economic Prospects (WDW/15/95, p.33), projects

that growth in Latin America and the Caribbean will average 2.4 percent in 1995-96. However, a relatively more pessimistic alternative by the Bank projects average growth of only 1.3 percent, for the same period.

These averages, as it is well known, mask wide differences in individual performance. There is consensus that the regional average will be pushed downwards by the negative performance in several major Latin American economies, such as Mexico and Venezuela.

For instance, the IMF's projection of 2 percent negative growth in Mexico for this year is considered too optimistic, with some expecting that the decline will exceed five percent. The World Bank sees hope for the Mexican economy in the medium-term, invoking the precedent of the Chilean devaluation of 1982, followed by a profound recession lasting until 1985. As recalled by the World Bank, "only with major real exchange rate adjustments in 1982-85, supported by wide-ranging structural reforms . . . Chile settled on its current stable, high-growth path." The Bank is hopeful "Mexico can follow" this precedent, "in far better external circumstances of world recovery than Chile faced in 1982."

The other economy that will experience its second year of negative growth this year is Venezuela, projected by the IMF to exhibit again negative growth of 2 percent. Some factors behind the poor performance expected in the Venezuelan economy, according to the World Bank, are: "large macroeconomic imbalances, financial sector crisis, accelerating inflation, large private capital outflows, and policy reversals." These factors, "have thrown the country into deep recession from which recovery is likely to be slow."

In this year, according to the IMF, Argentina and Peru will also experience drastic reductions in last year's impressive rates of growth of 7 and almost 10 percent, down to 3 and 4.5 percent, respectively. Because of the reduction in private capital flows, says the World Bank, "current account adjustment was placed squarely on the agenda in Argentina and in Peru."

Even in Brazil, the most vigorous economy of the region that usually performs above average, the World Bank is projecting a slowdown. "Restrictive fiscal and monetary policies set to maintain low inflation, according to the Bank, are likely to lead to some slowing in growth until fiscal reform can be completed." Therefore, this year, Brazilian growth is expected to remain close to the regional average.

Given this generalized slowdown, hidden behind the regional average, the World Bank finds a spectrum represented in one extreme by the Chilean economy, "which has combined fiscal surplus, moderate inflation, and modest external deficits and is expected to grow at almost 6 percent a year." At the other extreme, the Bank places the Venezuelan economy, in deep recession and only slowly recovering past levels of performance. Somewhere in the middle are all the other economies of the region, "that have made substantial progress on some aspects of stabilization and reform but face serious problems on others."

Anyway, the Bank recommends watching very closely the changes in the external environment faced by the developing countries, which will "influence significantly" their performance and policy responses. The "principal dimensions" of the external environment that should be watched are: 1) growth and inflation in the industrial countries; 2) interest rates; 3) capital flows; 4) world trade; and 5) commodity prices.

Briefly, in 1995-96, growth in the industrial countries is expected to remain at 2.9 percent, with stronger performances in Japan and Europe offset by the slower growth expected in the United States. By contrast, there is concern that high fiscal deficits in the industrial countries will continue pressuring real long-term interest rates, expected to remain moderately high at around 4 to 4.4 percent. A reduction of 1 percentage point in interest rates, for five years, is estimated to add 0.3 percent to the annual growth of developing countries and even 0.5 percent among the more indebted countries, such as those of Latin America and Africa.

Still, net private capital flows are expected to grow between 7 and 10 percent in the next decade and world trade will continue growing "at a brisk pace through 1996," projected at more than 6 percent a year. Finally. "the long term outlook for commodity prices remains unfavorable," with the index for non-oil commodities declining at an average of 2 percent a year in 1996-2004.

The negative signals to watch are higher interest rates in the industrial countries, accompanied by policy slippages in the developing countries, both leading to an initial boom and a consequent bust.

IV. 4. INSTITUTIONAL INVESTORS IN EMERGING MARKETS (WDW/25/95 13 SEPTEMBER 1995)

The search for the culprit in the Mexican crisis (WDW/8/95, p.44) is still going strong. A senior Mexican official blamed a bunch of youngsters from Wall Street, wearing tennis shoes and playing with their computers. By contrast, recently, the International Monetary Fund (IMF) said that domestic investors were the "front-runners" in the Mexican currency crisis, because they perceived the signals first.

Regardless of who ran first, a background paper of the recently released IMF report on capital markets (WDW/24/95, p.8) concludes that "the investor base in securities markets in industrial countries, and increasingly in developing countries, is dominated by a relatively small number of large institutional investors."

The IMF also found a simultaneous "trend" toward the internationalization of institutional portfolios. Additionally, one of the main consequences of this trend is that it

accentuates "the sensitivity of securities markets--especially the smaller, less liquid markets, notably in developing countries--to the behavior of a relatively small number of investors."

The definition of institutional investor comprises public and private pension funds; life and other insurance companies; mutual funds; hedge funds; trusts; foundations; endowments; and proprietary trading by investment banks, commercial banks, and securities companies.

In the United States the total assets of the 300 largest institutional investors, in 1993, amounted to $7.3 trillion, or 110 percent of GDP, up from $535 billion in 1975, or 30 percent of GDP. The same trend can be observed in other industrialized economies. In Canada, Germany, Japan, the United Kingdom and the United States, together, the assets under management by pension funds, insurance companies, and mutual funds amounted, in 1993, to almost $13 trillion. The relative importance of these figures is better appreciated when compared, in the same year, to global equity capitalization of $14 trillion and to the outstanding stock of public debt of the seven largest industrialized countries, which amounted in the same year to $9 trillion.

Given this astonishing growth in the total assets of institutional investors from industrialized countries, the next question has to do with their degree of international diversification. The IMF finds that there is a "general trend toward international diversification, especially by mutual funds and pension funds." Even so, the share of foreign securities in the total assets of institutional investors remains small. This shows the existence of a heavy bias toward domestic assets, also known as "home-asset preference," among institutional investors.

However, despite their domestic bias, the IMF found that institutional investor participation in emerging markets is increasing at "a rapid pace." Portfolio capital flows are experiencing "the most dramatic change," both in absolute and relative terms.

The main sources of these portfolio flows to emerging markets are institutional investors from the United States, especially mutual funds. The International Finance Corporation (IFC) has found that between 20 and 50 percent of all net flows of capital into emerging markets come from the United States, with a large proportion of these flows going to the Western Hemisphere.

Emerging market mutual funds have expanded rapidly in numbers and in total assets. By the end of 1993, the number of such mutual funds reached 594, with a total net asset value of $90 billion. In 1994, the number increased to 908 and the total net asset value climbed to $132 billion. In the same year, Asian markets accounted for 58 percent of the net asset value of all emerging market mutual funds, while Western Hemisphere markets accounted for 12 percent. Global emerging market mutual funds, which do not target specific countries or regions, were among the fastest growing with a relative participation of 28 percent.

By contrast to U.S. mutual funds, U.S. pension funds are less interested in emerging markets. In 1993, holdings of emerging market securities by U. S. pension funds represented less than 1 percent of total assets, or $18 billion, less than one fifth of the same holdings by U.S. mutual funds.

Despite the impressive flows of capital from mutual funds, emerging market securities represent only 1 percent of total assets held in the portfolios of institutional investors. Therefore, the recent activism displayed in emerging markets by mutual funds, particularly those from the United States, still cannot alter the strong bias toward domestic securities that prevails among institutional investors. Domestic ownership in the five largest stock exchanges remains very high, with 92 percent in the United States, 96 percent in Japan, 92 percent in the United Kingdom, 79 percent in Germany, and 89 percent in France.

Nonetheless, there is something distressing about this conclusion. At the still insignificant levels of internationalization described above, the emerging trend is already toward greater concentration of market power among the professional managers of a few big institutional investors. According to the IMF, this trend increases the "likelihood of market manipulation" and of less efficient markets, particularly in smaller emerging markets.

IV. 5. THE RISE OF THE CAPITAL ACCOUNT IN EMERGING MARKETS (WDW/31/95 25 OCTOBER 1995)

The numbers are there to confirm that managing the capital account is today more challenging than the current account. For instance, in 1994, the value of both world imports and exports, including commercial services, amounted to around $8 trillion. However, this amount was reached in one week of foreign exchange transactions. This figure also pales when compared, with the amount of outstanding derivative contracts, estimated by the International Monetary Fund to have reached $20 trillion in 1994.

Growth figures are even more impressive. International trade has grown recently at an average annual rate of about 4 percent, leading to 125 percent growth in the last decade. However, as described by the Chairperson of the U.S. Federal Reserve Board Alan Greenspan, cross-border finance has grown at a faster rate. Chairperson Greenspan mentions, for instance, that the stock of cross-border assets held by banks at the end of 1993 was more than 3 1/2 times as large as at the end of 1983. Also, annual issuance of international securities (bonds and equities) was more than four times as great in 1994 as a decade earlier, while global foreign exchange turnover tripled between 1986 and 1992. Finally, between 1988 and 1993, currency and interest rate swaps expanded five-fold.

The developing economies have not been excluded from this staggering growth in cross-border financial transactions. The IMF has estimated recently that net capital flows to these economies rose from an annual average of $3 billion in net outflows, between 1982-89 during the debt crisis, to a peak of net inflows of $149 billion in 1993. These capital movements declined to $119 billion in 1994 and they are estimated to have further declined as a result of the Mexican financial crisis.

