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PRESENTATION

This is the third 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]

Classified by subject only for their presentation here, the dispatches are ordered chronologically within each chapter, with each chapter heading revealing the saliency, during the year, of certain issues of the international economic agenda. For instance, measured by the number of dispatches transmitted, the evolution of the world and of the U.S. economy, followed by trade and the functioning of the multilateral financial institutions, appear prominently. While more distantly behind appear issues related to the indebtedness and the adjustment of developing countries.

By contrast with previous years, the agenda of 1989 was dominated by "high politics," in the form of the relaxation of what Raymond Aron called the "relationship of major tension" of the present international system. By the end of the year, the exhilarating evolution of events in Eastern Europe defied imagination. Some of the "economic" issues raised by these events give ground to optimism, as well as to some appalling uncertainties. Among these issues, there is the potential "peace dividend" expected to be generated by the relaxation of tension among the two superpowers; the consequences of the integration of the Eastern European countries to the world economy; the reordering of the process of European economic integration; the diversion of development finance from the developing countries to Eastern Europe, and so on.

In second place, 1989 saw an intensification of tension due to the persistence of imbalances among the major industrial powers, particularly in the form of a worrisome increase in the frictions between Japan and the United States.

Finally, very distantly behind appeared the indebtedness of developing countries, with the debt strategy modified and the first cases of implementation taking longer than expected. The main event took the form of a fracture within the creditor camp, as a result of differences between the commercial banks with the U.S. Treasury and the multilateral financial institutions about the debt reduction component of the new strategy.

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[1] ECLAC, <u>International Economic Highlights 1987</u> (LC/WAS/L.2) 17 August 1988; <u>International Economic Highlights 1988</u> (LC/WAS/L.4) 17 March 1989.

The purpose of gathering these dispatches in a single document is to make them available for easy consultation, in case they still have some testimonial value. Finally, unfamiliar readers should be reminded that each dispatch tries to remain within the self-imposed limit of 750 words, because their objective is only to bring to the reader's attention an issue that may or may not demand further consideration.

I. THE WORLD ECONOMY

I. 1. THE PLIGHT OF NON-FUEL COMMODITIES (WDW/3/89 - 1 FEBRUARY 1989)

The World Bank announced recently that, in 1988, its aggregate index for non-fuel commodities increased to 102.8 (1979-81=100), a level 10.2 percent higher than in 1987. The annual average of the prices of 33 selected commodities --excluding petroleum and steel-- stood, by the end of last year, at 96.4, an increase of 16.4 percent from the annual average for 1987, which remained at 80.5, almost the same level attained in 1985 and 1986.

These figures indicate an interruption in the downward trend that has characterized the prices of primary, non-fuel commodities, throughout the eighties. The reversal started in mid-1987, when the World Bank's current dollar index increased from the record low of 74.4 that it had reached in the first quarter of the same year.

The last increase in the index amounted to a mini-peak in the first quarter of 1984. Primary commodity prices declined steadily until the second half of 1987, behavior that, in the World Bank's opinion, "proved to be a major disappointment to most primary producers."

If annual averages are considered, "the non-fuel commodity price index in current dollar terms remained approximately constant (at about 80) in all three years--1985, 1986 and 1987," falling to what the World Bank characterized as "record-low levels in recent history." Thus, in constant 1985 dollar terms, without the sharp increase in beverage prices in 1986, the lowest point for the index would have occurred in the same year. Still, "the 1987 index was the lowest ever recorded for the series," which dates from 1950.

By different commodity groups, between 1984 and 1986, fats and oils experienced the steepest decline (45.9 percent), followed by cereals (23.5 percent). Industrial raw materials --metals and minerals (13.1 percent) and non-food agricultural commodities (22.3 percent)-- also attained record lows in 1986, while beverage prices remained at relatively high levels, because of drought related crop losses in Brazil throughout the 1984-86 period.

Two major traits stand-out from the recent price behavior of non-fuel commodities. First, the stability at historically low levels during the 1985-87 period, as well as the recovery that started in the second half of 1987 and that lasted throughout 1988.

Among other aspects of this erratic behavior, the World Bank finds "most intriguing" that "the 1984-87 decline in commodity prices... happened during a non-recessionary period." On the other hand, the reversal in 1987-88 is explained by several factors, such as "sustained demand increases, structural adjustments within industries that led to sharply reduced capacity, and perhaps because of the US dollar depreciation in the preceding years."

Nonetheless, as the World Bank states in its recent study on Price Prospects for Major Primary Commodities, this upswing may not be sustained in the short term. Over the next two years, the prices of non-fuel primary commodities "in aggregate nominal terms are expected to decline slightly from their 1988 level."

Between 1988 and 1990, the prices of different groups of commodities will decrease with divergent intensities. For instance, a decline of about 16 percent is expected in the prices of metals and minerals, because the present growth rates in industrial production will not be maintained. By contrast with the prices of cereals, also expected to decline, the forecast for the prices of beverages is positive, because coffee and cocoa will recuperate from what are termed "the disastrous lows experienced in 1988." Besides, the positive outlook for beverages is based on the assumption that the prevalent quota schemes will remain operational. Finally, the nominal prices of "other foods" are also expected to increase, particularly because "the international price of sugar in US dollars is expected to increase by 35% over the 1988-90 period."

To conclude, the World Bank asserts that "with the international inflation index forecast to increase by nearly 8% over the 1988-90 period, the non-fuel index in constant US dollar terms declines by 10%." This leads to the bleak prospect that "such a decline will wipe out the terms-of-trade gains in 1988, bringing the constant dollar index back to the record-low level of 1987."

The longer term forecasts are equally somber. In real terms, the World Bank concludes that non-fuel commodity prices will experience "only a modest improvement over the 1990-2000 period --increasing by only 5%."

For instance, the foods group price index will "decline even further because of substantial declines in the real prices of the fats and oils and other foods groups." In the same vein, the price of sugar will "decline significantly over the 1990-2000 period," because "the sugar market has been and will remain under considerable pressure from substitute sweeteners." Beverage prices will also "decline even further in real terms over the period 1990-1995," because of the "continuing production increases from very cost-competitive producers." By contrast, "real prices of raw material commodities --agricultural and metals/minerals-- should trend up fairly strongly in real terms in the 1990-2000 period."

Briefly, the World Bank concludes that "the baseline projections for the developing countries present a mixed picture for the 1990s. Despite a relatively optimistic outlook for the industrial countries, the economic situation in a number of developing countries will remain fragile, particularly in the medium term, as the trade and payments adjustment in the major industrial countries continues to unfold."

Nonetheless, there still is ground for some optimism, because "the baseline projection for the industrial countries suggests that real GDP growth in this group will accelerate to about 3% in the 1990s." Hopefully, this time, these rates of expansion will pull-out the prices of non-fuel commodities from the slump of the eighties.

I. 2. <u>THE WORLD ECONOMIC OUTLOOK, ACCORDING TO THE IMF STAFF</u> (WDW/12/89 - 3 MAY 1989)

During the World Bank-IMF Spring meetings, held in Washington from March 31 to April 4, the staff of the IMF released excerpts of the forthcoming <u>World Economic Outlook</u>. Published biannually, the descriptions of developments and policies, as well as the projections contained in the <u>Outlook</u> should be attributed to the Fund staff.

The contents are divided in four different chapters. The first summarizes the overall prospects and the policy issues; the second describes the current situation and short-term prospects; the third deals with the medium-term prospects and policy issues in the industrialized countries; and the fourth addresses the medium term prospects and policy issues for the indebted developing countries.

Last year's levels of economic activity, illustrate the contrasting performances of two different groups of countries. On one side, the industrialized countries, as well as a majority of Asian countries, exhibited what is considered a surprising "buoyancy of growth," that allegedly defied "virtually all forecasters." On the other, the developing countries with debt-servicing problems, particularly in the Western Hemisphere and sub-Saharan Africa, whose economic performance last year --by contrast-- was "even weaker than forecast early in 1988, in spite of a relatively strong expansion of exports."

This description of world economic performance is followed by an analysis of inflation, international monetary developments, trade and current account imbalances, financing and debt in developing countries, as well as the economic policies followed in industrial and developing countries.

The core of the report are the two chapters dedicated to the medium-term prospects and policy issues in the industrialized, as well as in the indebted developing countries.

The prospects for the industrialized countries are presented in the form of baseline projections for the medium term, followed by a description of alternative scenarios, as well as by a discussion of the main policy challenges.

The baseline projections for the medium term --from 1991 to 1994-- are based on the assumption that policies will remain unchanged, with constant real exchange rates and oil prices. Before describing the main conclusions of this exercise, it is indicated that "these projections should not be interpreted as forecasts, but rather as a technical baseline on the basis of which alternative medium-term scenarios can be developed."

From 1991 to 1994, the growth of output in the industrialized countries is projected to be moderate, at an average annual rate of 3 percent. This projection reflects the expectation that growth will be stimulated by the completion of the process of internal liberalization within the European Community, as well as by the impact of the free trade agreement between the United States and Canada.

Based on the assumption that monetary policy will continue slowing demand growth, inflation is expected to decline between 1990 and 1994. Furthermore, the assumption of unchanged policies and real exchange rates leads to the conclusion that differences in the growth rates of GNP and domestic demand of the three largest countries will narrow in 1989-90, with these variables projected to grow at broadly similar rates during 1991-94.

Three hypothetical scenarios are drawn from these projections. Scenario A depicts a market reaction to unchanged policies, since the stability of exchange rates and interest rates assumed by the projections is not judged to be consistent with the persistence of large current account imbalances among the largest industrial countries. Consequently, this scenario analyzes the consequences for foreign exchange markets of a shift in investors' preferences away from U.S. dollar denominated assets. There follows a real effective depreciation of the U.S. dollar compensated by a surge in inflation, which in the short run leads to an improvement in the competitive position of U.S. producers and in the real external balance of the United States. The corresponding pressures in U.S. prices are met with resistance from the central bank by means of increases in interest rates, with the result that growth rates rise initially in the United States to end well below the baseline projected by 1994.

Some of the consequences of this projected scenario are particularly harmful for the heavily indebted developing countries. As a result of the rise in interest rates in dollar denominated assets, the debt-service ratio of these countries rises considerably, leading to a cutback in external financing, to a compression of imports and to a reduction in output and real domestic demand.

Scenario B illustrates the effects of an improvement in the federal budget imbalance of the United States, along specified limits. The main consequence reflects itself in lower interest rates, because of the reduction in government spending. Annual growth rates are not markedly different in both scenarios, although in scenario B there is sustained improvement in the U.S. current account and inflation is much lower than in scenario A. Of course, the debt service ratios of indebted developing countries are considerably lower.

Scenario C describes the effects of a comprehensive package of budgetary and structural measures in the industrial countries. Fiscal policies are tightened in the U.S. and efficiency raising measures are implemented in other industrial countries, such as increased investment in Japan or a tax reform in Canada.

As a result, real GNP increases in 1994 by 1 1/4 and 1 percent in West Germany and Japan, respectively, as well as between 1 1/4 and 1 3/4 percent in Canada, France, Italy and the United Kingdom. The U.S. economy is slightly affected, except for lower inflation rates, while output in developing countries is somewhat higher at the end of the period. In all, higher growth of output and investment, lower inflation and interest rates, as well as reduced external imbalances among the three largest industrial countries are the main results expected from this scenario.

The policy challenge for the industrial countries is "to sustain the present expansion while resuming progress toward lower inflation and interest rates, reducing the large current account imbalances among major countries, and promoting a more open international trade environment." These objectives are also considered important for developing countries.

Finally, the prospects and policy issues for indebted developing countries are centered around an analysis of the debt problem. Here are some of the main highlights. First, it is recognized that the debt overhang --whereby "the contractual value of the country's liabilities exceeds its expected debt servicing capacity"-- may act as "a strong disincentive to adjustment." This is so, because of "the perception that the benefits from improved policies would accrue largely to creditors rather than to the country itself." Second, in certain "extreme cases," it is admitted that the debt overhang may become such a large disincentive that "debt reduction measures could make both debtors and creditors better off." Third, it is also recognized that "the size of the external resource transfer may in some instances have a direct bearing on the success of domestic reform programs."

I. 3. THE WORLD BANK EXAMINES WORLD DEVELOPMENT (WDW/20/89 - 28 JUNE 1989)

Embargoed until 5 July, the World Bank recently issued this year's World Development Report divided, as usual, in two parts. The first part consists of a review, in a single chapter, of recent trends in the world economy, as well as of their implications for the future prospects of developing countries. The subsequent eight chapters contain the special topic of this year's REPORT dedicated to the role of financial systems in development.

As further evidence of the different tempos at which the international economy has been performing during the present decade, the Report begins recognizing that "economic performance in the 1980s has varied widely among countries and continents."

For instance, "after a sharp recession at the beginning of the decade, the industrial countries are well into their seventh year of uninterrupted growth," with 1988 characterized as "an excellent year for the high-income countries."