However, acknowledging this explosion in capital movements should not lead to the conclusion that globalization is now complete and that the world economy has superseded national boundaries. As reminded recently by the Vice-Chairman of the Federal Reserve Alan S. Blinder, "pundits of all kinds, perhaps in an effort to appear chic and 'with it,' would have us believe that we now live in a brave--or perhaps scary--new world in which the old rules of economics no longer hold" (WDW/32/95, p.14).

Despite the impressive growth of capital movements, there remains a domestic bias that dominates investors preferences. The IMF estimated (WDW/25/95, p.36) that domestic ownership in the five largest stock exchanges is still very high, 89 percent in France; 79 percent in Germany; 96 percent in Japan; and 92 percent in both the United Kingdom and the United States.

Moreover, despite the also impressive growth in mutual funds dedicated to emerging market securities, these investments represent only 1 percent of total assets held by institutional investors in the United States.

Be it as it may, a debate is under way on how to manage these capital flows. For instance, last July, the IMF Board of Directors discussed capital account convertibility, understood as "freedom from exchange controls--quantitative controls, taxes and subsidies--applicable to transactions in the capital and financial accounts of the balance of payments."

On the issue of liberalizing the capital account in emerging markets, the IMF warned against several risks. First, there is the macroeconomic risk derived from the impact of sudden capital flows on the exchange rate and on inflation. Second, the banking system can be vulnerable to liquidity risks, mainly caused by short-term debts denominated in foreign currency. Therefore, the policy response to these risks, according to the IMF, could include some capital controls (WDW/24/95, p.8)

This conclusion, judged heretical by an editorial in the Wall Street Journal, is not enough, countered MIT Professor Rudi Dornbusch. In his well-known, straightforward style, Professor Dornbusch says "the IMF has already issued a verdict: there is a problem, something ought to be done, nothing can be done."

In a recent paper presented to the last G-24 meeting, Professor Dornbusch comes out in favor of imposing a variant of "a Tobin tax," in the form of "a cross border payments tax."

As described by Professor Dornbusch, simply stated, the capital flow problem of developing countries is that "either there is too much capital or there is too little and it is always mostly hot rather than cold." The policy response should be a "foreign exchange transactions tax. . .to lengthen horizons and shift agents from trading to investing." Among the supporters of such a tax are Nobel Laureate James Tobin and the present Undersecretary of the Treasury Lawrence Summers. The financial transactions tax would "heavily penalize short-run trading but puts virtually zero penalty on the long-term profitability of investment."

While some distance remains to be covered before we can conclude that the world is moving from "industrial capitalism" into "financial capitalism," already, several interesting conclusions have been drawn on capital movements in so-called emerging markets. First, the IMF at least recognizes the need for the adoption of certain capital controls. Second, there is support among respectable academics and influential policy makers for the adoption of a "financial transactions tax." This will encourage investors to "look for assets that promise serious returns in the long term, not for a way to get overnight returns from the negative-sum game of volatility."

V. THE MEXICAN ECONOMY

V. 1. THE MEXICAN PACKAGE
(WDW/4/95 8 FEBRUARY 1995)

It is a simplification to talk about "a Mexican package," because the one finally approved was the third version of a proposal that initially was perceived as simple borrowing by a distressed neighbor. However, as the crisis evolved, expressing itself in the peso plummeting and other emerging markets heading south, each new version of the package required more support. The second version of the package became entangled in the new balance of power that prevails in Washington, since the last elections in November. The third and final version only gained acceptance when President Clinton assumed the initiative, with the support of the congressional leadership of both parties. Thus, sighs of relief were heard in the U.S. Congress, in Mexico, and in emerging markets throughout the world.

The first attempt, on January 3, transformed earlier promises of $7 billion in lines of credit, from the United States and Canada, into a $18 billion package from several sources. The United States expanded its line of credit from $6 billion to $9 billion and Canada did the same from $1 billion to $1.5 billion. The rest consisted of $5 billion from the industrialized members of the Bank for International Settlements and $3 billion from a consortium of private commercial banks, led by Citibank and J.P. Morgan.

Nine days later, on January 12, President Clinton announced the intention of increasing the financial support available to Mexico. This time, the new package consisted of $40 billion in loan guarantees that required congressional approval. Therefore, the Administration secured, before the announcement, the support of the Republican congressional leadership.

Additionally, on January 26, the International Monetary Fund (IMF) announced that it would grant to Mexico a stand-by loan of $7.8 billion, the largest single credit ever granted in the Fund's 50 years.

Even so, the new proposal unleashed an intense debate that never came to fruition, because of the difficulties it experienced in the U.S. Congress among the ranks of both Democrats and Republicans. These difficulties, were overcome when President Clinton announced, on January 31, he would act on his own authority to lead in granting support to Mexico with a new package exceeding $50 billion. President Clinton pledged $20 billion from the U.S. Exchange Stabilization Fund, the IMF increased its support to the unprecedented amount of $17.8 billion, while credits from the Bank for International Settlements increased to $10 billion, with Canada and several Latin American countries contributing $1 billion each.

This was the version that finally got the peso to bounce back to 5.35 to the dollar, from the alarming 6.70 attained the day before. The next day, even the severely beaten Mexican stock market saw price increases of more than 20 percent, still insufficient to move it out of the position of worst performer in January, with staggering losses of 23.3 percent in dollar terms.

Regarding the unraveling of these anguishing events, in all, five weeks had to pass before the first signs of stabilization became apparent. The question is why did it take so long?

Now, it is easy to conclude that the magnitude of the crisis was underestimated. To be sure, the initial panic fed upon itself, in a vicious dynamic, transforming the first jitters into a generalized crisis of confidence that rippled through all emerging markets. Only drawing "lessons" was as swift, if not more, particularly among those who came out, from both ends of the spectrum, to proclaim "We told you so." Also, there were those who drew the "half-lesson" that it is better to avoid excessive reliance on the kindness of foreign investors.

Be it as it may, the slowness of the response has a political dimension that cannot be disregarded. The new balance of power that presently prevails in Washington generates parsimony in the search for bipartisanship. True, the President and the Republican leadership initially approved the package containing the guarantees. However, neither the President nor the new congressional leaders could contain a revolt from the populist and the more liberal wings of their own parties.

The populist challenge was led by columnist Pat Buchanan, with the support of many first-year Republican members of Congress. "Enough is enough," Mr. Buchanan wrote in the Washington Times, "for once, let the idiot-bankers of Wall Street and their duplicitous Mexican clients bail themselves out. If accountability is good for welfare mothers, why isn't it good for Wall Street."

This rift was even hurting Republican presidential politics. Senator Phil Gramm of Texas supported the populist rejection of the guarantees, projecting himself as defender of Main Street. By contrast, Senator Dole of Kansas supported the guarantees and was portrayed as defender of Wall Street.

Within the ranks of the Democrats the challenge came from the more liberal members. As House Minority Whip David Bonior from Michigan declared, in the Washington Post, "if the American people are going to be asked to guarantee billions of dollars in loans to Mexico, we need to demand certain conditions, including real reforms that would help working people on both sides of the border."

V. 2. FALLOUT FROM THE MEXICAN PACKAGE (WDW/5/95 15 FEBRUARY 1995)

Now that the dust has begun to settle, with the Mexican peso and emerging markets regaining some stability, the consequences of the last five weeks can begin to be sorted out.

First, there are the consequences for the Mexican economy. According to the International Monetary Fund (IMF), in 1995, the Mexican economy is projected to experience real economic growth of 1.5 percent, a rate of inflation of 19 percent and a decrease of the current account deficit from 8 percent to 4.3 percent of GDP. The devaluation is expected to contribute to a growth of exports of 25 percent and to a decrease in imports of 7 percent, which explains the drastic reduction expected in the current account deficit. Briefly, the Mexican economy will experience a recession that will only begin to be reversed sometime in 1996.

The second consequence is harder to measure because it has to do with the question of how can confidence be restored in the so-called emerging markets and in the economic policies of openness applied throughout the world. This was characterized by the IMF Managing Director Michel Camdessus as the "systemic risk" emanating from the Mexican crisis.

The Mexican economy was playing an "exemplar" role, since it was perceived approaching, according to Federal Reserve Chairperson Alan Greenspan "near-first-world status." Thus, in Mr. Camdessus' terms, "an unwarranted perception of failure of the Mexican approach might have had wide-ranging repercussions because a view might have spread that the market-based approach to development had failed." Chairperson Greenspan, saw such an outcome as "a tragic setback not only for these countries, but for the United States and the rest of the world as well."

This "systemic risk" has ignited a debate about the need for a "lender of last resort." The search is focused on the international financial institutions because, as recognized by Under Secretary of the Treasury Lawrence Summers, the United States "cannot be, and will not be any kind of lender of last resort." For Under Secretary Summers, the Mexican experience "has revealed with crystal clarity the need for thinking about what kind of institutional mechanisms we can forge to deal with problems of this kind in the future, and much more importantly, to prevent problems of this kind from arising in the future."

A debate is already taking place, described by Peter Passell in the New York Times, about the need for a mechanism similar to the General Agreements to Borrow, that exist among the industrialized economies. C. Fred Bergsten, director of the Washington-based Institute for International Economics, supports the creation at the IMF of a stabilization fund for endangered secondary currencies, accompanied by an enhancement of the surveillance capabilities of the IMF. Also, Mr. Camdessus has indicated that the IMF is "drawing lessons

from this experience with Mexico," which he described as "the first major crisis of our new world of globalized financial markets to have hit a developing country."