Contrastingly, not all the developing countries have taken advantage of this "favorable international environment." While "most countries of Asia did well," this was not the case in several other parts of the developing world. In Africa, the growth rates of many countries "remained near zero," as well as in the so-called heavily indebted economies, which "also continued to stagnate." Thus, the bleak conclusion is drawn that, in the eighties, "in Africa and Latin America hundreds of millions of people have seen economic decline and regression rather than growth and development."

The reasons given to explain this blatantly unbalanced distribution of growth are that "economies differ greatly in their structures, in their domestic development strategies, and in the extent to which they have been affected by external shocks." The plight of the heavily indebted countries is highlighted, because for them "higher real interest rates, reduced international capital flows, and lower commodity prices have made adjustment both necessary and difficult."

Under the heading of "the international economic environment, a brief review reveals that, during the eighties, real interest rates "have been higher than at any time since the Great Depression." Also, in volume, world trade is said to have "increased by more than 9 percent in 1988 --the fastest growth in the 1980s." Nonetheless, "high export growth among East Asian countries and low export growth in Latin America and Africa have significantly changed the regional distribution of developing country exports during the 1980s." Finally, the real prices of non-fuel commodities have undergone "a prolonged decline," posing "short-and long-term adjustment problems for producers and consumers alike." By contrast, the prices of oil have experienced "massive swings."

These circumstances generate challenges for structural adjustment policies. For instance, the "successful adjusters" of East Asia are advised "to depend less from external demand," while allowing "domestic consumers to reap some of the fruits of successful investment in manufacturing."

The "gravest development problems" are found in Sub-Saharan Africa, where "unfavorable external conditions and inadequate policies have caused economic, social and environmental decline." Even so, "some adjustment --painfully slow and not always sustained-- is occurring," although some African governments are said to be reducing their role in the economy. Looking ahead, it is considered essential "to correct overvalued exchange rates," as well as "to reverse the bias against agriculture."

Nonetheless, in cases where fairly strong economic growth has been accomplished, it "has yielded low or negative growth in per capita GNP," because of excessive population increase, which also "exacerbates the problems of food security, education, urbanization, and environment degradation."

After the adoption of drastic measures, the task of adjustment in the highly indebted countries, most of them in Latin America, is characterized as encompassing "trade reform, fiscal and public sector reform, and control of inflation and debt."

Lastly, the centrally planned economies are seen facing "a formidable challenge in moving toward decentralized decision making and greater reliance on markets."

The Report also identifies the main "development issues" that lie ahead. First, poverty, population growth and the environment are lumped together. Second, since the "world's trading system has become markedly less liberal," protectionism is identified as a constant danger. Third, "the debt problem," is now subject to a new debt strategy aimed at ensuring that those countries that "pursue serious adjustment policies will be able to return to growth."

The Report concludes with an analysis of growth prospects for the next decade, depicting three alternative scenarios:

1) A positive scenario of "adjustment with growth" assumes that the tackling of macroeconomic imbalances "within and among" the industrial countries will lead to a fall in real and nominal interest rates, while the dollar will depreciate further against other hard currencies. Also, those low and middle income countries that adopt "structural adjustment policies" will be able to "take advantage of growth," while lower interest rates will "ease their debt burden." In conclusion, this relatively optimistic scenario anticipates that the "combination of plausible adjustments by both high-income and low- and middle-income governments yields, overall, good prospects for world growth through the year 2000." Nonetheless, it is admitted that "many low- and middle-income countries would be unlikely to achieve the high growth rates they experienced in the 1960s and 1970s."

A less optimistic alternative is explored in a "low scenario." It assumes that "the appropriate policy actions are taken neither in the high-income countries nor in certain of the low- and middle-income countries." In this case, "crisis is averted through continued financing of the imbalances, but the low scenario entails great macroeconomic uncertainty, higher real and nominal interest rates, increased protectionism, and lower growth."

Based on the present debt strategy, the third alternative is a "debt reduction scenario." It is characterized by a combination of "a reduction in the debt of the highly indebted countries with the shift in the macroeconomic policy mix of the industrial countries that is part of the adjustment-with-growth scenario." It assumes that "debt stocks are reduced by 20 percent over three years." This leads to a reduction in net transfers, "in the form of interest payments associated with the reduction in debt stocks," of $5 to $6 billion over the same period. As a result, it is estimated that "GDP for the highly indebted countries could be about 1 percent higher at the end of the three years."

I. 4. THE BASTILLE SUMMIT (WDW/23/89 - 19 JULY 1989)

With the conspicuous absence of reigning monarchs, the leaders of the seven most industrialized nations --Britain, Canada, France, Italy, Japan, the United States and West Germany-- met in Paris over the weekend, to celebrate what the Parisian daily Liberation called "the two-for-the-price-of-one-summit-bicentennial."

Besides the six summit participants, President Mitterand invited also twenty seven leaders from all over the world, to participate in the US$75 million bicentennial celebration of the French Revolution. From Africa came Cameroon, Congo, Djibouti, Egypt, Gabon, Ivory Coast, Madagascar, Mali, Niger, Senegal, Togo, Uganda; Zaire; and Zimbabwe. From Asia came Bangladesh, India, Pakistan and Philippines. From Europe came Cyprus, Greece, Portugal, and Yugoslavia. Finally, from Latin America came Presidents Sarney, Salinas, Sanguinetti, and Perez.

In addition to a spectacular parade and fireworks, as well as lavish luncheons and receptions, the summit itself consisted of an opening session, held on Friday afternoon, in the new glass pyramid designed by the American I.M. Pei, at the main entrance of the Louvre Museum, as well as of two working sessions, held on Saturday and Sunday at the Arche de la Defense.

The Bastille summit --considered by Secretary Baker, a veteran of nine summits, one of the most harmonious ever-- concluded issuing two statements. The first consisted of a political declaration addressing East-West relations, China, terrorism and human rights. The second contained an economic declaration addressing the international economic situation, monetary coordination, trade, development of the poorest and the highly indebted countries, the environment, drugs, and international cooperation against AIDS. What follows is a summary of the main highlights contained in the economic communique.

Three main challenges were identified in the present world economic situation. First, adjustment of external imbalances and sustained growth, through the promotion of international trade and investments. Second, the improvement of the economic situation of developing countries, through their further integration into the world economy. And third, to safeguard the environment for future generations.

The international economic situation was described as positive, although not without risks. Among these last the threat of inflation was considered contained, but demanding continued vigilance. Also, the momentum of adjustment to external imbalances was said to have "recently weakened markedly." Thus, while deficit countries were asked to reduce budget deficits and increase exports, surplus countries were asked "to contribute to sustaining global expansion through policies providing favorable conditions for growth of domestic demand and imports." Finally, newly industrialized economies (NIEs), exhibiting "substantial surpluses," were requested "to contribute to the adjustment of external imbalances and the open trade and payments system." To this end, the NIEs were asked to "permit exchange rates to reflect their competitive position, implement GATT commitments and reduce trade barriers."

In the monetary field, it was recognized that international coordination has made a positive contribution to world economic development and it was expected to continue reflecting economic fundamentals. Also, the ninth review of quotas of the International Monetary Fund (IMF) was welcomed with a view to its completion before the end of the year.

Strong support was granted to the further removal of inefficiencies in the industrialized economies, as well as to the GATT's dispute settlement procedures and the Uruguay Round. A pledge was also made "to oppose the tendency toward unilateralism, bilateralism, sectorialism and managed trade." Even so, unilateral procedures to open markets, such as the Super 301 contained in the Omnibus Trade Act of 1988, were not even mentioned, probably reflecting the presence of a Japanese delegation weakened by domestic political scandals.

Development was termed "a shared global challenge," and help was offered through opening the world trading system and by supporting structural adjustment, as well as by underlining "the continuing importance of official development assistance."

The situation of the "poorest countries" was considered separately, by pledging support for the efforts of multilateral financial institutions for the reduction of debt-service payments, for the replenishment of International Development Association (IDA) resources, as well as by attaching "great importance" to the celebration of the United Nations conference on the least developed countries, to be held in Paris in 1990.

Also, separately mentioned was the strengthening of the debt strategy for the highly indebted countries, recognizing that the following challenges remained: "sound economic policies" in the debtor countries; "voluntary, market-based debt and debt service reduction operations," to complement new lending by creditor banks; support by the IMF and the World Bank to debt reduction through policy-based lending; and continued Paris Club rescheduling. Finally, in what was afterwards interpreted as a blunt warning, the commercial banks were urged "to take realistic and constructive approaches in their negotiations with the debtor countries and to move promptly to conclude agreements on financial packages including debt reduction, debt service reduction and new money."

That almost one third of the final economic communique was dedicated to the environment led some to call it a "green summit." Nonetheless, even before the communique was issued, differences appeared among environmental activists about the significance of the declaration. U.S. Environmental Protection Administrator, William Reilly, thought "terrifically encouraging" that "environmental policy is beginning to move from the margins to the mainstream of concern." By contrast, environmental activists, gathered for a simultaneous meeting in Paris, welcomed the extensive treatment given for the first time to the environment by the summit, although "they expressed strong concern at the seeming slowness to commit resources to the problem." Or, as The New York Times briefly sentenced, on the environment "the seven were more loquacious than specific."

Receiving extensive treatment for the first time were drug related issues. The summitteers pledged "to counter drug production, to reduce demand, and to carry forward the fight against drug trafficking itself and the laundering of its proceeds." Accordingly, the following concrete measures were mentioned: to support the United Nations Fund for Drug Abuse (UNFDAC); to support an international conference on cocaine and drug demand reduction in 1990; to strengthen exchange of information and cooperation, as well as to conclude bilateral and multilateral agreements to stop illicit traffic; and to "convene a financial action task force...to assess the results of cooperation already undertaken in order to prevent the utilization of the banking system and financial institutions for the purpose of money laundering."

Finally, the participants accepted the invitation extended by President Bush to meet next year in the United States.

I. 5. THE IMF'S WORLD ECONOMIC OUTLOOK (WEO)
(WDW/30/89 - 11 OCTOBER 1989)

The last issue of the WEO, released during the annual meetings, contains chapters on the current situation and short-term prospects, alternative medium- and long-term scenarios and policy issues in industrial countries. It also addresses the question of restoring growth in developing countries.

Among the recent developments in the world economy signs are found that "the economic expansion in the industrial countries is moderating to more sustainable rates." In the developing countries, while some have grown strongly, the weak performance exhibited by the heavily indebted and the low-income countries is one indicator of the "less satisfactory" side of the world economy. Other indicators of dissatisfaction are found in the slower "pace of external adjustment among the largest industrial countries," as well as in the persistence of high levels of unemployment in some European countries.

In the short run, in the industrialized countries, "a continued moderation of output growth is expected in the second half of 1989 and 1990." Also, assuming the continuation of firm policies, inflation will diminish gradually. Even so, such moderation is unlikely to turn into "a pronounced cyclical downturn," because of the absence of "major cyclical imbalances --such as a large inventory overhang or an erosion of profit margins-- that typically emerge prior to a recession."

The medium-term baseline projections for the industrial countries foresee a moderate rate of growth in output, from 4 1/4 percent in 1988 to under 3 percent in 1980. During 1990-94, output growth will average 3 percent a year and inflation is expected to accelerate significantly in 1989, but it will slow in the following years.

The alternative medium-term scenarios suggest that "considerable costs would be incurred by delaying the reaction of monetary policy to an inflationary shock," while action to reduce fiscal deficits "would lighten considerably the task of monetary policy in resisting inflation."

The darkest cloud in the medium-term outlook is "the prospect of sizable and persistent current account imbalances among the three largest industrial countries." The persistence of these imbalances raises several concerns. First, there is a risk of "an explosive spiral or rising interest payments and growing external asset and liability positions." Second, "disruptive market reactions and exchange rate swings." Third, "where the industrial countries are operating at high levels of resource utilization," adjustment could have undesirable consequences. Finally, there is concern about "pressures to restrict imports and limit foreign investment."

Three "major challenges" should be overcome by the economic policies of the industrialized countries, for "the long-term objective of achieving maximum sustainable growth." First, an environment of confidence and stability, without the uncertainties and distortions caused by inflation. Second, an adequate rate of capital formation, therefore raising the level of national saving. And third, to improve the allocation of resources, by removing "the distortions that hinder the operation of market forces."

The chapter on the restoration of growth in developing countries recognizes that this remains "a particularly urgent concern for the international community." After "close to a decade of unsatisfactory economic performance," it is "clear that considerable additional efforts are required by the indebted countries themselves, as well as by the international community."

The medium term prospects "depend crucially on the balance of external financing." Even so, the projections "imply the continuation of a substantial net transfer of resources from the debt-problem countries to the rest of the world."

The annual transfer, understood as the balance on goods and non-factor services, would still exceed 1 percent of the net debtor countries GDP over the 1989-94 period, with the largest burden borne by the heavily indebted middle-income countries, amounting to 2.3 percent of GDP during the same period.