Not everybody agrees. MIT Professor Rudi Dornbusch is concerned about "moral hazard," described as "the settlers inclination to move into hostile Indian territory when they believe the cavalry is ready to ride to the rescue." In Chairperson Greenspan's terms, moral hazard occurs "where the active involvement of an external guarantor distorts the incentives perceived by investors." The alternative, for Professor Dornbusch, is "a bit less worship at the altar of wide-open international capital markets and a lot more caution on the part of investors."

Finally, there is concern that the Mexican experience may have delayed the first steps toward creating a free trade area in the Western Hemisphere, a goal recently adopted by the heads of state that participated in the Miami Summit of last December. After all, with the approval of the North American Free Trade Agreement (NAFTA), Mexico was seen as opening the way for extending free trade throughout the Americas.

The NAFTA debate was reopened in the U.S. Congress with the proposal of granting guarantees to Mexico. The difference, for some observers, is that this time the debate was nastier, because of the list of conditions that was proposed. To mention only a few of these conditions: it was proposed that Mexico stop emigration and drug trafficking; privatize the state oil company; stop trading with Cuba; enact labor reforms and guarantee free elections; create a currency board and bring back the peso exchange rate to 3.5 to the dollar; finally, some went as far as to propose an exchange of prisoners. For this reason the New York Times editorialized, "Mexico needs help, not extortion" and the Administration decided to go ahead with a package that did not have to be approved by Congress.

The question remains if, with the new balance of power that prevails in Washington, there will be enough support in Congress to begin extending trade negotiations to the rest of the Hemisphere. Chile is the only country that has decided to request admission to the NAFTA. The U.S. Trade Representative, Ambassador Mickey Kantor has declared that the Administration is committed to complete the negotiations with Chile and to observe the schedule for hemispheric trade negotiations approved by the Miami Summit.

V. 3. THE SEARCH FOR THE CULPRIT IN THE MEXICAN MELTDOWN (WDW/8/95 8 MARCH 1995)

The debate about the Mexican package has not subsided, it is just taking an ominous turn. On one side are those, like Jim Hoagland in the Washington Post, who describe Mexico as President Clinton's "quagmire." Others, like Paul Gigot in the Wall Street Journal, are

asking the ominous question of "who lost Mexico." As it is well known, the first is an analogy drawn from Vietnam, while the second refers to the witch hunt unleashed by the so-called "loss of China."

Beyond these comments, some decisive questions are being asked in the U.S. Congress, particularly among some newly elected Republican representatives and by the Chairperson of the Senate Banking Committee, Alphonse D'Amato (D-NY).

In the House of Representatives, what Keith Bradsher in the New York Times characterized as an "unusual coalition" of liberal Democrats and conservative Republicans approved a resolution, 407 to 21, requesting that "the Administration turn over all its files on Mexico's economy, debts and financial dealings with the United States." However, the resolution allows for the withholding of documents whose release the Administration judges to be "inconsistent with the public interest."

In the Senate, the Chairperson of the Banking Committee is also requesting from the Administration the presentation of documents related to the Mexican package. The request, includes documents from the Treasury, the Federal Reserve, the State Department and even the CIA. In letters addressed to the heads of these agencies, these officials are instructed to submit to the Senate Banking Committee "all records in your custody, control or possession regardless of format," from January 1, 1994 to the present, on Mexican currency policies and any assistance provided to Mexico by the Treasury, the International Monetary Fund, the World Bank and the Bank for International Settlements. Senator D'Amato said, "these documents should help answer the pivotal question--what did the Administration know about Mexico and when did the Administration know it?"

Senator D'Amato has also expressed the intention of organizing a major hearing to analyze these documents. "Now that American taxpayers have been put on the line for $20 billion," Senator D'Amato said, "they have an absolute right to know if the Administration was asleep at the switch or helped to bring about this crisis."

Subject to scrutiny is, first, Treasury Undersecretary Lawrence Summers, who will be questioned about the advice he gave to the Mexican authorities before the peso devaluation. Senator D'Amato has said that he is not satisfied by the Undersecretary's explanations, "you hear Larry Summers and you watch his body language--the things he is saying, you just can't get your arms around them."

Also under the limelight is Treasury Secretary Robert Rubin, confirmed by the Senate 99-0, on January 10, in the middle of the crisis. Secretary Rubin has refused to reveal the communications between the U.S. Treasury and their Mexican counterparts. In a statement to the House Banking Committee, Secretary Rubin said, "it has been our position . . . that we should not disclose the conversations we had with another government. If we do, then governments in the future will not be willing to discuss these kinds of matters with us in a candid fashion." This led to the accusation, by Representative E.J. Istook (R-Okla.) that the Secretary of the Treasury was "stonewalling."

Some Republican Representatives are also interested in Secretary Rubin's previous role as co-chairman of Goldman Sachs, before he joined the Clinton Administration to be Chairperson of the National Economic Council at the White House. In that position, Secretary Rubin recused himself in matters affecting a list of Goldman Sachs clients, among which was the Mexican government.

When Representative Istook, at a hearing of the House Appropriations subcommittee, interrogated him about his ties with the Wall Street investment bank, Secretary Rubin answered: "what Goldman Sachs has to do with Mexico is of no interest to me."

Even House Speaker Newt Gingrich has been criticized by some recently elected Republican Representatives, for offering bipartisan support to the Mexican package. For instance, Representative Dana Rohrabacher (R-CA) said House Speaker Gingrich had not given "much attention" to the Mexican package, because he was "so focused on achieving his goal of passing his Contract with America in 100 days."

Finally, the Federal Reserve is also blamed for the Mexican crisis, because of the low interest rates policy that it had been practicing. George Melloan, in the Wall Street Journal, says low interest rates are responsible for pushing U.S. investors to search for higher yields abroad. Also Norman Bailey, in the Journal of Commerce, sees a replay of the 1982 debt crisis. Again, says Bailey, "the credit expansion, as a result, was directed outwards, and since the best available returns were in the emerging markets, the great financial asset inflation of the 1990s took place there." Thus, when interest rates increased in 1994, "the capital flows reversed themselves and rendered the Mexican crisis inevitable."

V. 4. LOOKING FOR A LENDER OF LAST RESORT (WDW/10/95 22 MARCH 1995)

More than twenty years ago, MIT Professor Charles Kindleberger, in his book The World in Depression, explained that the Great Depression of 1929-1939 was caused by England's inability and the United States unwillingness to provide the leadership required by the international economic system to function adequately. In Professor Kindleberger's terms, "the responsibilities of leadership are maintaining an open market for goods, a counter-cyclical export of capital and a mechanism for rediscounting in crisis."

Suddenly, several outbursts of turbulence, which have taken place in the first quarter of this year, have propelled some observers to wonder if these attributes of leadership are readily available, in what Under Secretary of the U.S. Treasury Lawrence Summers characterizes as today's "age of rapidly moving money."

The succession of events that started with Mexico's devaluation of the peso, rippling through all emerging markets, followed by the dollar's most recent plunge, and the failure of Barings, one of the oldest investment bankers, are among the events that have stimulated the search for leadership in today's international economic system.

Mexico's devaluation of the peso led to a debate in the United States Congress, that is still raging, about the wisdom of the devaluation as an economic policy instrument and about the wisdom of bailing out a neighbor in distress (WDW/8/95, p.44). Pressured by the Congress, controlled by the opposition, U.S. officials emphasized Mexico's unique situation and why it is not a precedent. In Under Secretary Summers' terms, "what compels the action in this special situation is the fact that Mexico is a country with which we share a 2,000 mile border."

Furthermore, Under Secretary Summers has emphasized repeatedly that "the United States cannot be, and will not be any kind of general lender of last resort" (WDW/5/95, p.43). This has turned the attention toward the international financial institutions, particularly the International Monetary Fund (IMF).

According to the IMF Managing Director Michel Camdessus, the main topic of the next spring meetings of the Bretton Woods institutions, to be held in Washington by the end of April, will be the creation of a "quick response facility" at the IMF. Also, Italian Prime Minister Lamberto Dini has suggested that the same issue be discussed at the G-Seven summit, to be held in Halifax, Canada, since the summit's agenda already includes a discussion about the future of the Bretton Woods institutions.

Even so, several difficulties have been identified concerning the possibility of granting the IMF the capacity to create such a facility. The main issue is the amount of resources required to make the facility credible, in a world that registers $1 trillion a day in foreign exchange transactions.

By contrast, the IMF's paid-in capital amounts to $240 billion, or only six times the amount of the Mexican rescue package. Therefore, C. Fred Bergsten, from the Washington-based Institute for International Economics (IIE), estimates that such a "quick response facility" would need at least $100 billion to be credible. Never mind that this is proposed at a time when there is resistance, in the U.S. Congress and other industrialized countries, to increase contributions to the multilateral financial institutions.

Princeton University Professor Peter Kenen, anticipating some of these funding difficulties, has proposed that the facility should be self financed. Those countries that experience large capital inflows, Professor Kenen proposes, would be asked to deposit part of these funds at the IMF. In return, these countries would be able to borrow larger amounts in times of crisis. This raises the question of how to persuade the surplus countries to participate.

William Cline, also from the IIE, has proposed the creation of an "International Bondholders Insurance Corporation," to be created at the World Bank with a mixture of private and public capital. The corporation would operate once the IMF and the industrialized countries have agreed on a rescue package and its role would be to issue guarantees on a country's debt in exchange for a fee. This profit making facility would have the capacity to guarantee debt up to a decade and its fees would vary according to the country's financial standing. These fees could also be used by private investors as appropriate signals to evaluate their own risks.

These proposals have been put on the table to endow the international financial institutions with the capacity to perform the role of lender of last resort. Also at issue is the role of these institutions in preventing those situations that end up requiring rescue packages set up in haste. Recently, for instance, the U.S. Executive Director at the IMF, Karin Lissakers declared that the Fund's surveillance instruments had not worked in Mexico's case. She said the fund "was not on top" of the Mexican situation.

Given the record and invoking "moral hazard" (WDW/5/95, p.43) other economists, such as MIT Professor Rudi Dornbusch, say that there is not enough preventive care, nor safety net capable of substituting for the discipline that the market imposes on overambitious investors and governments addicted to short term capital flows.

V. 5. FACTORS BEHIND THE MEXICAN FINANCIAL CRISIS, ACCORDING TO THE IMF (WDW/14/95 24 MAY 1995)

The last World Economic Outlook (WDW/13/95, P.1), recently released by the staff of the International Monetary Fund (IMF), contains an annex that reviews some attempts that have been recently made to identify the factors responsible for the Mexican financial crisis.

After a lengthy description of the events that preceded the plummeting of the Mexican peso since 1988, the annex presents "three broad and complementary views" about the causes of the crisis.

The first focuses on both internal and external shocks. The second emphasizes how an external position that became unsustainable left no option but to devalue. And the third, blames several policy slippages that eroded internal and external confidence.

It should be noted that the first two of these explanations almost absolve the decision makers of responsibility, while the third explanation blames them almost exclusively.

The "adverse shocks" explanation identifies several domestic and external shocks that made it "very difficult, if not plainly impossible, for the authorities to gauge the size and anticipate the recurrent nature of these shocks."

According to this view, relative calm prevailed between May and November 1994 in Mexican foreign exchange and financial markets. Additionally, the absence of inflationary pressures, may have reassured the decision makers in their perception that at least the domestic political shocks were temporary. Therefore, the elections and the inauguration of a new government were expected to contribute to overcome those sources of domestic instability.

However, against this viewpoint, it is argued that some external shocks were not transitory. The increases in international interest rates and other indicators, such as the drop in the Mexican stock market, could have justified the adoption of a set of measures to carry out a tightening of monetary conditions.

The second explanation suggests that because the stabilization program was based on exchange rate stability, the consequences inevitably were going to be a current account deficit and an overvalued exchange rate. Both the current account deficit and the appreciation of the exchange rate, at some point, become "unsustainable," demanding a restoration of competitiveness and of external equilibrium through a devaluation. The size of the current account deficit, at 7 percent of GDP in 1992-94 and projected to increase to 8 percent in 1995, is used to illustrate this point.

However, a more optimistic interpretation argues that, with enough time, the external deficit can be reduced by the effects of increased productivity on export competitiveness, making the devaluation unnecessary. Unfortunately, the full effects of the North American Free Trade Agreement (NAFTA) could not be felt in time to avoid the devaluation. For instance, foreign direct investment had resumed its strong growth after the approval of the NAFTA and exports were expanding rapidly, even with an appreciating peso, due to gains in productivity.

The third viewpoint asserts that there were "policy slippages." It is argued that a tighter monetary policy and an early widening of the exchange rate band were required, precisely, to confront the effects of the adverse shocks and the weakness of the external accounts.

Three indicators are recalled to illustrate this viewpoint: first, the behavior of interest rates; second, the management of government short-term debt; and third, the expansion of credit.

From the behavior of interest rates, between May and November 1994, the conclusion is drawn that "the authorities were attempting to accelerate the convergence of domestic interest rates to international levels." Additionally, the dollar indexation of short-term debt

increased the vulnerability of the financial system, while immediately before and after the presidential election there was a substantial expansion of credit from commercial and development banks.

Against blaming these "policy slippages," it is argued that "it was very difficult to gauge the size and nature of the shocks." Also, it is not clear "what a tightened monetary policy stance would have involved in terms of output and employment losses, or whether it would have sufficed to avert the crisis."

Anyhow, based on evidence from similar episodes, the conclusion is drawn that "a substantial hike in interest rates late in the day probably would have been insufficient to preclude the crisis."

Asked to choose, the IMF staff does not pronounce itself in favor of any one of these explanations. The response is "all of the above" and the conclusion is that "the various factors behind the crisis that have been discussed in this annex probably all played a role." From the beginning, the three viewpoints were presented as "not necessarily competing explanations of the crisis." Therefore, the conclusion is that "in all likelihood, future and more comprehensive analyses of this episode will find that many, if not all, of the factors emphasized by these views played a role in the crisis."

VI. TRADE

VI. 1. THE CLINTON ADMINISTRATION'S TRADE LIBERALIZATION POLICY (WDW/7/95 1 MARCH 1995)

The longest chapter of the last Economic Report of the President (WDW/6/95, p.21) is dedicated to "liberalizing international trade." Rightfully so, because it is in the field of international trade where the Administration exhibits some of its brightest accomplishments.

The objective of liberalizing international trade is pursued at three distinctive levels. At the worldwide level, through multilateral initiatives such as the successful completion of the Uruguay Round negotiations. At the regional level, through so-called "plurilateral" initiatives such as the enforcement of the North American Free Trade Agreement (NAFTA), and the agreements to move toward free trade in the Western Hemisphere by 2005, and in the Asia-Pacific by 2020. Finally, through bilateral initiatives with specific trading partners, such as the Framework for a New Economic Partnership with Japan, or the measures aimed at improving trade relations with China.

The Report prides itself of these accomplishments saying, "in its first two years in office the Administration has achieved more in international trade policy than any other postwar administration."

The basic rationale for pursuing trade liberalization, through this three pronged strategy, relies on the principle of nondiscrimination. A main consequence of practicing nondiscrimination is that it "makes trade liberalization a public good," because "what is produced by one country in negotiation with another is available to all." This generates a coordination problem, characteristic of all public goods, of "getting each party to participate rather than sit back and let others do the liberalizing, free riding on their efforts."

The way out of this "dilemma" is "commitment on the part of the major trading nations, coupled with ingenuity and the artful use of the fear of exclusion." Therefore, bilateral and regional initiatives are proposed "both as a way of extending market opening and as a way of pressing for greater liberalization in the full multilateral arena."

A good summary of the Uruguay Round results is included and the chapter also describes the areas where multilateral negotiations are still necessary, because they could not be completed, such as services and agriculture. Additionally, negotiations are also required in other new areas, such as the environment, competition policy, investment rules, and labor standards.

The Administration's "most distinctive legacy in international trade is the foundation it has laid for the development of open, overlapping plurilateral trade agreements as stepping stones to global free trade."

The main justification for undertaking these regional initiatives, in the Western Hemisphere and in the Asia-Pacific, is found in the dynamism presently exhibited by the economies of both regions. For instance, "both Latin America and Asia are seeing a virtual explosion in the number of households with middle class incomes and consumption patterns." Consequently, these initiatives are as "critical for placing the United States squarely at the fulcrum of two of the most dynamic regions of the world."

Regional agreements can become building blocks instead of stumbling blocks. These last are understood as "preferential trade agreements that reduce the discretion of member countries to pursue trade liberalization with nonmembers." By contrast, building blocks are those agreements "structured according to principles of openness and inclusiveness."

Thus, regionalism "is a complement rather than an alternative to U.S. multilateral efforts," in several ways. First, regional agreements "may achieve deeper economic integration among members than do multilateral accords because the commonality of interests is greater and the negotiating process simpler." Second, the creation of a free trade area is "a reinforcing process," under which "it becomes increasingly attractive for outsiders to join in order to receive the same trade preferences as member countries." Third, regionalism builds support for liberalization by encouraging "partial adjustment of workers out of the import-competing industries in which the country's comparative advantage is weak, and into exporting industries in which its comparative advantage is strong."

Regional agreements "structured according to principles of openness" are the foundations of the policy of "open regionalism." This requires that trade agreements be "fully consistent with Article XXIV of the GATT, which prohibits an increase in average external barriers." Also, regional agreements should "not constrain members from pursuing additional liberalization either with nonmembers on a reciprocal basis or unilaterally." Finally, open regionalism requires that agreements "both allow and encourage nonmembers to join."

For all these reasons, "the United States is pursuing a policy of open regionalism. The Administration is working to lay the foundations for a world with several overlapping, open plurilateral arrangements, with the United States playing a leadership role in North America, Asia and Latin America, rather than two or three competing blocs."

VI. 2. THE U.S. TRADE POLICY AGENDA FOR 1995
(WDW/9/95 15 MARCH 1995)

Section 1541 of the Omnibus Trade and Competitiveness Act of 1988 mandates that "the President shall submit to the Congress during each year (but not later than March 1) a report on A) the operation of the trade agreements program . . . and B) the national trade policy agenda for the year in which the report is submitted." Both requirements are contained in a single volume, issued on deadline, by the United States Trade Representative (USTR), with the title 1995 Trade Policy Agenda and 1994 Annual Report of the President of the United States on the Trade Agreements Program.