To achieve such transfers requires "domestic absorption to be restrained" to generate the necessary trade surplus. Therefore, investment can only recover if there is "a significant rise" in domestic saving. Even more so, because "the medium term baseline projections envisage only a moderate decline in the net resource transfer from debt-problem countries to the rest of the world."

Still, as a result of rising export values and continued constraints on external borrowing, "debt ratios in the net debtor countries are projected to decline gradually, from 163 percent of exports of goods and services in 1988 to 116 percent in 1994." Already in 1988, for the first time in the last 20 years, a "slight decline in the external debt of developing countries" was registered. The decline in debt was "most pronounced in the Western Hemisphere, where outstanding liabilities to non-official creditors fell by almost 6 percent."

Admittedly, this medium-term outlook is "associated with considerable risks." Net debtor countries will face more difficult prospects in case of a steeper economic slowdown in the industrial countries, if world interest rates rise or if there is a further deterioration in the terms of trade.

It is also reminded that it was the relationship between the debt overhang, the need to reduce the net outward resource transfer, and the growth performance of the net debtor countries that led to the search for the reduction of the debt and debt service burdens. Nonetheless, "in and of itself," debt reduction is "no more a panacea for the economic difficulties of the indebted developing countries than new lending would be on its own."

Consequently, "substantial additional efforts are required both by the indebted countries themselves and by their creditors, trading partners, and international organizations."

An overview of the external environment, that goes beyond the maintenance of growth in the industrial countries, reveals other "less satisfactory" aspects, such as the sharp rise in international interest rates, rising protectionism and deteriorating terms of trade despite rapid growth in export volumes.

Additionally, two elements of the debt strategy are considered "most problematic," the external financing situation and the continued inadequacy of adjustment efforts. Although it is recognized that "the political and social difficulties surrounding the sustained implementation of appropriate measures will certainly be eased if the sacrifices required can be tempered by a reduction in the net transfer of resources to the rest of the world, which is particularly heavy for the middle-income indebted countries.

I. 6. MOUNTING TENSION BETWEEN JAPAN AND THE U.S. (WDW/33/89) 1 NOVEMBER 1989

As before the first clinch between two sumo wrestlers, the economic relations between Japan and the United States are becoming acrimonious and are showing ominous signs. The interdependence between these two giants has become the relation of major tension of the present international economy. Thus, it is better to sound the alarm early, before the contenders crash against some of the appalled bystanders.

Beyond the mutual accusations of Japanese hostility to imports or of U.S. economic mismanagement; beyond the mutual recriminations of "unpredictability," as in the case of the FSX fighter plane or of the erection of intractable or invisible trade barriers; not to mention Super 301 or the stubborn trade figures, across the Pacific, voices are being heard that are allegedly "poisoning" this fundamental relationship of today's international economy.

In the United States, a "revisionist" school offers a critical interpretation of Japan's performance that allegedly "demonstrates" the inevitability of conflict. In Japan, the depiction of the United States as an implacable adversary leads to the conclusion that the only alternative left is to break lose from a heedless partner.

Gone seem to be the days, in the United States, when the accepted wisdom was to imitate Japanese management, productivity, thriftiness, solidarity and other so-called "cultural" virtues. The "new critics," according to Mr. George Packard, dean of the Paul H. Nitze School of Advanced International Studies of the Johns Hopkins University, "seem determined not only to destroy the benign image of Japan that has been painted by an earlier generation of specialists: They seem to want to destroy the specialists themselves."

Among the intellectual inspirators of the revisionists appears University of California, San Diego, Professor Chalmers Johnson's pioneering study of MITI and the Japanese miracle. Characterized as a "capitalist developmental state," Japanese strength is said to derive from a solid partnership between bureaucrats and industrialists, that despite solemn pledges do not practice free trade. Also among the inspirators of the new school is Mr. Clyde V. Prestowitz, former U.S. trade negotiator and author of the celebrated book <u>Trading Places</u>, bitterly critical of Japanese trade negotiating tactics.

These works have influenced a group of journalists and "hard-line critics" who, allegedly, "dominate American media coverage of Japan." For instance, an August Business Week/Harris poll revealed that 68 percent of Americans today consider "the economic threat from Japan" as more serious than the military threat from the Soviet Union.

Among these commentators appears Mr. Karel van Wolferen, a Dutch journalist who has lived in Japan for the last twenty years, fifteen of them as East Asia correspondent for the Dutch newspaper <u>NRC Handelsblad</u>. Mr. van Wolferen is the author of <u>The Enigma of Japanese Power</u>, a description of the functioning of the Japanese "System" of rule by bureaucrats and corporate interests.

Another leading revisionist is Mr. James Fallows, the correspondent of <u>The Atlantic</u> monthly, who wrote an article, in May 1989, depicting Japan as an adversary that should be "contained." In August 1989, in another article, Mr. Fallows grouped American experts on Japan in four different categories: those who place security above economics; those naive believers in free trade; those that are "on the Japanese payroll;" and finally, those old-fashioned commentators that do not understand the new Japan.

The revisionists in Japan are just as formidable. First and foremost among them appears none other than Mr. Akio Morita, founder of the consumer electronics giant SONY and most recently the highest bidder in the $3.4 billion purchase of Columbia pictures.

Mr. Morita recently co-authored a book with Mr. Shintaro Ishihara, a senior Japanese politician who ranked third in the last contest to become Prime Minister of Japan. Their book is entitled The Japan That Can Say No and it concludes that "the roots of the U.S.-Japan friction lie in the soil of racial prejudice." Furthermore, Mr. Ishihara recognizes as his mentor, General Minoru Genda, the young naval officer responsible for planning the attack on Pearl Harbor.

Another revisionist from Japan is Professor Mototada Kikkawa, author of an op-ed in The Journal of Commerce urging Japan to enact its own Super 301. An "Omnibus Foreign Economic Relations Law," containing a "key provision," to adjust capital flows in response to U.S. measures against Japan. For example, "the imposition of trade sanctions could automatically trigger a 20% slash in Japan's purchases of Treasury notes." Thus, Professor Kikkawa concludes, Japan "might never have to retaliate, but the law would be available just in case Washington launches its Super 301 missiles."

Recently, more serene voices entered the arena. For instance, Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York, participated in a conference on Japanese direct investment in the United States, held in Tokyo on October 12, 1989. Focusing on the financial sector and on the basis of "an overview of the extent of Japanese presence in U.S. banking," Mr. Corrigan concluded that "the stakes for us and for the world economy are so very large that we have no choice but to find the will and the way that ensures success."

Also, the Managing Director of the IMF, in a speech delivered to the Japan Society in New York, on October 18, concluded that "Japan will want to exert a more active and positive role --and will be expected by the rest of the world to do so."

One week later, Clyde Farnsworth in The New York Times quoted "American and foreign officials" saying that "behind the scenes, Japan is positioning Toyoo Gyohten, a well-known official in international circles as a candidate to succeed Michel Camdessus of France as managing director of the I.M.F."

II. THE U.S. ECONOMY

II. 1. 1989 LOOKS HOPEFUL (WDW/1/89 - 18 JANUARY 1989)

1988 concluded without major surprises, equivalent to the stock market crash of October 1987, which brought forward memories of 1929 and opened the door to the specter of recession. To the credit of the incumbent Administration, 1988 passed without major upsets which could have endangered the victory of the Republican candidate in the Presidential elections of November. Additionally, the most important external event of 1988, in the form of the improved relations between the two superpowers, also supported a positive outlook for 1989.

This is not to say that what lies ahead is a cloudless horizon, because several pending issues could turn upside down the most optimistic expectations. For instance, there is the question about how the budget and the trade deficits of the United States will be confronted. Also, a consensus seems to be finally emerging that, unless something is rapidly done, the main Latin American debtors are close to the most critical point of their fatigue with debt servicing. Still, amidst these apprehensions, at least three different factors indicate that in 1989 there is enough ground for hope.

First of all, a majority of economists agree that there will be no recession in 1989. A survey undertaken by Blue Chip Economic Indicators, quoted by Leonard Silk in The New York Times, indicates that out of 44 economists interrogated about present economic prospects, 40 percent do not see a recession, until 1991; 27 percent predict the recession will come in 1990; and only 33 percent foresee that a recession will start in 1989.

Moreover, the Reagan Administration's assumptions about economic prospects, contained in the budget proposal submitted to Congress, are more optimistic than those of private forecasters, to the point that Hobart Rowen in the Washington Post called them "Reagan's last rosy scenario." The President's chief economic adviser, Mr. Beryl Sprinkel, predicts the economy will grow at a rate of 3.2 percent over the next five years, if and when the same policies of steady money growth and limited government will continue. Furthermore, when someone recalled that other analysts expected lower rates of growth, Mr. Sprinkel replied that he felt "pretty confident that there is going to be a lot of egg on their faces."

Second, the economic team assembled by the incoming President is said to constitute a network "based on a brotherhood of affluence and patrician credentials," characterized by Peter Kilborn in The New York Times "economic agnostics," who call themselves "results-oriented." The basic triangle of this network is said to be formed by Secretary of State Baker, Secretary of the Treasury Brady and Budget Director Darman. The main orientation of the triangle is said to be pragmatic, more than ideological, more willing to negotiate than to confront.

This pragmatism is considered crucial, because its prime test will come soon, in the form of the debate with Congress about how to balance the budget, as promised during the campaign, without imposing new taxes. The results of this confrontation will be closely watched, as the signal that will unleash other actions, such as the stance adopted on interest rates by the Federal Reserve, which in its turn will influence decisively the dollar exchange rate and thus the trade deficit.

Finally, the last upbeat factor giving ground to present optimism comes from the domain of "high politics," in the form of the relaxation in the relations among the two super-powers, or what Raymond Aron used to call "the relationship of major tension" of the present international system. The optimism fueled by this relaxation derives from the expectation that it will translate itself into deep cuts in present military spending on both sides of the equation, furnishing the necessary breathing space to address internal problems, without demanding more burdensome sacrifices. Obviously, the reduction of military outlays would allow incoming President Bush to fulfill his promise of balancing the budget without new taxes, which in its turn would decrease the threat of a financial collapse envisaged among professional Cassandras.

To sum up, the consensus, upbeat forecast about the economy, added to the pragmatism said to inspire the incoming economic team, as well as the impact expected on outlays from the relaxation of tensions among the superpowers are the three factors which give ground to 1989's hopeful outlook.

II. 2. THE CASE AGAINST THE DECLINISTS
(WDW/5/89 - 15 FEBRUARY 1989)

Before returning to Stanford University, former Secretary of State George Shultz in his valedictory address to the Citizens Network for Foreign Affairs, assailed the "false prophets" who hold that the United States is in decline, because it is overextended.

These remarks were aimed at the thesis that appears in the book by Yale Professor Paul Kennedy, entitled The Rise and Fall of Great Powers: Change and Military Conflict from 1500 to 2000. The spectacular success of this book, in early 1988, almost transformed the proposition that the United States is in decline into an issue in the subsequent electoral campaign.

Nonetheless, it was not until the electoral hype wound down that serious arguments began to appear against this proposition, besides those contained in Secretary Shultz's valedictory.

In the winter 1988/89 issue of the prestigious quarterly Foreign Affairs Harvard Professor Samuel Huntington, presents the most elaborate argument that has yet appeared against what he calls "the declinists."

The "declinist" argument, according to Professor Huntington, is based on three core propositions and on three bodies of evidence.

The three "core propositions" are: 1) the United States is declining economically compared to other market economy countries, most notably Japan; 2) a decline in economic power eventually affects other dimensions of national power; and 3) the relative economic decline of the United States is caused by excessive military spending, as a result of what Professor Kennedy calls "imperial overstretch."

The present "over-extension" of the United States, according to Professor Kennedy, only confirms what is revealed by other cases of decline, such as Spain, France and Britain, that have taken place in the span of the last five hundred years, "from the rise of the western world to the twenty first century."

The "three bodies of evidence" are: 1) the mounting U.S. trade and fiscal deficits; 2) the continuing and even accelerating declines in U.S. shares of global economic power and rates of growth in key areas of economic performance; and 3) "systemic weaknesses," such as research and development practices, primary and secondary education, production of scientists and engineers, as well as savings and investment patterns.

Professor Huntington comments on each one of these bodies of evidence. First of all, he recalls that the deficits were not "a major problem before 1982." He also believes that these deficits "stem from the weaknesses, not of the American economy, but of Reagan economics." The conclusion is that if the deficits were "produced quickly by one set of policies, they can be reversed almost as quickly by another set of policies." Hence, "it is a mistake to view them as open sores that will continue to bleed away American strength."

Second, concerning the evidence of "declining shares," Professor Huntington holds that after the rapid decline from post-war levels, since 1960, the United States accounts for 22 to 25 percent of the major forms of global economic activity and has done so consistently at least for the last twenty years. Consequently, "if hegemony means producing 20 to 25 percent of the world product and twice as much as any other individual country, American hegemony looks quite secure."