In the introduction, USTR Michael Kantor characterizes the accomplishments of 1994 as the conclusion of "a series of historic agreements." Ambassador Kantor mentions the following: 1) the approval by the U.S. Congress of the Uruguay Round, "the broadest trade agreement in history." 2) The agreement reached with the leaders of the Asia Pacific Economic Forum (APEC), "to create free and open trade and investment by 2020 . . . the fastest growing economic region on earth." 3) The agreement among the participants in the Summit of the Americas in Miami, "to create a Free Trade Area of the Americas." 4) The agreement among the members of the North American Free Trade Agreement (NAFTA), to include Chile. 5) Under the Framework of a New Economic Partnership, "significant progress in opening markets in Japan." 6) The negotiation of a procurement agreement with the European Union. 7) After five years of negotiations, the completion of a shipbuilding agreement with key nations that "will cover 80 percent of world shipbuilding." 8) The conclusion of textile agreements with India and Pakistan. 9) The negotiation of investment agreements with numerous countries, "ranging from Jamaica to the Ukraine." 10) Finally, initial steps were given to "address substantially the intersection of trade and the environment as well as trade and internationally recognized labor standards."

The main objective of the 1995 Agenda is "to implement and build on the major achievements of the last two years." The agenda for 1995 was defined taking into account the following "two long-term changes in the global economy." First, the "globalization of business," which has "altered the context of trade and investment policy." And second, most developing countries have "shifted decisively toward market-oriented policies, creating new market opportunities for U.S. goods and services."

The specific objectives contained in the agenda for 1995 are classified according to the multilateral, regional and bilateral instruments that will be utilized. Also, enforcement and dealing with remaining trade distortions are included as main objectives.

Multilaterally, the "first task" in 1995 is the application and enforcement of the Uruguay Round agreements, including the establishment of the new World Trade Organization (WTO) in Geneva. The "second task" is to achieve progress in some specific sectors or areas included in the Uruguay Round. First, "market access" will focus on those activities where the United States is highly competitive. Second, in services, the emphasis

will be on those sectors where commitments are still considered inadequate, such as financial services, basic telecommunications, and maritime services. Third, higher standards in intellectual property protection will be sought, particularly in the developing countries, beyond those contained in the Uruguay Round agreement on Trade Related Intellectual Property Rights (TRIPS). Fourth, on investment, bilateral treaties will be negotiated and negotiations will be launched at the Organization for Economic Cooperation and Development (OECD) on a Multilateral Investment Agreement. Finally, agreements on standards will focus on mutual recognition of testing, certification, and conformity assessment procedures.

Regional trade expansion includes the Americas, APEC and NAFTA. In the Americas, the implementation of the goal approved by the Miami Summit of creating a Free Trade Area of the Americas by 2005, will be pursued through existing trade and investment arrangements and at a ministerial meeting hosted by the United States next June in Denver. Within APEC, the activities will be focused on the agenda for the next leaders meeting, to be held in Osaka in November 1995. Finally, full accession negotiations to NAFTA with Chile are expected to begin after May 31.

Bilateral initiatives are identified for Japan, China and the European Union. Additionally, legislation will be proposed to extend the Generalized System of Preferences (GSP), beyond its expiration date in July 31, 1995. Finally, the Administration will work with Congress to expand access to imports of textiles and apparel from the countries that benefit from the Caribbean Basin Initiative (CBI).

Enforcement initiatives are identified as central parts of the strategy, through Section 301, Super 301 and Special 301 for intellectual property also through antidumping / countervailing actions, Title VII for government procurement and Section 1377 on telecommunications.

To conclude, the abolition of remaining trade distortions includes the promotion of deregulation and privatization, the problem of corruption, sound competition policy, to improve working conditions and to ensure that trade expansion and environmental policies are mutually supportive.

VI. 3. THE DENVER MINISTERIAL (WDW/17/95 14 JUNE 1995)

The plan of action issued by the thirty-four heads of state that met in Miami last December, mandates that the ministers of foreign trade should meet twice, in June 1995 and next year in March. Ambassador Mickey Kantor, Trade Representative of the United States (USTR), has invited his thirty-three colleagues to the first of these ministerial meetings, to be

held in Denver, Colorado, on June 30. The ministerial meeting will be followed by a two-day forum of private sector representatives, sponsored by Secretary of Commerce Ron Brown of the United States.

In preparation of these meetings, which are the formal kick-off for the creation by 2005 of a free trade area in the Hemisphere, an intense process of consultation at different levels is also under way. First, there have been bilateral consultations through the US embassies with each of the participating governments. Second, Associate USTR Peter Allgeier has met separately with representatives from the different subregional groupings that exist in the Hemisphere, such as the Caribbean Community (CARICOM), the Central American Common Market (CACM), Mercosur and the Andean Pact. Finally, there have been consultations in Washington between deputy trade ministers and separately with the ambassadors accredited at the White House.

These consultations have revealed certain differences, particularly between the countries of Mercosur, led by Brazil, and the proposals presented by the United States. For instance, there is consensus about the creation of several working groups on specific issue-areas, which must report to the next ministerial of March 1996. However, differences remain about the number of working groups that will be created.

On this issue, on one side, Mercosur suggests the creation of five working groups. On the other, the United States suggests the creation of eleven. Brazil is proposing working groups on market access, investment, trade remedy measures, customs procedures and technical standards, and phytosanitary and sanitary measures. The United States is proposing the creation of working groups in market access, customs procedures, government procurement, services, financial services, investment, intellectual property rights, standards and technical barriers to trade, sanitary and phitosanitary measures, antidumping, and competition policy.

This debate about the number of working groups illustrates the indirect manner in which the participating governments are approaching the key question of how the hemispheric negotiations will eventually take place.

Mercosur's position is that working groups should be created only in those areas where there can be rapid progress, because there already exists consensus about them. Too many working groups, Mercosur argues, could indicate the intention of creating a separate structure to carry out hemispheric negotiations. Instead, the member governments of Mercosur prefer deepening and expanding existing agreements.

The United States, according to a recent statement by Peter Allgeier, Associate USTR for the Western Hemisphere, is pursuing a two-track policy. On one track are the negotiations for accession to the North American Free Trade Agreement (NAFTA), as those launched formally in Toronto on June 7 for the accession of Chile. On the other track, are the hemispheric negotiations that will be launched in Denver, which may lead to a process of convergence among different "nodes of integration."

The agenda proposed by the United States for the Denver ministerial includes three plenary sessions, a luncheon and a dinner for heads of delegation, and a closing ceremony where the Ministers will approve the Denver Declaration, expected to contain the navigation chart to approach the goal set in Miami.

In the first plenary session presentations will be made by the spokepersons of existing subregional agreements, Andean Pact, CACM, CARICOM, Mercosur and NAFTA and individual comments by participating ministers.

The second plenary session will discuss different "paths" toward the creation of the Free Trade Area of the Americas (FTAA). Some of the issues are: accession to, or linking of, existing subregional arrangements; promoting commonality in specific trade and investment; enhancing transparency of existing subregional agreements and domestic laws; means for obtaining domestic views on international trade from the private sector, including business, labor, small business and relevant non-governmental organizations; working toward common objectives in the World Trade Organization (WTO); improving working conditions; avoiding corrupt practices in trade and investment; perspectives of smaller nations; trade liberalization and environmental policies; finally, technical assistance and cooperation.

The luncheon for the heads of delegation will discuss domestic economic constraints and adjustments to hemispheric integration. The third plenary session will receive a report by the Special Commission on Trade of the Organization of American States (OAS); it will also discuss post-Denver mandates for the tripartite commission formed by the OAS, the Inter-American Development Bank (IDB) and the Economic Commission for Latin America and the Caribbean (ECLAC); and it will select the host for the March 1996 ministerial. To conclude, the closing ceremony will approve the Denver Declaration.

VI. 4. BRAZIL AND THE UNITED STATES REVIEW THEIR TRADE RELATIONS (WDW/33/95 8 NOVEMBER 1995)

Observers recall the acrimony, short of outright rupture, which characterized contemporary trade relations between Brazil and the United States. Be it because of Brazilian opposition to the inclusion of "new themes" in the launching of the Uruguay Round; the imposition by the United States of countervailing duties against Brazilian imports of non rubber footwear; Brazilian attempts to build its own computer industry; or Brazil's designation, under the U.S. section 301, as a priority country subject to retaliation because of its import licensing system.

Even so, these "irritants" never went as far as to cause total rupture, because there were simultaneous instances of fruitful cooperation among these two giants. For instance, as the Uruguay Round negotiations evolved, Brazil became actively involved in the Cairns

group, with the United States, Canada, Australia, Argentina and other exporters of temperate agricultural products. Also, in the second half of the eighties Brazil initiated a process of domestic adjustment and reform that has entailed a clear but gradual shift toward trade liberalization.

As a result, friction between Brazil and the United States has decreased to the point that both governments have now undertaken a comprehensive review of their trade relations.

To be sure, this 'rapprochement' was neither linear nor without relapses. The domestic instability that prevailed in Brazil in the past decade, generated a policy void and several attempts to fill it by reverting to anachronistic forms of defensive nationalism. Some of these reactions even appeared recently, as alternatives to the U.S. initiative aimed at building a free trade area in the Western Hemisphere.

For instance, deepening first the Southern Common Market (MERCOSUL), or building first a South American free trade area (SAFTA) were presented as prerequisites to any hemispheric negotiation. Other reactions took the form of ephemeral delaying tactics attempted throughout the process that led to the Summit of the Americas and some of its subsequent activities.

Anyhow, the turning point was the state visit by the newly elected President of Brazil Fernando Henrique Cardoso to Washington, in April of this year. An almost unnoticed communiqué revealed that Presidents Cardoso and Clinton had instructed Brazil's Minister of External Relations Felipe Lampreia and U.S. Trade Representative Mickey Kantor to review Brazil-U.S. trade relations.

The Presidents said the review should cover four topics: 1) bilateral trade relations; 2) the mutual goal of achieving a free trade area of the Americas (FTAA); 3) an expanded relationship between MERCOSUL and the North American Free Trade Agreement (NAFTA); and 4) cooperation in the functioning of the World Trade Organization (WTO).

As requested, on November 1, Minister Lampreia and Ambassador Kantor released the joint ministerial report to the Presidents containing the Brazil-United States Bilateral Trade Review.

The bilateral segment includes an agreement to address the following issues: government procurement; the Generalized System of Preferences (GSP); sanitary and phitosanitary measures; antidumping and countervailing duty laws; overcoming obstacles to investment; and intellectual property rights. To carry out these commitments the support of the private sector will be obtained through the U.S.-Brazil Business Council, as an active participant in the bilateral review process.

On the FTAA, both governments support the process initiated by the Miami Summit and the Trade Ministerial meeting, held in Denver last June. For this purpose, they agree to

carry out consultations before the next ministerial meeting, to be held in Cartagena, Colombia in March 1996.

Recognizing that MERCOSUL and NAFTA "account for more than 95 percent of the hemisphere's GDP and for more than 85 percent of intra-hemisphere trade," they agreed to hold an initial meeting between both by July 1996.

Finally, there was agreement on seeking common ground in ongoing negotiations in the World Trade Organization (WTO).

Given the relative weight of these economies, enormous potential is involved in an improvement of their trading relationships. To illustrate how repressed is this potential, consider that two way trade between the United States and Canada, in 1994, reached $250 billion. The corresponding figure, also in 1994, between Brazil and the United States was $16.7 billion.

Furthermore, the Brazilian share of world exports has been decreasing, from 0.5 percent in 1970-79 to 0.4 percent in 1994. Additionally, except for South America, the United States remains the most dynamic market for Brazilian exports of manufactures.

Therefore, the understanding between Brazil and the United States is a positive sign, amid less encouraging news such as the loss of bipartisan support that trade issues are experiencing in the United States. The improvement in bilateral trade relations between Brazil and the United States has tremendous potential and intrinsic value. Also, due to the participants' relative weight, it is a fundamental requirement for the construction of any hemispheric-wide alternative.

VI. 5. THE END OF CONSENSUS ON U.S. COMMERCIAL POLICY?
(WDW/35/95 22 NOVEMBER 1995)

After the legislative elections of a year ago, which gave the Republican party control of both the House and the Senate, there was hope for the emergence of a solid bloc of bipartisan support for free trade. After all, the North American Free Trade Agreement (NAFTA) and the Uruguay Round were approved by the previous Congress with the support of most Republicans and a minority of Democrats.

However, contrary to these early hopes, the Administration and the Republican congressional majority, throughout this year, have disagreed over the terms in which the Congress may grant authorization to the President to negotiate trade agreements. Among the negotiating objectives, the President wants to include the protection of environmental and

labor rights. The Republican majority holds that negotiating authority will be granted, only if it is circumscribed to strictly commercial objectives, without labor and environmental standards, in what is better known as a "clean fast track" authorization.

Despite the continued commitment to free trade of both the administration and the congressional majority, several attempts to bridge the distance between these two positions have failed. More worrisome still is the fact that, within the Republican majority, questions have emerged about the wisdom of negotiating more free trade agreements.

On November 3, Senator Robert Dole, Senate majority leader and front-runner in the race for Republican presidential candidate, declared his opposition to extending authorization to negotiate more free trade agreements. Senator Dole said "it would be a mistake to extend new fast-track authority at this time." He sees "most Americans shaking their heads," because they do not understand why "the President seems to want to rush into more free trade agreements."

The positive reaction from the most conservative ranks of the Republican Party did not make itself wait. According to the Journal of Commerce, Presidential contender Patrick Buchanan said, "beaming," that Senator Dole's speech proved his "message is getting through. We're winning!" he exclaimed.

Furthermore, the results of a poll among 999 active voters, released last week by EPIC-MRA Mitchell and the Journal of Commerce, confirm Mr. Buchanan's assertion.

The poll asked two questions based on Mr. Buchanan's campaign proposals. The first question was do you "approve or disapprove of a proposal to impose tariffs on products from countries that have a trade imbalance with the United States?" 69 percent approved, while 22 percent disapproved. The second question was would you "approve the imposition of tariffs on products from countries where workers receive extremely low wages?" 54 percent approved and 34 percent disapproved.

Finally, a third question asked who is responsible for the stagnation of industrial wages in the United States? 37 percent said trade/overseas competition; 32 percent blamed immigration; and 19 percent new technologies.

Trade issues may still disappear from the presidential campaign, as they did four years ago. Presently, they are only beginning to be part of the debate among the contenders for the Republican presidential nomination. However, according to the Journal of Commerce, the results of the poll indicate that Mr. Buchanan "is a good judge of public opinion," since he has made of the opposition to free trade "one of the top issues in his bid for the presidency."

On the other side, the requirement that the authorization to negotiate trade agreements include labor and environmental standards reveals the powerful grip that, in an election year, these groups have on the positions adopted by the Democratic Party.

In those terms, the centrist coalition, which supported the approval of the NAFTA and the Uruguay Round is losing ground. It remains to be seen, if the coming elections will confirm or contradict this trend.

Meanwhile, several serious negotiations must wait. This is the case, for instance, of the commitments to liberalize trade in the Western Hemisphere by 2005, approved in the Miami Summit; or by 2020 in the Asia-Pacific region, as confirmed recently by the Osaka Summit. In Senator Dole's terms, Congress should extend fast-track authority only after an "adequate cooling-off period," to allow for the digestion of the NAFTA and the Uruguay Round.

Seymour Lipset and Jeffrey Hayes, in a recent paper analyzing "the social roots of U.S. protectionism," recall that the ideological history of the United States reveals the existence of an "American creed," based on anti-statism, individualism, populism and egalitarianism. At different times, this "creed" has supported both inward looking isolationism and idealistic internationalism. According to Lipset and Hayes, the first 150 years of U.S. history were of "largely uninterrupted protectionism." Outward-looking internationalism has been dominant only for the last fifty years, following the Great Depression and the last world war.

Only time can tell if the pendulum is turning back to isolationism. As the depression and the world war catalyzed the adoption of internationalism, the end of the cold war may have inaugurated a return to isolationism and protectionism.

VII. MULTILATERAL FINANCIAL INSTITUTIONS

VII. 1. NEW PRESIDENT FOR THE WORLD BANK (WDW/11/95 29 MARCH 1995)

The designation by President Clinton of the investment banker James Wolfensohn, 61, as new President of the World Bank, has been received positively almost everywhere. On March 16, the appointment was unanimously approved by the Bank's Board of Executive Directors. Mr. Wolfensohn, Australian born and naturalized U.S. citizen, will become the ninth president of the Bank on June 1, succeeding Lewis Preston, who is retiring after three and a half years because of ill health.

During more than half of its fifty years of existence, the Bank was directed by two presidents, Eugene Black who served almost fourteen years (1949-1962) and Robert McNamara for more than thirteen years (1968-1981). Other presidents have served one period of five years and almost all have been investment bankers, as George Woods (1963-1968); A.W. Clausen (1981-1986); and the incumbent L. Preston, from September 1991 until June 1995.

Among those who have served only one term, the exception was Barber Conable. He was an experienced politician, member of the U.S. House of Representatives for twenty years, before becoming president of the Bank from July 1986 until August 1991.

Running the Bank's operations has become a complex task, since it lends more than $20 billion a year and it is estimated to have almost 8,000 staff members and to hire about 3,000 consultants. Until very recently, the daily operations of the Bank were run by Ernest Stern, who came to the Bank from the U.S. Agency for International Development in 1971, under McNamara, and rose rapidly to become senior vice president for operations in 1981, under Clausen. Stern recently joined J.P. Morgan, leaving behind the question of how the operational side of the Bank will be managed.

However, there is more to directing the bank than the operational aspects. The president is expected to offer inspirational leadership, to mobilize the bureaucracy and to persuade the donor governments and the borrowing members to move in the same direction. Without this inspirational role, the Bank's president becomes a lonely figure dedicated to balance the interests of the bureaucracy and those of the member governments, as they manifest themselves in the decisions adopted by the Board of Executive Directors.

This lack of inspirational leadership has been well described by former Bank vice president Willi Wapenhans, who became known for a departing report, released in 1992,

criticizing the state of the Bank's portfolio management. According to Mr. Wapenhans, quoted in the Financial Times, "a distinction between corporate direction and operational management is presently--and has been for some time--missing. Instead, operational management filled the void and thereby defined strategic direction."

Mr. Wolfensohn's credentials are perceived by almost everybody as excellent for the performance of this inspirational-operational role. He has the experience of a successful investment banker, as deputy manager of Schroders in London, as partner of Salomon Brothers leading the rescue of Chrysler, and as creator of his own "investment banking boutique" in New York, that advises thirty multinationals under the guidance of former Federal Reserve chairman Paul Volker.