Finally, in relation to "systemic failures," the main threat to the strength of the United States, for Professor Huntington, comes from "consumerism, not militarism." He argues against Professor Kennedy's assertion that "the burden of empire usually becomes onerous when it amounts to ten percent or more of the society's product," because it does not apply to U.S. military outlays of only six or seven percent of GNP.

But Professor Huntington not only questions the evidence, he identifies the "central sources of strength" of the United States. He finds them in "the competition, mobility and immigration characteristic of American society." In his opinion, "the ultimate test of a great power is its ability to renew its power" and these traits "enable the United States to meet this test to a far greater extent than any other great power, past or present."

Finally, these internal sources of strength, are "supplemented by three aspects of the American position in international affairs." First, the strength of the United States is said to be "peculiarly multidimensional," because it "ranks extraordinarily high in almost all the major sources of national power." This generates the capability of sustaining "reverses in any one arena while maintaining its overall influence stemming from other sources." Thus "at present," concludes Professor Huntington, "no country can mount a multidimensional challenge to the United States, and with one conceivable exception no country seems likely to be able to do so in the relevant future."

Second, several structural factors "pull the United States into a leadership role in dealing with international problems and disputes." Some of these factors are: the geographical distance from the major areas of world conflict; a past relatively free of overseas imperialism; an antistatist philosophy and a strong sense of identification with universal international institutions.

Finally, Professor Huntington believes that "no alternative hegemonic power, with one possible exception, seems likely to emerge in the coming century." For instance, admittedly, the

Soviet Union still has "the resources, size and military strength of a superpower," but it is also said to have "lost out economically, ideologically and diplomatically." Japan is called "the choice of the declinists," and it is also dismissed as lacking the "size, natural resources, military strength, diplomatic affiliates nor, most important, the ideological appeal to be a twentieth-century super-power." Only the European Community, "if it were to become politically cohesive, would have the population, resources, economic wealth, technology and actual and potential military strength to be the preeminent power of the 21st century."

To conclude, Professor Huntington sees some positive consequences deriving from what he calls the "fifth wave of declinism." The first wave is said to have taken place in 1957 and 1958, as a result of the Soviet Union launching of the Sputnik. The second "declinist surge" came at the end of the 1960s, in the form of the Nixon-Kissinger announcement of the end of the bipolar world and the emergence of a "pentagon of power." The third "declinist scare" occurred after the OPEC oil embargo of 1973 and the increase in oil prices. The fourth declinist "fear" arrived in the latter 1970s, with the Soviet Union again becoming the focus, after "the U.S. defeat in Vietnam, Watergate, the expansion of Soviet power." Finally the fifth and last wave is said to have been largely triggered "by budget and trade deficits and the seeming competitive and financial threat from Japan."

For all these reasons, Professor Huntington closes his remarks arguing that, after all, "the declinists play an indispensable role in preventing what they are predicting," because "the more Americans worry about the health of their society, the healthier they are." Thus, it is predicted that "the current wave will serve a useful historical function if it encourages the new president and Congress to take prompt and effective actions on the deficits and to inaugurate longer-term policies designed to promote saving and investment." This is, according to Professor Huntington, "the self-renewing genius of American politics,."

As for the debate itself, given the present impossibility of verifying its terms --except in what is known among initiates as "la longue duree"-- it is better viewed as yet another aspect of the traditional rivalry between Harvard and Yale.

II. 3. <u>THE ECONOMIC STATE OF THE UNION</u> (WDW/6/89 - 22 FEBRUARY 1989)

This year's Economic Report of the President constitutes "the eighth and final" of the Reagan Administration. It is the outgoing President's valedictorian, rather than an expression of the incumbent's intentions.

In the message of transmission to the Congress, President Reagan compares the situation when he assumed office in 1981 with that of eight years later. In his own terms, then, "there was widespread doubt concerning the ability and resolve of the United States to maintain its economic and political leadership of the Free World." By contrast, "today, it is as if the world were born anew. Those who doubted the resolve, and resilience, of the American people and economy doubt no more. The tide of history, which some skeptics saw as ebbing inevitably away from Western ideals of freedom of thought, expression, and enterprise, flows in our direction."

This assertion is placed in the "historical perspective" of the last forty years, singling out that "the prime historical reality of this period has been the rivalry between two competing political and economic systems." The conclusion drawn from this historical exercise is that "today, few doubt which of these systems will emerge triumphant," because those "systems that emphasized individual initiative, open markets, and personal freedoms --as opposed to collective action-- have prospered most."

In the rest of the presentation, the President refers to the role of government --one of his favorite subjects-- by drawing a balance of the past eight years and by describing what are termed "the challenges ahead."

First, "the central role of government" is described as to nurture the individual genius of man, as opposed to "shackle it in a morass of regulations or to tax away the incentives for innovation." Nonetheless, the President admits that "this is not to deny that there are vital functions that a government must perform," although warning that "it must always do so in the least intrusive and costly fashion."

Based on this premise, the "Federal Government action should be reserved only for those functions that require national attention." These functions are: 1) to provide for national defense; 2) to protect the health and financial security of the elderly; and 3) to provide a safety net for the poor. Furthermore, "there are some limited circumstances in which government regulation of private activity may be beneficial," for instance, to protect the water and air from pollution. Finally, "the main role of government" is characterized as "to provide a stable economic environment that allows each individual to reach his or her full potential."

Internationally, the government's role is described as "similarly circumspect," with its "primary responsibility" described as "to promote sound and stable financial markets that encourage international commerce and to reduce barriers to trade at home and abroad."

On the last eight years' record, the message first points out the main accomplishments. First, "a peacetime economy entering an unprecedented 7th year of expansion." Second, this has been "accomplished without simultaneously fueling inflation." And third, "this record has been achieved not through alchemy, but by using that good old-fashioned recipe of reducing the role of government."

These successes are also found in the international sphere. First, "the strong U.S. recovery, coupled with a weaker recovery abroad, helped create a sizable U.S. trade deficit." This "served as an excuse for those seeking protection from foreign competition." Second, protectionism is chastised "like most forms of government intervention in the economy," because "it serves only to enrich the few at the expense of the many."

Based on these assertions, the main accomplishment in the international sphere is described as to "have successfully resisted this protectionist pressure, while pursuing major trade liberalization efforts abroad."

Among the remaining challenges, the "first and foremost" is defined as "to reform the budget process and to bring Federal spending under control." Additionally, "there is still work to be done" about inflation. Finally, "the challenge for the future is to maintain and expand upon the progress ... in taking economic decisions away from the government and returning them to the private sector, where they properly belong."

In conclusion, the President describes his mandate as a "second American revolution," that "in eight short years," reversed the "50-year trend of turning to the government for solutions." This message is also said to have "inspired changes throughout the world."

Finally, in his usual upbeat style, President Reagan closes asserting, "I leave office secure in the knowledge that these policies have worked, and confident that this great Nation will continue to lead the way toward freedom and prosperity for all mankind."

The Annual Report of the Council of Economic Advisers itself comprises the following seven chapters: I) free markets, stability and economic growth; II) fiscal policy and economic expansion; III) growth and evolution of international capital markets; IV) world trade and economic growth; V) rethinking regulation; VI) science, technology and the U.S. economy; and VII) the U.S. economy in the 1980s and beyond.

Here are some of the highlights contained in the Report. The first chapter concludes that "the lessons of the past suggest that solutions to economic and social problems should place maximum reliance on free markets." Even so, "government has a role in providing a stable macroeconomic environment, encouraging free trade and investment, providing basic public goods and a social safety net."

The examination of the role of fiscal policy in economic expansion concludes that "the Nation must avoid the temptation to increase marginal tax rates to reduce the Federal budget deficit."

The evolution of international capital markets contains a section dedicated to "the debt of developing nations," that does not offer new proposals to overcome this problem.

The agenda for the future of international trade recognizes the existence of a "tendency toward bilateralism," whose manifestations are not in themselves necessarily judged as "negative factors." The conclusion is drawn that "whether bilateral or multilateral liberalization will prevail depends significantly on two major events: the outcome of EC integration, scheduled to be completed by 1992, and the outcome of the Uruguay Round GATT negotiations, scheduled to end in 1990."

The fifth chapter describes the lessons and challenges of government regulation in a way that deserves full quotation. The lesson is that "regulation should be applied judiciously." The challenge is "to design institutions that create incentives for private market solutions to address problems, such as pollution, that can arise as a result of marketplace activity."

On the role of science and technology (S&T), "major changes in the role of the Federal Government do not appear to be needed." What is required is to improve the "understanding of the factors --institutional relationships as well as incentives-- that determine how effectively the S&T system works."

Finally, the last chapter projects an average annual rate of growth of real GNP of around 3 percent until 1994.

II. 4. SETTING THE INTER-AMERICAN AGENDA
(WDW/7/89 - 1 MARCH 1989)

The prestigious Inter-American Dialogue has issued its fifth report on the state and the future of hemispheric relations. In its own terms, this is the "most succinct and action oriented" of these reports and the timing for its release is also most appropriate.

On the agenda's top, the Dialogue urges the adoption of actions "to reduce Latin America's debt as an indispensable step toward reviving the region's economies." Otherwise, "if Latin America's perilously deep and prolonged depression is not ended soon, the consequences will be disastrous."

In second place appears Central America, where the new Administration is urged to "move promptly to support the efforts of Central America's presidents to forge a secure peace."

Third, the drug trade needs to be "vigorously fought throughout the Americas," with Inter-American cooperation "urgently needed to identify which approaches work best to reduce demand and supply and to avoid damaging friction over drugs."

Fourth, the democratic governments of the Hemisphere are called upon to work together to strengthen democracy, which is said to be "at grave risk" in Latin America.

Fifth, remedial and preventive actions are urged in a concerted manner from all the governments "to halt environmental degradation throughout the Hemisphere."

Finally, "Inter-American cooperation" is said to be both "necessary and achievable," because "ideological approaches have given way in the 1980s to a new pragmatism."

The ordering of the elements of this proposed agenda for action sharply contrasts with the salient issues that predominated during the past year. As surveyed by Margaret Daly Hayes, in the last issue of Foreign Affairs, America and the World 1988/89, four issues prevailed in last year's agenda of Inter-American relations. First, "Nicaragua and the U.S. support for the contras;" second, "Panama and the effort to oust General Manuel Antonio Noriega;" third, "drug trafficking;" and fourth, "the persistent debt problem." Also, "beyond these headlines," there was the continued "struggle to institutionalize democracy and modernize economies."

In the end, the priorities that will prevail in the future depend on the new Administration, which still finds itself involved in the process of appointing the persons charged with putting into practice what is recognized as a more pragmatic foreign policy stance.

Until now, discussions about Inter-American relations have centered around the person chosen to occupy the position vacated by Mr. Elliot Abrams, as Assistant Secretary of State for Inter-American Affairs, the highest ranking position in charge of Hemispheric relations.

The Secretary of State, in search for a bipartisan approach, has chosen a Democrat, Mr. Bernard W. Aronson, for this position. During the Carter Administration, Mr. Aronson worked as a special assistant and speech-writer for Vice President Walter Mondale. Also, from 1981 to 1983 he was director of policy for the Democratic National Committee. Moreover, the main reason invoked for his selection is the role played by Mr. Aronson in drafting the speech made by President Reagan, on June 24, 1986, requesting military assistance to oppose the government of Nicaragua. Mr. Aronson is credited with helping then President Reagan to obtain the support of several Democratic votes for the approval by Congress of such military assistance.

For this reason, reportedly, Secretary of State James Baker III "concluded that Aronson's background would help him reconcile the disputes that split Democrats and Republicans during the Reagan administration."

Even so, the choice of Mr. Aronson has been criticized by some liberal Democrats, as well as by centrist and conservative Republicans. For instance, Senator Claiborne Pell (D-Rhode Island) declared "if you look at his record, he doesn't seem to have all that much background." By contrast, when asked if the selection of Mr. Aronson was a good decision, Senator Bill Bradley (D-New Jersey) declared: "among the alternatives I've heard, I think it is."

Senator Nancy Kassebaum (R-Kansas) declared: "I'm sure he is a very quick study, but my disappointment is that he just doesn't seem to be someone who has a broad background and a sense of the history of the region, and he doesn't speak the language." Also, Senator Richard Lugar (R-Indiana) reportedly "expressed concern that, aside from his Central American involvement, Aronson has no experience with such regional issues as the debt problems of Brazil, Mexico, Argentina and other major Latin American countries." Last but not least, aides to Senator Jesse Helms (R-North Carolina) have "expressed concern about the selection," because "Mr Aronson seemed to have little knowledge of or experience in South America."

Consequently, the controversy surrounding Mr. Aronson's appointment, in fact, has to do with the issue that should appear at the top of the hemispheric agenda. Briefly, on one side appear those who see the wider issue of debt and economic depression as the primary concern. On the other appear those who want Central America to remain as the top item.