Also highlighted is Mr. Wolfensohn's experience as an accomplished cellist and as patron of the arts. During ten years, he chaired the reconstruction of Carnegie Hall for its centennial, where he also performed with the New York Philharmonic to mark his 50th birthday. For the last five years, Mr. Wolfensohn rebuilt the finances of the Kennedy Center and won praise for his handling of a six week strike by the center's Opera House Orchestra. These credentials were mentioned, by Peter Truell in the New York Times, to describe Mr. Wolfensohn as "the renaissance banker."

President Clinton chose Mr. Wolfensohn over two insiders, Treasury Undersecretary Lawrence Summers and the deputy managing director of the International Monetary Fund Stanley Fischer, both former chief economists of the World Bank. To edge out these two powerful insiders and other candidates, Mr. Wolfensohn's involvement in environmental and development issues, reportedly, made him the candidate favored by Vice President Al Gore.

Still, Mr. Wolfensohn's appointment did draw some criticism, from nongovernmental organizations that lately have voiced their disapproval of the Bank's lending practices. For example from Ms. Juliette Majot, a member of the "50 Years Is Enough" campaign that is calling for "profound changes in an institution whose extended midlife crisis must come to an end." Ms. Majot wrote in a letter to the editor of the New York Times that Mr. Wolfensohn will need to be more than a "Renaissance Banker," also stating that, "once again, a Wall Street insider has landed the job of World Bank president." She added that Mr. Wolfensohn "is becoming captain of a sinking ship. It is a ship that has long been on a wrong course and suffers from severe structural problems. The only way to right it is to redesign it, rebuild it and set it on a new course." Mr. Wolfensohn, concluded Ms. Majot, "may have rebuilt Carnegie Hall; the World Bank is something else."

VII. 2. THE SPRING MEETINGS OF THE BRETTON WOODS INSTITUTIONS (WDW/12/95 10 MAY 1995)

Three issues dominated this year's spring meetings of the International Monetary Fund (IMF) and the World Bank, held in Washington on April 23-27. First, the world economic outlook; second, the evolving role of the IMF; last, recent developments in exchange markets.

As it is well known, the spring meetings bring together the industrialized countries in the G-Seven and the G-Ten and the developing countries in the G-24. These meetings are held in preparation for those of the Development and Interim Committees, which oversee the performance of the World Bank and of the IMF, respectively.

According to the IMF staff, the recent performance of the world economy signals "the start of a new expansion following the 1990-93 slowdown." However, two trends "cast a shadow on the otherwise encouraging picture." First, the "recent changes in financial market sentiment toward some emerging market countries," following the devaluation of the Mexican peso. Second, the "turmoil in exchange markets," caused by the devaluation of the U.S. dollar and the corresponding appreciation of the Japanese yen and the German mark.

In the terms of U.S. Treasury Secretary Robert Rubin, "we are living in a curious time. The fundamental health of the global economy looks stronger than it has in thirty years. Yet, the opportunities created by the rapid development of global capital markets have created new challenges, and recent turbulence in financial markets casts a shadow of uncertainty over the outlook."

It is against this background that the spring meetings examined the evolving role of the International Monetary Fund, in an environment described by the Interim Committee "of increased globalization and integration of markets."

Secretary Rubin mentioned some new realities to which the "international financial institutions must adapt," because "capital markets have become truly global in size and scope." One example used by Secretary Rubin to illustrate how capital markets have become globalized is that "today, foreign exchange transactions exceed in a week the value of international trade for a year."

The Mexican financial crisis revealed, according to Secretary Rubin, the need for "an architecture for the IMF that is as modern as the financial markets." Moreover, Secretary Rubin declared that "the markets can be unforgiving if latent problems go uncorrected too long."

For the IMF, the Mexican episode "serves as a powerful reminder for all economies of the speed with which perceptions about a country's situation can change, and of the heavy

costs of allowing economic imbalances to persist until financial markets force the necessary policy adjustments."

The pillars of the new institutional architecture will allow the IMF to serve as an effective early warning and prevention mechanism; to respond quickly and effectively to liquidity crises; and to deal with the difficulties of the heavily indebted poorer countries.

Ministers and Governors of the G-Ten supported "the ongoing efforts to strengthen the IMF's ability to exercise effective surveillance over its members' policies, and to ensure that it has adequate resources and policies to respond promptly and effectively to temporary balance of payments and liquidity problems of its members."

Also, the statement issued by the G-Seven Finance Ministers and Central Bank Governors recognized that the adaptation of the IMF's role to the new circumstances would be a central topic for discussion at the forthcoming annual Economic Summit, to be held in June in Halifax, Nova Scotia.

Finally, the turbulence in exchange markets was the third issue that dominated the spring meetings. The weakening of the U.S. dollar against the Japanese yen and the German mark have already caused some interest rate increases in certain countries and may exacerbate inflationary pressures in others.

The statement released by the G-Seven said that these exchange rate movements "have gone beyond the levels justified by underlying economic conditions in the major countries." Also, the G-Seven informed that there was agreement "that orderly reversal of those movements is desirable."

Again, Secretary Rubin was more direct to describe the present turbulence in exchange markets. "The movement of the dollar, Secretary Rubin said, has coincided with a sharper movement of some other currencies, most notably the yen." Among the reasons to explain this situation, Japan "unlike the other industrialized countries has not participated in the revival of activity that took hold in 1994." More to the point, Secretary Rubin declared "Japan needs to import more and to absorb more of its available savings, so that its external surplus adjusts to a more sustainable level." However, the IMF believes the threats posed by the turbulence in the exchange markets can be countered by "the recent decisions by Germany and Japan to lower official interest rates." Also for the IMF, "it would be appropriate for the Federal Reserve to reinforce the actions by the Bundesbank and the Bank of Japan by raising short-term interest rates in the United States."

VII. 3. THE IMF'S ANNUAL REPORT (WDW/26/95 20 SEPTEMBER 1995)

This year's annual report of the International Monetary Fund (IMF), for the fiscal year ending April 30, 1995, marks the fiftieth anniversary of the Bretton Woods conference that created the institution.

Besides stimulating what the Report characterizes as "a lively worldwide debate about the functions and policies of the Fund," the anniversary year also saw some extraordinary events.

As recognized by the Report, "the dominant single event of the anniversary year" was the financial crisis in Mexico. The events that started in Mexico by the end of 1994, led to the largest financing package, amounting to a total of $19 billion, ever granted to any member country in the Fund's fifty years.

These events also led the Fund's Board of Directors, in April 1995, to engage in a discussion about the effectiveness of the Fund's surveillance activities.

As revealed in the Report, the Board agreed that in 1994, before the outburst of the crisis, the relations between the Fund and Mexico "had revealed certain weaknesses." On the Mexican side, there were "delays" in reporting "key data to the Fund on a timely basis." On the IMF side, surveillance had not "functioned as a clear early warning signal to Mexico." The conclusion agreed by the Board was that "the responsibility was shared by the member and the Fund."

Additionally, during this anniversary year, the Fund attained almost universal membership, with the admission of Eritrea as the 179th. member. Also, there were two countries awaiting succession to the membership of the former Yugoslavia, the Republic of Serbia/Montenegro and the Republic of Bosnia Herzegovina, while Brunei Darussalam applied for membership by the end of the fiscal year.

Besides the Mexican financing package, during the fiscal year, the Fund approved substantial assistance for Russia and Ukraine, so-called "economies in transition from command to market economies," amounting to about $9.5 billion. Also, "to stop the spread of contagion effects arising from the crisis in Mexico," on April 6, 1995, the Board approved a fourth year extension of the existing arrangement with Argentina, increasing it to $6.3 billion.

In all, during the last fiscal year, IMF commitments under stand-by and extended arrangements amounted to about $24 billion, a record figure which exceeds the $22 billion committed a decade before, at the peak of the developing countries' debt crisis.

In fiscal year 1994/95, purchases (drawings) from the IMF's general resources account amounted to SDR 10.6 billion, double the level of the previous year. Repurchases (repayments) amounted to about SDR 4.0 billion, slightly below the SDR 4.3 billion of the previous fiscal year.

A regional breakdown for fiscal year 1994/95 reveals that the purchases by Latin American countries, from Mexico and Argentina together, exceeded by far those from other regions and amounted to SDR 6.7 billion. Purchases by the economies in transition, Russia and Ukraine together, amounted to SDR 2.9 billion. By contrast, African countries purchased SDR 0.7 billion and Asian and Middle Eastern countries purchased SDR 0.3 billion. These figures reveal that without the operations in Latin America and in the transition economies, the use of IMF resources in the last fiscal year would have been insignificant.

The level of outstanding overdue obligations to the Fund increased slightly during fiscal year 1994/95, from SDR 2.9 billion on April 30, 1994 to SDR 3.0 billion on April 30, 1995. However, the number of countries in arrears to the Fund decreased from nine to eight, since Haiti became the last country from the Western Hemisphere to eliminate its overdue obligations. Out of the eight countries in arrears, five remained ineligible to use the general resources of the Fund--Liberia, Somalia, Sudan, Zaire, and Zambia.

For the performance of these activities, in fiscal year 1994/95, the Fund employed 2184 staff members from 115 countries, down from the 2610 staff members from 114 countries employed in the previous year.