II. 5. MANAGING A $5 TRILLION ECONOMY
(WDW/18/89 - 14 JUNE 1989)

The debate about the budget deficit in the United States has generated several proposals about the management of the economy. Probably one of the most original has been presented in the book Governing The $5 Trillion Economy (Oxford University Press, 1989). The author of this book is Mr. Herbert Stein, a prestigious, mildly conservative, and one of the wittiest that can be found among Republican economists.

The debate about the federal budget deficit is characterized by Mr. Stein as "defeatist and escapist," because "it despairs about making rational, informed choices through the political process." Also, because it tries "to bypass that process," by means of "freezes, across-the-board expenditure cuts, or constitutional amendments."

The budgetary debate is characterized as a clash of contending arguments that is considered essential to modern budgeting, understood as the "process of allocating scarce resources among competing uses."

These debates were useful when the size of federal operations was relatively small, affecting only insignificant aspects of the economy's overall performance. Mr. Stein recalls that in 1929 federal expenditures were 3 percent of GNP, mostly for defense, veterans' benefits and interest on the war debt. Also, in 1948, federal expenditures were 12 percent of GNP, with expenditures outside traditional areas, such as defense, veterans' benefits, interest, international affairs, administration of justice, and general administration, representing less than 2 percent of GNP. This changed radically in the sixties and seventies, when the federal government moved into new fields, such as health, education and assistance for the poor. For instance, in 1978, "federal expenditures outside the traditional areas were 13 percent of GNP, whereas traditional expenditures were only eight percent." In 1988, in a more than $5 trillion economy, federal expenditures amounting to $1 trillion represented almost one fourth of the national output.

Given this impressive growth in federal outlays and thus of the relative importance of government in the overall economy, Mr. Stein derives the conclusion that one of the responses to this transformation should be to change the terms of the budgetary process.

The federal government's decisive influence on the allocation of the national income is exercised not only through budgetary outlays, but also through regulations, taxes, lending programs, and so forth. Consequently, Mr. Stein proposes that the budgetary process be changed to achieve a better allocation of the national output, in what amounts to a process of so-called "budgeting the GNP."

Three major advantages justify this change toward "looking at the budgetary problem as one of budgeting the GNP."

First, pondering federal expenditures in the context of total output, instead of comparing them with other budgetary items, means that a "bridge" is established between national objectives and budgetary decisions. Because choices should be made among ends --such as investment or consumption-- rather than among instruments --such as taxes or deficits.

Second, by definition, budgetary decisions involve sacrificing some objectives with the aim of attaining others. In GNP terms, more of one objective entails less of another one, instead of the illusion that everyone's aims can be met without sacrifices, "just by increasing the budget."

Finally, the allocation of GNP allows for a widening of the choices, by focusing on other non-budgetary measures, through which the government also exercises influence upon the economy.

On the basis of these considerations, the proposal for "budgeting the GNP" contains three elements:

- a statement from the President on national objectives;
- the allocation of the national output among these objectives; and
- a list of programs to achieve the proposed allocations.

The President's statement should be based explicitly on a perception of "the nation's chief problems and objectives." To arrive at this perception, Mr. Stein suggests the use of a technique from defense decision-making, called "net assessment," by which experts appraise the situation and how it can be changed.

The categories into which the national output is broken down "depend on the chosen objectives." Mr. Stein, for instance, proposes the following: defense, education, consumption, investment and other government. Admittedly, "the selection of these categories is itself a judgment about what the major national issues are," because there is no agreement about a "functional" classification of GNP.

Even so, it is considered more difficult to evaluate the impact of the proposed changes on the allocation of the national output. For instance, much work has been dedicated "to estimating the consequences of various tax changes on savings, consumption, investment, and economic growth." While less work exists about the "incidence" of budgetary expenditures.

Finally, it is proposed that the objectives to guide the allocations of GNP should be contained in a four year program, or budgetary framework, within which proposed appropriations would be made every two years.

To conclude, Mr. Stein denies that the proposal is aimed at overcoming the inefficiencies that emanate from "the fact" that budget-making is an essentially political activity. In his own terms, budgeting is "an adversary process, like war," whereby "it is assumed that the participants will try to cheat, to evade their commitments, to disguise their intentions, and to limit the options of their adversaries." Consequently, instead of changing the nature of the confrontation, the proposal aims realistically at changing "the terms of the struggle," by raising "the decision-making level to a point where more people can see their interests and be informed."

The purpose is thus defined as to displace the debate from the ideological domain, that usually prevails in discussions about taxes, deficits, or the size of government, to the more pragmatic domain, where the concerns refer to the alternative uses of limited resources, such as reducing investment to increase consumption, or the perennial alternative between guns and butter. As succinctly stated, the purpose of the proposed reform is "to face the fact that there is no free lunch."

Finally, those who react skeptically, by saying "that's planning," are forewarned that the proposal does not include an increase in the powers and responsibilities of government. It only tries to deal with "the fact that the federal government is going to be very big" and that Mr. Stein would like "to see it be better," because public policy improvement requires "more informed, objective, and honest discussion" in the private sector.

II. 6. <u>ADJUSTMENT WITH GROWTH IN THE U.S. ECONOMY</u>
(WDW/24/89 - 26 JULY 1989)

The main question raised in the seventy-fourth annual report of the Federal Reserve Bank of New York (FRBNY) is how the U.S.economy can be adjusted "in an environment of continuing economic growth abroad and financial stability in the world economy" (WDW/22/89). "After all, a nation cannot spend more than it produces <u>forever.</u>"

In macroeconomic terms, for the FRBNY, the U.S. external imbalance is a reflection of overspending on consumption and undersaving/underinvestment in the economy. Also, as the result of three "technically equivalent" gaps --the export-import gap the output-spending gap and the saving-investment gap-- adjustment entails the reversal of these underlying macroeconomic forces.

Three "compelling reasons" explain the need for adjustment. First of all, "a disturbing sharp decline in the level of net investment relative to GNP" has to be stopped and reversed. This must be accomplished in a context in which "investment is financed from domestic sources instead of capital inflows from abroad." Therefore, overspending on consumption must be curbed, while the level of national saving must be raised.

The second reason has to do with one of the major risks posed by the persistence of the external deficit, seen as "ultimately centered on falling dollar confidence." In the United States, foreign capital inflows have become decisive "to maintain orderly conditions in foreign exchange, money and capital markets." Thus, the unwillingness of foreign investors to increase their dollar holdings, in case of a loss of confidence, could have staggering consequences on the dollar and on domestic interest rates.

Finally, the third reason is that "a continued spending-output gap is a significant threat to price stability." Until now, idle capacity utilization and moderate price increases account for the fact that overspending has not resulted in an acceleration of U.S. inflation. Even so, "to avoid inflationary pressures, the domestic output-spending gap must be reduced by lowering spending and not by increasing output."

Focusing on these underlying macroeconomic forces leads to the conclusion that "the external deficit cannot be reversed immediately." The medium term, or five years, are considered "a more realistic and concrete target," if and when certain conditions are met.

First, exports must grow more rapidly than imports, with the bulk coming from manufacturing, which requires "a significant shift in resources." Second, to deal with the domestic spending-output gap, "consumption and government expenditures must grow much more slowly than in the recent past and must decline relative to GNP." Third, if the foreign savings inflow falls, the saving-investment gap must be closed with "increases in private saving and/or reductions in the public sector deficit." Fourth, foreign domestic spending must grow faster, making surplus trading partners "match the decline" in the U.S. deficit.

In other terms, the three gaps must be confronted simultaneously, with the reduction of the federal budget deficit judged as the most "appropriate U.S. macroeconomic policy response." The aim of such reduction should be to shift resources into investment spending by lowering public and private expenditures.

This poses the question of what is the appropriate policy mix to carry out this needed shift in resources, from consumption into savings, investment and the international trade sector. First of all, fiscal measures to reduce the federal budget deficit may either cut directly the share of government spending on goods and services, or raise taxes and/or reduce government transfer payments, reducing private spending.

Second, monetary policy must "aim at avoiding inflationary overheating," although by itself it cannot increase savings or switch resources. Additionally, the dollar exchange rate will depend on factors such as domestic external inflation, relative productivity performance and perceptions of expected results. Consequently, "combinations of monetary policy and exchange rate changes will simply not produce a satisfactory adjustment." On the contrary, drops in the dollar exchange rate can feed inflationary expectations and push up interest rates, affecting levels of domestic investment.

As a counterpart to the U.S. adjustment effort, surplus trading partners are expected to compensate for the corresponding reduction in their surpluses with sufficient domestic demand expansion, "to maintain a sustainable pace of overall noninflationary economic growth." This is also expected to "reduce the risk to the stability of financial markets and the world economy."

Finally, commercial policy measures aimed at opening markets abroad are expected to produce results that are judged "modest in economic terms," because they will not deal with "domestic macroeconomic imbalances." Even so, it is recognized that commercial policy can make a large contribution "to contain protectionist tendencies" in the U.S.

To summarize, the FRBNY concludes that "to count on private forces to shift a large amount of resources smoothly from consumption into saving, investment and the international sector seems impractical." What is required is "a credible plan to eliminate the budget deficit over the next four years." Otherwise, as depicted by Marina v.N. Whitman, "the risk of a market enforced 'hard landing' cannot be ruled out."

II. 7. HERALDING THE MILLENNIUM (WDW/25/89 - 6 SEPTEMBER 1989)

Besides the scandals that usually fail to awake Washington during the summer and that whither away after Labor Day, the capital's foreign policy establishment has been aroused by non other than by Hegel's World Spirit. This time, it came embodied in an article published in the summer issue of The National Interest, a mildly conservative quarterly journal, created not so long ago as an alternative to the more traditional Foreign Affairs and to the more liberal Foreign Policy.

Perhaps one of the main reasons for the excitement generated by this article is because it was written by Mr. Francis Fukuyama, who presently is the Deputy Director of the State Department's policy planning staff. As Hegel announced in 1806, after Napoleon defeated Prussia in the Battle of Jena, Mr. Fukuyama entitles his article "The End of History?" and holds that, in 1989, this well known Hegelian question can be answered affirmatively.

To anybody who claims nowadays that he is "Hegelian," it is always good to ask the question what kind of Hegelian, given the very diverse interpretations that are available of the Prussian philosopher's work. Mr. Fukuyama recognizes that his interpretation of Hegel is that of Alexandre Kojeve, the well known Russian emigre who in the 1930s taught in Paris, at the Ecole Pratique des Hautes Etudes. Kojeve's influence was such that among his students were Raymond Aron and Jean-Paul Sartre, two of the foremost representatives of the Parisian, contemporary intellectual landscape.

To summarize it very briefly, Mr. Fukuyama claims that "something fundamental has happened in world history." In his opinion, this is "not just the passing of a particular period of postwar history," but "it may be the end of history," understood as "the end point of mankind's ideological evolution," in the form of "the emergence of Western liberal democracy as the final form of human government." For Mr. Fukuyama, "the century that began full of self confidence in the ultimate triumph of liberal democracy seems at its close to be returning full circle to where it started: not to an "end of ideology" or a convergence between capitalism and socialism, but to an unabashed victory of economic and political liberalism."

Two "major challenges" have been confronted successfully by liberalism in the present century: fascism and communism. In Mr. Fukuyama's terms, "fascism was destroyed as a living ideology by World War II," because "expansionist ultra-nationalism, with its promise of unending conflict leading to disastrous defeat, was no longer viable either as a political movement or as an idea."

What he terms "the other great alternative to liberalism" is communism, which admittedly posed a "far more serious challenge." Even so, "as a result of the receding of the class issue, the appeal of communism in the Western world, it is safe to say, is lower today than at any time since the end of World War I."

But it is in the "non-European world" that Mr. Fukuyama finds "the occurrence of major ideological transformations." He mentions as the "most remarkable examples" those of Asia, such as Japan and the newly industrialized countries. Although he claims that "the power of the liberal idea would seem much less impressive if it had not infected the largest and oldest culture in Asia, China." What is important is that "the People's Republic of China can no longer act as a beacon for illiberal forces around the world, whether guerrillas or middle class students." Also, recent developments in the Soviet Union are deemed "the final nail into Marxism-Leninism's coffin."

Having reviewed the fate of these challenges to liberalism, Mr. Fukuyama concludes that "at the end of history it is not necessary that all societies become successful liberal societies." What is important is "that they end their ideological pretensions of representing different and higher forms of human society."

Asserting that "the fascist and communist challenges to liberalism are dead," Mr. Fukuyama asks if there are "any other ideological competitors left?" He identifies religion and nationalism, but dismisses them promptly. In the case of religion, because beyond the contemporary world of Islam "the doctrine has little appeal to non-Muslims, and it is hard to believe that the movement will take on any universal significance." In the case of nationalism, Mr. Fukuyama considers that it does not represent "an irreconcilable contradiction in the heart of liberalism." Consequently, he does not see any clear challenges in sight to the reign of liberalism.

Having dismissed these remaining challenges, Mr. Fukuyama describes the implications of "the end of history for international relations." They will be characterized by what is called "Common Marketization," which consists of "the diminution of the likelihood of large-scale conflict between states." Admittedly, there still will be conflicts, "for the world at that point would be divided between a part that was historical and a part that was post-historical."

The only complication Mr. Fukuyama anticipates is that "the end of history will be a sad time," and it is here that his perspective becomes millenarian. Because he holds that, "at the end of history," what will come are "centuries of boredom."

The excitement generated by Mr. Fukuyama's article can be understood, because of the provocative nature of his assertions. To conclude, an observation made by one of those asked to comment Mr. Fukuyama's article is of interest here. Mr. Irving Kristol, a leading neo-conservative, said: "we may have won the Cold War, which is nice--it's more than nice, it's wonderful. But this means that now the enemy is us."

II. 8. THE SCARE OF FRIDAY THE 13TH (WDW/32/89 - 25 OCTOBER 1989)

Once again, it was Friday afternoon in October, only this time it was Friday the 13th. In the last hour of trading, the Dow Jones Industrial average lost 150.9 points, or 6.9 percent, its second steepest fall, exceeded only by the 508 point drop of Monday, October 19, 1987. Although in percentage terms, the decline was only the 12th worst, more terrifying was the speed of the dive, amounting to 154 points in 65 minutes. The stock market was left "holding its breath," over the weekend, as many believed it had to brace for another "Black Monday."

When the market opened, on Monday, with a loss of more than sixty points in the first hour, it appeared as if history could repeat itself. But the Dow Jones turned around to close, with a "big sigh of relief," 88.1 points above the fearful finale of Friday the 13th. Thus, with hindsight, the scare became a "sharp correction," instead of the anticipated "calamity."

Several factors were singled out to make some sense out of this erratic and frightening behavior. For instance, there was consensus that the immediate cause of the plunge was the collapse of the take-over of United Airlines' parent company UAL, because the bidders were unable to secure enough financing.

This denouement was interpreted as the last of several signals indicating the end of "the take-over era," that fueled some of the most spectacular gains in the stock market. Investors apparently interpreted the collapse of the UAL deal as an indicator that financing would no longer be easily available for such deals, thus they rushed to sell their take-over related stocks.

In its turn, these panic sales of take-over stocks unleashed a wave of selling of large volumes of non take-over stocks, because in the afternoon computer driven "program trading" triggered sales of baskets of stocks by many large investors, such as pension funds.

Even so, The Wall Street Journal editorialized, "the consensus seems almost as wide that one faltering bid is no reason to write down the value of all U.S. business." Thus, it turned towards a more political explanation, identifying another "piece of news" as the culprit. Just "an hour before Friday's plunge," the Journal recalled, the Senate Democrats succeeded "in stalling the capital gains tax cut," proposed by the Republican Administration.

In the same vein, the neo-conservative economist Jude Wanniski wrote, also in the Journal, that on Friday the 13th he called Senator Bradley (D-New Jersey) to "cheerfully inform him that he and his fellow Democrats were to blame" for the plunge. After all, said Mr. Wanniski, the stock market represents "the collective expectations about the value of the future income stream of the nation's capital stock, discounted to present value." For this reason, Mr. Wanniski concluded, "the struggle over capital gains is the most important game in town, in Washington and on Wall Street," the UAL deal was "a flea," while the setback to capital gains was "an elephant rumbling through Wall Street."

Other explanations pointed to some recent changes in the structure of the market, rising interest rates abroad and the confrontation between the Treasury and the Federal Reserve about the dollar exchange rate.

Changes in the structure of the market have, allegedly, transformed its primary goal of instrument for raising capital for public companies. For instance, with the emergence of stock futures, trading has become an end in itself. For the former chairman of Merrill Lynch and former Secretary of the Treasury, Donald Regan, the stock market has become "more like a commodity auction market, bringing the frenzied buying and selling and wild price swings." Hobart Rowen made this point more graphically, in his weekly column in the Post saying that "the stock market has become a casino."

Others, as Floyd Norris in The New York Times, suggested that recent interest rate increases in Japan, West Germany and Great Britain were to blame, because the slowdown that higher interest rates will provoke will "reduce the demands of those countries for American goods, thus cutting profits of American companies and increasing the United States trade deficit even if the dollar also drops in value."

The tension between the Treasury and the Fed over the value of the dollar was also blamed. Nonetheless, optimists thought the plunge might end up being "good news for the economy," because "in one wild hour of trading, the market managed to accomplish what the Bush administration has been trying to do, unsuccessfully, for weeks. It is forcing the Federal Reserve to ease its grip on credit and by taking the wind out of a previously irrepressible dollar. The resulting decline in interest rates and the value of the dollar could reinvigorate American business --indeed, the entire economy."

Be it as it may, as The Washington Post editorialized, the market's fall was stopped by the interplay of two factors. First, the "skillful intervention" of the Federal Reserve, to steady interest rates and to provide liquidity. And second, "pure good luck," because the fall had taken place during the last hour of trading, on Friday, giving "everybody time to think" over the weekend. The question is how long will the Federal Reserve and good luck succeed in "insulating the economy from the shock of a falling market."

It used to be that "the market" served as an indicator of the economy's health. The crash of 1987 revealed that, contrary to "common wisdom," the market may plunge without major consequences for overall employment or income. No wonder, Steven Pearlstein in the Post asserted that "The Market" has become "an amalgam of contradictions that defies logic or simple explanation and almost always eludes prediction."

Still, one of the few remaining certainties is that when "The Market" suddenly plummets it invariably cries for government intervention. But when "normalcy" returns, in the form of sustained gains, "The Market" prefers to be left alone.

III. TRADE

III. 1. THE U.S.-JAPAN TRADE IMBALANCE (WDW/8/89 - 8 MARCH 1989)

The private sector Advisory Committee for Trade Policy and Negotiations (ACTPN), created by the U.S. Trade Act of 1974, recently presented the results of a one year review of U.S. trade relations with Japan. The study was carried out by the ACTPN's Japan Task Force, composed of 45 representatives of some of the leading corporations, trade groups and labor organizations from the agricultural, industrial and service sectors of the United States.

The report's title is Analysis of the U.S. - Japan TRade Problem (February 1989). It contains six chapters: 1) the problem; 2) the U.S. macroeconomic problem - the budget deficit; 3) Japan's macroeconomic problem -excessive saving; 4) impact of macroeconomic policy adjustments on the bilateral trade imbalance; 5) the role of Japanese trade barriers; and 6) lessons from the Administration's experience with Japan.

The results are presented in two sections. First, an analysis of the main causes of the present imbalance. And second, a set of recommendations for the attainment of "meaningful results without unnecessarily straining the relationship."

The task force recognizes that the bilateral trade deficit between the U.S. and Japan "remains frustratingly high," at an expected $55 billion in 1988, compared to $59.8 billion in 1987. It also identifies the factors responsible for what it calls "this stubbornly resilient deficit," that accounts for almost one third of the U.S. global trade imbalance.

On the side of the United States, macroeconomic policies have led to: 1) "a shortfall in U.S. saving relative to investment (equal to 3.5 percent of GDP at its peak in 1986) which raised real U.S. interest rates;" 2) "the tremendous inflow of freely available foreign capital, particularly from Japan, to make up the shortfall in saving, an inflow which raised the real value of the dollar;" and 3) "faster U.S. economic growth in the early 1980's than in the rest of the industrialized world, which attracted imports." The single most important cause of this "historic decline in the personal saving rate" of the United States is found in the U.S. federal budget deficit.

On the side of Japan, macroeconomic policies are also blamed for the generation of the "excess national saving that has flowed to the United States, depressing the yen relative to the dollar, and in turn distorting trade flows." Additionally, in the first half of the 1980's, "these policies also relied on exports for the lion's share of domestic economic growth."

Microeconomic policies and practices are also singled out, because they "reduce the role of imports substantially below what would normally be expected of an industrial economy with Japan's economic attributes."

For instance, agricultural prices are found to be "much higher than world market prices." From 1980 to 1982, Japan's weighted average price at the producer level for seven major commodities was 2.44 times higher than the comparable world market price, which contrasts with a factor of 1.54 for the European Community and 1.16 for the United States.

Japan exhibits the lowest ratio among the industrialized countries of imports as a percentage of apparent consumption of manufactures. This ratio of 4.4% is contrasted with 13.8% for the United States and 37.2% for West Germany.

When compared with other mature industrialized economies, Japan exhibits a very low degree of intra-industry specialization, that acts against the possibility of importing and exporting within the same industry. For 21 industries in 1980, Japan's index for intra-industry specialization was only 0.30, compared to 0.67 for the United States, 0.69 for West Germany and 0.88 for France. Moreover, the same index for 94 industries, was only 0.25 for Japan, compared to 0.60 for the United States, 0.66 for West Germany and 0.82 for France.

Japan makes extensive use of non-tariff barriers to protect its producers of primary products, principally agriculture and certain light manufacturing industries, such as textiles, apparel, leather, and leather shoes. On agricultural imports, Japan maintains 12 quotas, compared to 4 in the United States, 2 in Belgium, 19 in France, 3 in Germany, 3 in Italy, and 1 in the United Kingdom.

Finally, Japan makes intensive use of invisible barriers to trade against manufactured imports that are considered "much more important and restrictive than formal, visible barriers." Among others, the report finds: discriminatory standards and public procurement; defense of depressed, non-competitive industries; promotion of high technology industries; inadequate protection of intellectual property; and a complex, inefficient distribution system.

To confront the situation thus depicted, the following macroeconomic recommendations are offered: 1) the gradual reduction of the U.S. budget deficit; 2) the stimulus of domestic demand by means of structural reforms in Japan; and 3) bilateral consultations on the adoption of these measures.

At the microeconomic level, the adoption of a results-oriented strategy is recommended for the United States, to promote Japan's imports of value-added manufactured and agricultural goods.

Other options were also examined and rejected. First, the negotiation of a U.S.-Japan free trade area (FTA), because "it simply does not get at Japan's invisible trade barriers." Second, a so-called "do-nothing" option, because "Japan does not react like other nations to macroeconomic conditions that normally correct external imbalances." Third, the negotiation of a managed reduction of the imbalance, because "it would deal with the symptoms of the problem and not the fundamental causes." Fourth, the negotiation of "market-based rules," as well as the establishment of an independent dispute settlement panel to enforce the rules, because invisible barriers to trade "do not lend themselves to discipline through a rules-based system." Fifth, filing a complaint based on article XXIII of the GATT, because it is not possible to file a case against an entire country. Finally, free trade zones in Japan to promote imports, because of their ineffectiveness to overcome Japan's invisible barriers.

The two labor representatives of the task force dissented from the contents of the report. Although they considered the analysis useful, the recommendations "fell far short of what is needed." Because, in their own terms, the issue is "not simply growth rates, but the propensity of the two countries to import."

To conclude, the task force derived a list of lessons from the experience of negotiating with Japan. These lessons illustrate the negotiating posture recommended by the task force. Lesson 1: be very tough and willing to use all your leverage; lesson 2: giving the Japanese the initiative is dangerous; lesson 3: protectionism in Japan is still a problem; lesson 4: protectionism in Japan is multidimensional; lesson 5: temporary U.S. import restrictions are justified; lesson 6: trade issues have a rationale that extends beyond improving the trade imbalance.

If adopted, this negotiating stance will certainly transform the trade imbalance between Japan and the United States into the relationship of major tension of the present international trading system.

III. 2. <u>SUPER 301 UNLEASHED</u> (WDW/16/89 - 31 MAY 1989)

Amidst a soaring dollar and news that Japan's trade surplus is growing, last Friday, President Bush issued a statement indicating that, as mandated by the Omnibus Trade and Competitiveness Act of 1988, the U.S. Trade Representative (USTR) would present to the Congress a list of priority practices and countries to be submitted to investigation, according to the so-called Super 301 provisions.

The practices and the countries that will be subject to investigation are:

- Quantitative restrictions and import licensing in Brazil;
- Exclusionary government procurement of satellites and supercomputers in Japan;
- Trade-restrictive technical standards of forestry products in Japan;
- Barriers to trade in services, such as the closure of India's market to foreign insurance companies; and
- Trade-related investment measures, such as export requirements or the use of locally-produced inputs as practiced by India.

The identification of these countries triggers investigations and negotiations, during the following 12 to 18 months, that will seek to eliminate the identified barriers.

Additionally, a sixth category of barriers was addressed separately, through the so-called "Special 301" procedure of the 1988 Omnibus Trade Bill, designed to deal with the inadequate protection of intellectual property rights (IPRs). The procedure in this case is somewhat different, because it has led to the identification of 25 countries whose practices are said to "deserve special attention." Seventeen of these countries have been placed on a <u>Watch List</u> while the remaining 8 countries were placed on a <u>Priority Watch List</u>.