The Fund's administrative budget for the fiscal year ending April 30, 1995 amounted to $488.3 million and capital projects totaling $17.4 billion. Actual administrative expenditures reached $462.2 million and capital project disbursements totaled $32.9 million. For fiscal year 1995/96, the Board approved an administrative budget of $475.1 million, a decrease of 2.7 percent over the revised budget for the previous year, and a capital project budget of $13.4 million.

Finally, because of the "lively debate" generated by the fiftieth anniversary, the Fund is carrying out a policy of increased openness. For instance, in July 1994, the Board adopted the decision to make available to the public the documents that serve as background to Article IV consultations, known as "staff country reports," if the member government does not object to such disclosure. Therefore, the Report reveals that by April 30, 1995, 46 such documents had been released. Among them, several from Latin American and Caribbean countries, listed by date of release, such as El Salvador, Colombia, Costa Rica, Colombia, Belize, Suriname, Trinidad and Tobago, Honduras, Bolivia, and Jamaica.

VII. 4. THE WORLD BANK'S ANNUAL REPORT (WDW/27/95 27 SEPTEMBER 1995)

The annual report of the World Bank, covering the fiscal year (FY) that goes from 1 July 1994 to 30 June 1995, describes an institution that is undergoing profound changes.

Some of these changes are generated by external circumstances. As a consequence of the decline in multilateral lending, as a share of total capital flows to developing countries, the Bank's functions are shifting. From the role of "primary purveyor of capital," to that of an advisor on investment related services, providing guarantees, aid coordination, technical assistance, and sectoral and macroeconomic advice. Other changes are internally driven, after the appointment of James Wolfensohn, as the ninth President for a term of five years that began on 1 June 1995. The challenges faced by Wolfensohn, a prestigious private investment banker and patron of the arts, basically consist in adapting the institution to these rapidly changing circumstances.

Wolfensohn has recognized the legacy of his predecessor, the investment banker Lewis Preston who was president from 1 September 1991 until his death on 4 May 1995, by reaffirming the fight against poverty as the Bank's central objective. For this purpose three dominant themes are singled out: human resources development; environmentally sustainable development; and finance and private sector development. Through lending activities in these three areas, the Bank intends to respond to "a continuum of country needs," from those that are able to attract private capital flows, to those that are not yet fully integrated in the global economy, and those that are facing some degree of economic and social stress.

The Bank's operations for FY 95 reveal the distance that remains to respond fully to these criteria. Total new lending commitments in FY 95 amounted to $22.5 billion, an increase of 8 percent from the $20.8 billion of the previous year. However, from this total, adjustment lending amounted to 24 percent, up from the 12 percent reached in FY 94. The relative participation of other sectors was 17.3 percent for basic social sectors; energy 12.6 percent; agriculture 11.8 percent; financial sector 11.4 percent; and transportation 9.5 percent.

By regions, the biggest increase in commitments was in Latin America and the Caribbean, with 52 projects approved for a total of $6.1 billion, by contrast with the previous year when $4.7 billion were committed for 48 projects. Lending commitments also increased in Europe and Central Asia, with 58 projects amounting to $4.5 billion, an increase of $772 million over the previous year. Therefore, among the five largest borrowers of both Bank and International Development Association (IDA) funds, in FY 95, China was first with almost $3 billion, followed by Mexico $2.38 billion; India $2.06 billion; Russia $1.74 billion; and Argentina $1.42 billion.

The most remarkable events of FY 95 are the reactivation of the provision of Bank guarantees to catalyze infrastructure finance; the approval of a project of $20 million for the West Bank and Gaza; and Vietnam becoming the third largest borrower of IDA credits, after India and China.

In the segment dedicated to Latin America and the Caribbean, the Bank's lending to Mexico, of $1 billion to support financial sector reform in Mexico and $500 million to provide a safety net to cushion the poor from the effects of the crisis, is presented as evidence of flexibility and responsiveness.

Furthermore the Report describes "seven fundamental lessons" that can be drawn from the Mexican crisis: 1) create an environment that promotes domestic savings; 2) encourage investment and long-term capital inflows; 3) fixed exchange rates need fiscal and monetary policies that can react promptly against external disequilibria; 4) promote productivity gains; 5) open economies subject to external shocks need healthy banking systems; 6) improving income distribution and reducing poverty cannot be left to trickle-down effects; and 7) a strong state is a prerequisite for a strong economy.

To carry out its activities, in FY 95, the Bank's total budget amounted to $1.42 billion. However, as announced last year, the Bank's administrative budgets for FY 96-97 would be reduced by approximately 12 percent. Consequently, the total budget approved for FY 96 is $1.38 billion, a reduction of 6.4 percent over the previous year.

To these budget cuts correspond reductions in staffing, with almost 600 persons expected to be declared redundant at the end of FY 96. Therefore, at the end of FY 95, there were 6,059 regular and fixed term staff members, down from 6,185 at the end of the previous year. The redundancy payments are estimated to amount to $131 million, more than offset by anticipated savings of $78 million in FY 96 and $143 million in FY 97.

Out of the total staff employed, in FY 95, 3,983 were higher-level staff (4,094 on 30 June 1994), with 59 percent from industrialized countries and 41 percent from developing countries. Additionally, long-term consultants, at the end of FY 95, amounted to 1,112 (1,166 on 30 June 1994). Finally, out of the 186 higher-level staff recruited, during FY 95, 29 percent were from developing countries and 38 percent were women. Also, among the 39 persons recruited through the Bank's Young Professionals program, in FY 95, eleven were from developing countries and twenty were women.

VII. 5. THE IMF-WORLD BANK ANNUAL MEETINGS (WDW/30/95 18 OCTOBER 1995)

This year's annual meetings of the International Monetary Fund (IMF) and the World Bank were held in Washington, from October 5 to 12.

The main highlights of the meetings were the fallout from the Mexican crisis and a contradiction. Just when the world economy is becoming increasingly globalized, the multilateral institutions are experiencing difficulties in persuading the member governments to meet their financial obligations. The new President of the World Bank characterized this contradiction as "bitterly ironic." This reveals how the managers are lagging behind the intense level of interdependence that prevails in today's globalized economy.

Evidence of the saliency of this issue was the statement, for the first time in fifty years, by the Secretary General of the United Nations to the Development Committee meeting. Secretary General Boutros Boutros-Ghali came "at a moment of grave crisis." He said, "today, the United Nations is owed a total of 3,242 million dollars." He concluded forcefully, "I urge you, as Ministers of Finance or Development Cooperation, to ensure that your countries financial obligations to the United Nations are met in time and in full measure."

President Clinton closed his remarks to the annual meetings calling for funding the International Development Association (IDA). He said that to make a contribution to IDA, it was "not necessary for the United States to walk away from its commitment to balance the national budget." Furthermore, President Clinton said none of the 179 members of the Bretton Woods institutions, "including the United States can afford to detach itself from the business at hand and hope that others will take up the slack."

It was in this stringent context that the IMF Managing Director proposed a set of measures to deal with the consequences of the Mexican crisis. Despite a certain defensiveness in explaining the swiftness and the magnitude of the Fund's response to the Mexican crisis, Managing Director Michel Camdessus proposed and the Interim Committee supported the adoption of several measures.

First, "the regular and timely provision of comprehensive and good quality data," that allows the Fund to carry out the task of surveillance of the members' economies. As described in the communiqué of the Interim Committee, this entails the timely publication of 12 data categories and the creation of a two-tier approach. This last consists of a general standard for all members and a more demanding standard "for those having or seeking access to the capital markets."

The first tier of twelve indicators includes traditional figures, such as foreign exchange reserves; the current account balance; the central bank's balance sheet; fiscal

accounts; interest rates; money supply; consumer prices; output; and foreign debt and debt burden. The indicators constitutive of the more comprehensive standard include a sharper focus on others, such as indebtedness and maturities; currencies borrowed; interest rate spreads; and collateral.

Second, to preserve an adequate level of Fund's liquidity, the Interim Committee approved the Managing Director's suggestion of doubling the members' quotas for the Eleventh Quinquennial Review.

Additionally, the Interim Committee also welcomed the proposal approved by the Group of Ten, "to develop new parallel financing arrangements complementary to the General Agreements to Borrow (GAB), with the aim of doubling the resources currently available." For this purpose, contributions for another $25 billion will be requested from the Group of Ten and from "other countries with the capacity to support the international financial system." The countries mentioned as potential new contributors are Australia, Brazil, Korea, Malaysia, Singapore, Spain, and Thailand.

However, the immediate reaction from the new contributors was skeptical, because they request, in exchange, to participate at least in the G-10 meetings. Without such participation, declared John Williamson from the Institute for International Economics, to contribute to the GAB would amount to "taxation without representation."

Managing Director Camdessus described "the persistence of zones of extreme poverty" as "a scandal that is potentially more disruptive to the world than ever before." Therefore, the "third leg of the strategy" consists in supporting the continued financing of the Enhanced Structural Adjustment Facility (ESAF), before it becomes self-sustaining. Additionally, the Interim Committee supported addressing the problems of the lower-income countries with unsustainable debt situations, including the more controversial issue of the debt to multilateral institutions.

Finally, a bright spot was the participation of the new World Bank President. James Wolfensohn's directness and frankness have generated the impression among Bank-watchers that, finally, a leader like Robert McNamara has been found to run the institution. For example, a most quoted remark from Wolfensohn's opening statement at the annual meetings had to do with the need to change the way the Bank does business. He said, "we must focus on our clients and results, and break the armlock that, I sense, bureaucracy has placed on this institution."