The countries that appear in the Watch List are: Argentina, Canada, Chile, Colombia, Egypt, Greece, Indonesia, Italy, Japan, Malaysia, Pakistan, Philippines, Portugal, Spain, Turkey, Venezuela and Yugoslavia. Within the next year, the USTR will step up efforts with these countries to resolve problems derived from the existence of barriers to market access or with the inadequate protection of IPRs.

The countries that appear in the Priority Watch List are: Brazil, India, Mexico, People's Republic of China, Republic of Korea, Saudi Arabia, Taiwan and Thailand. Because of recent progress with each of these countries in bilateral or multilateral negotiations, only accelerated action plans for resolving outstanding issues will be agreed within the next 150 days. Consequently, their status will be reviewed again no later than November 1, 1989.

The statement by President Bush mentioned that the decision had been discussed extensively with the members of the Economic Policy Council --the Secretaries of Agriculture, Commerce, State and Treasury, the Director of the Office of Management and Budget, the Chairman of the Council of Economic Advisers, the National Security Adviser and the USTR. Consensus finally emerged that these Super 301 measures were used: "1) as a tool to open foreign markets, and 2) in support of the objectives of the United States in the on-going Uruguay Round of trade negotiations."

Nonetheless, as reported, the Economic Policy Council split in two clearly distinct factions. On one side, Commerce Secretary Mossbacher, Agriculture Secretary Yeutter and USTR Hills were in favor of mentioning specific countries, to avoid a Congressional backlash. On the other side, Secretary Baker, Budget Director Darman, Economic Adviser Boskin and Security Adviser Scowcroft were opposed to the specific mention of Japan, mainly because of overall foreign policy considerations, such as the risk of a trade war and even of a financial crisis. They also wanted to avoid embarrassing a government already paralyzed by political scandals. In the end, President Bush and Secretary Brady sided with the first group, or with "the pragmatists," as they prefer to be called.

Several other trading partners were able to escape mention for several reasons. One of the most notable was the Republic of Korea, barely escaping its inclusion in the Super 301 list because just a few days before it had "agreed to liberalize conditions for foreign investment and to eliminate import bans and other measures to protect local production."

Almost the same happened with Taiwan, because reportedly it was in the process of agreeing "to develop an action plan that liberalizes trade and promotes" opening its market "to all exporters."

The absence of these trading partners from the Super 301 "hit list" was offered as a demonstration of "the value of bilateral negotiations on particular practices to complement multilateral negotiations on generic rules to discipline such practices."

Nonetheless, probably the most conspicuous absentee from the list is the European Community (EC). The explanation given in this case was that "important U.S. negotiating priorities, will be better pursued at this time outside of section 301, especially through multilateral negotiations in the Uruguay Round." Specifically mentioned are certain "agricultural practices," such as the EC variable import levies on grains, sugar, dairy products, beef, poultry, eggs, pork and processed products made of these commodities." These practices are said to "afford protection to European producers of these products, adversely affecting U.S. exports to the EC." Also mentioned are European Community export subsidies, as well as Japanese import barriers on rice.

Finally, another issue that was seen as "better addressed outside of section 301 at the present time is the substantial financial support European Airbus partner governments have provided to their AIRBUS CONSORTIUM member companies."

Obviously, reactions to these decisions did not make themselves wait. For instance, Japan's Minister of International Trade and Industry (MITI), Hiroshi Mitsuzuka, declared that "the Government of Japan has no intention of entering into negotiations with the United States under the conditions imposed" by the new trade bill.

A Brazilian official who works on debt negotiations said, if the U.S. restricts the entry of Brazilian goods, it would "condemn us to having problems in paying the debt." Also, the Director of the Brazilian Foreign Ministry's economy department, Samuel Guimaraes, said that the licensing requirements cited by the U.S. "are not discriminatory, are temporary and are necessary to the debt situation."

Finally, India's Commerce Minister, Dinesh Singh, said "we regard this law and action as totally unjustified, irrational and unfair."

To conclude, beyond this opening Super 301 salvo and its aftershocks, it remains to be seen if the "hit list" has not opened the gates to unprecedented levels of turbulence in international trade relations.

III. 3. IMPLEMENTING THE U.S. TRADE POLICY AGENDA
(WDW/19/89 - 21 JUNE 1989)

On March 1, according to the Trade Act of 1974 as amended, the President of the United States submitted to the Congress a national trade policy agenda for the current calendar year. This year's agenda contains the following seven objectives:

1) Seek substantial progress in the GATT's Uruguay Round of multilateral trade negotiations is the "higher trade priority in 1989."
2) Broaden access to foreign markets by eliminating or offsetting foreign unfair trade practices.
3) Implement the free trade agreements with Canada and Israel.
4) Promote exports of goods and services.
5) Use temporary relief for U.S. producers injured by fairly traded imports.
6) Eliminate trade-restrictive barriers practices of developing countries, while helping their economies to develop further.
7) Ensure appropriate consideration of trade objectives in any conflicts between trade and national security interests.

While all these objectives are pursued simultaneously, in two of them concrete results were recently registered. For instance, within the Uruguay Round, in Geneva on 5-8 April 1989, the Trade Negotiations Committee (TNC) successfully completed the Mid-Term Review, initiated in Montreal in December 1988. It should be recalled that in Montreal the participants were unable to attain consensus on four of the fifteen negotiating items contained in the agenda of GATT's Ministerial meeting. On these four outstanding issues, agreement was finalized at the senior official level only until the Geneva April meeting.

The differences were more profound on agricultural reform, particularly about the negotiations' long term objective, finally defined as "to obtain substantial progressive reductions of agricultural protection and support, resulting in correcting and preventing restrictions and distortions in world agricultural markets."

The text approved specifies that all direct or indirect measures affecting agricultural import access, be it tariffs, non-tariff barriers, subsidies, as well as export competition, will be subject to negotiation. Moreover, the approved work program has been considered ambitious, because it should lead to the presentation, by December 1989, of detailed proposals for the attainment of the long-term objective of converting non-tariff measures into tariffs, as well as to the more controversial decoupling of trade from income support. Finally, the agreement reached also endorses the harmonization of health and sanitary regulations. No wonder, the U.S. Department of Commerce considered the results in agriculture "an outstanding success."

Although in December agriculture appeared as the main hurdle, as time went by, it became evident that intellectual property rights (IPRs) were more loaded with controversy. The text approved specifies that negotiations should lead to the approval of a comprehensive agreement on IPRs containing the following: 1) adequate substantive intellectual property standards; 2) effective means for enforcement of such standards, and 3) effective and expeditious dispute settlement procedures.

The U.S. Department of Commerce considers that "all of the key U.S. objectives for the IPR framework text were met," and that "all areas of major concern" will be covered by such an agreement. Among these areas, the following appear prominently: patent protection for pharmaceuticals and chemical products, copyright protection for sound recordings and computer software, trade secret protection for proprietary manufacturing processes and data, and effective enforcement to stop the counterfeiting of trade marks and copyrighted materials, such as books, motion pictures and recordings. To illustrate the importance attached to IPR protection, a study by the International Trade Commission, of February 1988, "estimates worldwide annual losses to U.S. industry from inadequate foreign protection of IPR to be between $43 and $61 billion," which represents two-to three times as much as estimated in 1983.

The third issue left outstanding in Montreal was textiles. The agreement reached aims at undertaking "substantive negotiations on negotiating approaches that could permit the eventual integration of this sector into the GATT."

Finally, contrary to expectations, the issue of safeguards was the least controversial of the four left unresolved in Montreal. A framework was agreed for the establishment of multilateral control over safeguard measures.

These four agreements, added to the previous eleven reached in Montreal --on services, functioning of the GATT system, dispute settlement, tariffs, non-tariff measures, tropical products, trade-related investment measures, MTN agreements and arrangements, subsidies and countervailing measures, GATT articles, and natural resource-based products-- provide the guidelines for the remainder of the Uruguay Round, scheduled for conclusion on December 1990. It remains to be seen if this final phase of the negotiations will yield the same positive results.

The other objective of the U.S. trade policy agenda, about which more controverted steps have been adopted, is the expansion of access to foreign markets by seeking the dismantling of what are judged as "unfair trade practices."

These steps took the form of the initiation by the United States Trade Representative (USTR) of investigations of practices judged unfair in three trading partners: Brazil, India and Japan, in what has been termed "the unleash of SUPER 301" (WDW/16/89).

The case of Brazil has to do with "certain quantitative import restrictions," contained in "an import prohibition list that covers approximately 1,000 items, barring U.S. exports." Also, Brazil is accused of "using its licensing regime to implement company-specific and sectoral import quotas, which impede many important U.S. export items." Thus, the conclusion is derived that "the lack of transparency of Brazil's licensing system creates uncertainty for U.S. exporters to Brazil and inhibits market access."

The government of India is cited twice, for the imposition of trade-related investment measures and for the existence of barriers to sales of insurance in India by foreign insurance companies.

Finally, the government of Japan is under investigation for the following practices: prohibiting the procurement of foreign satellites by government entities; the denial of access to U.S. super-computer suppliers to the Japanese public sector market; and the imposition of import restrictions of forest products.

From this very brief description, it can be said that the activism of the new Administration in pursuing the objectives of its trade policy agenda has generated some immediate pay-offs. Hopefully, these intermediate results will sustain the accomplishment of outlasting and positive consequences for the international trading system as a whole.

III. 4. U.S. EXTERNAL IMBALANCES (WDW/22/89 - 12 JULY 1989)

The seventy-fourth annual report of the Federal Reserve Bank of New York (FRBNY) is dedicated to the external imbalances of the U.S. economy. In the report's letter of transmission, FRBNY President, Gerald Corrigan, states that he regards these "massive and unsustainable imbalances" as "the most formidable problem facing the U.S. and the global economy over the next three to five years."

Within a broad macroeconomic framework, based on the national income accounts, the report defines the external imbalance "in three technically equivalent ways." First, the export-import gap, or the difference between national exports and imports of all goods and services; second, the output-spending gap, or the difference between national output and spending; and third, the saving-investment gap, or the difference between national saving and investment.

The current account balance fell into a large deficit in 1983 and worsened ever since, in sharp contrast with the balanced position exhibited during the previous thirty years. In 1987, the current account deficit peaked at $154 billion, or 3 1/2 percent of GNP, while in 1988 it reached $128 billion, or 2 1/2 percent of GNP.

Among the different components of the current account balance, the merchandise trade deficit accounts for almost the whole, reflecting "both a weakening in export performance and a more rapid expansion of imports." By commodity group, since 1982, trade in manufactures has accounted for more than four fifths --with automobiles representing approximately one third-- of the total merchandise trade deficit. By regions, the deficit has been widespread throughout all of them, with Japan and the Asian Newly Industrialized Economies (NIEs) accounting for more than two thirds of the overall trade deficit. In Latin America the U.S. remains the major trading partner, but U.S. exports have been considerably affected by the severe constraints on the capacity to import imposed by the adjustment process undertaken throughout the region, wiping out the small U.S. surpluses that previously prevailed.

Since 1982, the output-spending gap "reflects a major break from the past on the spending side, but not on the output side." As shares of GNP, of the three main aggregate components of domestic spending on goods and services, only private consumption has grown faster than in previous years. Meanwhile, the other two --government purchases and investment-- have not experienced significant changes. Even so, it is "quite misleading" to conclude that "the external imbalance problem is limited to consumer spending alone."

Relative to GNP, since 1982, private consumption expenditures, on average, have remained "unusually high," at more than two and a half percent over the total average output of 1948-82, and over 3 to 3 1/2 percent in the late 1970s.

Presently, total government purchases of goods and services are lower than the average for 1948-82. Nonetheless, transfer payments from the federal government have been "substantially greater since the early 1980s." Since these are almost fully converted into consumption spending, in recent years, "close to 15 percent of private consumption spending" is generated by transfer payments.

The level of net investment as a ratio of GNP has averaged about 5 percent, two percent below the postwar average. This reduced share of net investment over GNP has led to increased borrowing from abroad. Since 1982, more than half of U.S. net private investment has been financed by net inflows of foreign savings, destined to the purchase of financial and nonfinancial assets. In these terms, "the total amount of such holdings is now equivalent to almost 13 percent of the U.S. capital stock, compared with only 6 percent in 1982."

The saving-investment gap resulted from a drop in the national saving rate, "from an average of about 6 1/2 percent of GNP in the 1968-82 period. . . to an average of about 2 1/2 percent of GNP in the 1983-88 period."

In the private sector, on average, no significant change is found in the rate of corporate saving during the preceding 15 years. By contrast, "household saving as a ratio to GNP fell to the lowest levels in the postwar period during 1986 and 1987, and averaged only about 3 1/4 percent over 1983-87, compared with 5 1/4 percent over 1968-82." As a consequence, "total net private saving as a ratio to GNP averaged about two percentage points below the level" of the 1968-82 period.

In the public sector, "the largest contribution to the decline in national saving as a ratio to GNP has come from the unprecedented increase in dissaving generated by the federal budget deficits since the early 1980s." This is illustrated by the fact that "nearly 70 percent of the decline in net national saving from the 1968-82 period to the 1983-87 period is attributable to the rise in federal budget deficits."

The international dimension of the problem shows that two other factors are decisive to arrive at a complete overview of the U.S. external deficit. First, the pace of overall demand and economic growth among the major U.S. trading partners and second, the dollar exchange rate.

The major industrial countries exported "a larger share of their output to the United States over the period 1982-86 than in the preceding 15 years." Furthermore, "a disproportionate share of domestic and foreign spending was shifted from U.S. goods to foreign goods because of the dramatic rise in the exchange value of the dollar over the first half of the 1980s".

Some of the financial consequences of external deficits are also mentioned. For instance, "U.S. borrowings abroad have averaged about $100 billion on an annual basis over the last six years." During the same period, U.S. "borrowings used up about 14 percent of total net savings of all other industrial countries, with the ratio peaking at about 18 percent in 1985."

From 1983 to 1985, private capital inflows provided all of this external financing, "more than four-fifths of those inflows consisted of bank financing and securities acquisitions by foreigners, while direct investment flows accounted for only about 15 percent of the overall financing requirement." This has been reversed since 1986, because "increases in net official holdings of dollar assets," have compensated for a shortfall in private flows from private sources. In 1987, "central bank purchases of U.S. dollar assets were almost equal" to the total U.S. external deficit.

Foreign borrowing, measured by the holdings of financial and nonfinancial assets, has transformed the United States "from a net creditor status of $140 billion in 1981-82 to a position as the world's largest debtor by far, with an outstanding net external debt of nearly $500 billion at end 1988."

Also, "in absolute dollar terms, the U.S. external debt is the largest in the world," amounting at the end of 1988 to 10 percent of GNP. This is judged as "neither particularly large nor historically unprecedented." After all, the United States is "not just a large industrial country but the largest economy in the world by far." It represents "one-fourth of the world's GNP," and it is "roughly equal to the combined GNP of Japan, Germany, France, and the United Kingdom."

The main question raised by this overview is how can the U.S. economy be adjusted "in an environment of continuing economic growth abroad and financial stability in the world economy." By themselves, trade and monetary policy cannot do the job, unless they are accompanied by direct measures to deal with domestic macroeconomic imbalances, particularly in the form of a reduction of the federal budget deficit "aimed at shifting resources to investment spending by lowering public and private expenditures on other activities."

III. 5. FREER TRADE BETWEEN MEXICO AND THE UNITED STATES
(WDW/31/89 - 18 OCTOBER 1989)

Preceded by ample press coverage about the successful application of economic reforms, such as the privatization of state enterprises and the control of inflation by means of an agreement between business and labor, President Carlos Salinas initiated his first state visit to the United States, from Sunday October 1 until Friday October 6.

The program of the visit was impressive. It began with an informal dinner offered by President Bush at Camp David and included a working lunch at the White House, as well as a speech by President Salinas to a joint session of Congress.

The main highlight of the meeting took the form of an "understanding," signed by Secretaries Baker and Solana, "regarding trade and investment facilitation talks." Also, an "action plan" was signed by the U.S. Trade Representative and the Mexican Secretary of Commerce to initiate such talks.

According to the U.S. Trade Representative, Ambassador Carla Hills, this new "understanding" builds on the continuing work of the 1987 "framework of principles and procedures for consultations regarding trade and investment relations." Additionally, Ambassador Hills explained that "unlike the 1987 Framework, which simply provides a consultative forum for resolving problems, the new Understanding establishes a negotiating process for seizing and expanding trade and investment opportunities."

The preamble of the understanding recognizes "the importance of the bilateral trade and investment relations to the well being and prosperity of their peoples" and takes into account "the economic interdependence between Mexico and the United States."

The agreement thus recognizes Mexico's position as the third-largest market for U.S. exports, only preceded by Canada and Japan, as well as that almost three quarters of Mexican exports go to the United States. In all, trade in both ways amounted in 1988 to $44 billion, with Mexico enjoying a surplus of $3 billion. Furthermore, the relationship has intensified, because in 1987 trade in both ways amounted to $35 billion.

Secretaries Baker and Solana also recognized the progress made under the 1987 Framework, "in further improving the bilateral process of consultations," pointing to the role of the work groups established in the areas of agriculture, industry, investment and intellectual property rights, services, tariffs and coordination.

The "mandate for trade and investment facilitation talks" contains the following decisions:

1) "To move beyond the consultative and dispute settlement functions of the Framework Understanding to negotiate in product areas and interrelated issues in order to facilitate trade and investment and to promote predictability and certainty in both countries."

2) "To conduct these negotiations in a manner consistent with the principles set forth in the Framework Understanding, and with the rights and obligations of each country under the General Agreement on Tariffs and Trade (GATT) and the Uruguay Round of Multilateral Trade Negotiations."

3) "To ensure the continuation of consultations initiated under the Framework Understanding, in particular the ongoing activities under the above cited Work Groups."

4) "To expand, where appropriate, the scope of these Work Groups to provide for a comprehensive evaluation of trade and investment issues that is conducted through analyses of product areas and interrelated issues, including (but not limited to) tariffs, non tariff barriers to trade, investment, intellectual property rights, technology, services, marketing restraints, distribution problems and trade remedy actions."

5) "To initiate 'trade and investment facilitation talks,' which are to be comprehensive negotiations on market access and trade and investment facilitation in product areas and interrelated issues."

The "action plan" for the implementation of this mandate contains a very detailed schedule for negotiations, beginning in November with joint decisions adopted in binational teams of experts, on the specific topics that will be initially covered. These binational teams will then proceed to gather information and to analyze current trade and investment difficulties. The results of these analyses will be contained in reports that will serve as the basis for the negotiations that will start in March 1990. The results attained during the first phase of these negotiations will be announced in July 1990. The same system will be followed for the second phase with the hope that the results of this phase will be announced by October 1991, when new binational teams will be created.

The comments made by the Presidents during the signing ceremony reveal the importance attached to the new understanding. President Bush said that it "moves beyond the consultation ... to create a mandate for negotiation." For President Salinas it "opens up additional sources of employment in Mexico for Mexicans. It is also encouraging the export of products to generate the well-being amongst all our citizens. It will further the investment processes so that Mexicans can find a job in Mexico. That is the central purpose of my visit to this country."

To dispel any doubts, Ambassador Hills made it quite clear that these agreements "are not aimed at reaching a 'free trade agreement' with Mexico, nor are they intended to provide Mexico with preferential treatment." Nonetheless, in Ambassador Hills' terms, they constitute "another important step in the liberalization of trade between the United States and its third largest trading partner."

Trade was not the only subject in the agenda. Another agreement was signed on the environmental protection of Mexico City and of border areas. Also, agreements were reached on Mexican exports of steel and of textiles and apparel, as well as on intellectual property rights. Finally, besides other more politically sensitive topics, such as Central America, information was exchanged on issues such as agriculture, motor vehicles, motor carriers, the Uruguay Round, subsidies and countervailing duties, investment and the Generalized System of Preferences (GSP).

In conclusion, as President Bush said during the signing ceremony, the agreements constitute a recognition of the "special relationship" that exists between the two countries.

III. 6. THE U.S. NEGOTIATING PROPOSAL ON SERVICES (WDW/34/89 - 8 NOVEMBER 1989)

With the presentation, on October 23, of a comprehensive negotiating proposal on services, according to the U.S. Trade Representative, Ms. Carla Hills, the Uruguay Round of international trade talks is "entering the most creative phase."

As described by the office of the U.S.T.R., this "is the first proposal by any country that expresses in legal terms the obligations countries would assume under a services agreement." Thus, the U.S. delegation continues setting the international trade agenda, incorporating novel issues placed beyond the scope of existing national and international rules.

The problem, as described by Ms. Hills, "is that trade has outgrown the GATT," because there are "areas poorly covered by GATT rules, like agriculture, or not covered at all, like services, investment and intellectual property," that have become "of much greater importance than they once were."

The relative importance of services in the U.S. economy and in international trade is undeniable. Defined broadly as "all economic activity other than agriculture, mining and manufacturing," services represent about two thirds of U.S. GNP, amounting in 1987 to nearly $2.6 trillion (in constant 1982 dollars). In August 1989, about three quarters of U.S. employment, or 83.2 million jobs, were in service industries. Furthermore, in recent years, more than 90 percent of the new jobs created in the U.S. have been in services.

Understood as cross-border transactions, as well as sales by affiliates located abroad, trade in services has been growing steadily. Cross border sales of services amounted to $37 billion in 1980 and $92.1 billion in 1988. Additionally, overseas sales of services by foreign affiliates of U.S. corporations are estimated to have reached $85 billion in 1987. Finally, in the second quarter of 1989, of the $31 billion deficit in the U.S. current account, $27.7 billion were accounted by merchandise trade.

In balance of payments terms, "services" comprise everything other than merchandise trade, including receipts and payments of investment income. On September 12, 1989, it was learned that the U.S. "balance on services" showed a deficit of $176 million in the second quarter of 1989, with the same item showing a surplus of $1.5 billion in the first quarter.

In these same terms, during the second quarter of 1989, "the investment component," that covers slightly more than half of all the "services," showed a deficit of about $5 billion, by contrast with a surplus of $2.3 billion during all of calendar year 1988. However, the other half of the "services," sometimes called "true services," exhibited a surplus of $6.8 billion during the second quarter of 1989.

In 1988, U.S. exports of services amounted to $92 billion, while imports totaled $73 billion. Most of this $19 billion surplus was accounted by "other private services," including some fastest growers, such as education, financial services, insurance, telecommunications, as well as business, professional and technical services, including accounting, advertising, computer and data processing, data base and information services and engineering. The surplus in these "private services" amounted to $12.9 billion in 1988. Other services that are growing comprise "royalties and fees" for industrial processes, books records and tapes, trademarks, broadcasting and recording of live events and franchises. This group, in 1988, attained a surplus of $8.7 billion.

Finally, recent revisions have been made in U.S. figures for three major areas of the service sector --expenditures by foreign students in the U.S., net after expenditures by Americans studying abroad; some exports by professional firms, such as law firms; and improved data from travel and tourism. As a result, the Commerce Department found $23 billion more exports than previously reported, as well as $11.6 more imports. Added to revisions in other trade areas, the unrecorded value of U.S. net exports amounted to about $20 billion a year. Thus, as reported in The Wall Street Journal "the U.S. trade deficit was running closer to $75 billion than to the $95 billion in 1988, and $55 billion (annualized) rather than the $80 billion in the first quarter of 1989."

The stated goal of the proposed agreement is "to establish a multilateral framework of principles and rules for trade in services, including elaboration of possible disciplines for individual sectors, with a view to expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting economic growth of all trading partners and the development of developing countries."

The principal obligations that would be assumed by the subscribers to the proposed agreement include: 1) national treatment: foreign services would receive treatment no less favorable than that accorded to domestic services; 2) establishment: foreign service operators have the right to establish or expand a commercial presence for the provision of a service in the host country; 3) cross-border services: no restriction can be imposed on the provision of services on the basis that the provider is located partially or wholly outside the territory of the host country; 4) temporary entry of service providers should be unrestricted; 5) transparency: to publish laws and regulations affecting services and to allow interested parties to comment on proposed regulations; 6)non-discrimination: no less favorable treatment can be granted to other signatories; 7) domestic regulation is allowed when it does not nullify or impair the obligations of the agreement; 8) government monopolies and exclusive service providers should provide services on a non-discriminatory basis; 9) subsidies are prohibited, if they cause injury to foreign services providers; and 10) restrictions to payments and transfers across borders derived from services transactions are limited.

The agreement would be applied to "a universe of service activities" listed as Annex I, containing in the first column a schedule" of those service activities excluded by the signatory. This list of service activities will be identified by the GATT Secretariat and it should be approved by the signatories. Additionally, special provisions for individual sectors can be developed in "annexes" to the basic agreement and "protocols" can be added, if interested signatories decide to increase degrees of liberalization for a sector already covered by the agreement. Also, reservations with respect to specific services made by any signatory, on the condition that they should be withdrawn as soon as circumstances permit. The removal of these reservations becomes the primary purpose of subsequent negotiations that will be held after the agreement enters into force.

Finally, an intergovernmental Committee on Trade in Services is proposed to oversee the agreement's functioning with the support of the GATT Secretariat.

III. 7. THE U.S. NEGOTIATING PROPOSAL ON AGRICULTURE (WDW/35/89 - 29 NOVEMBER 1989)

Two days after presenting a proposal on services (WDW/34/89), on October 25, the United States Trade Representative (USTR) submitted to the Uruguay Round "a comprehensive proposal for agricultural reform." In the words of Ambassador Julius Katz, Deputy USTR, the presentation of this proposal to the Agricultural Negotiating Group "at this time has provided a spark to these critically important negotiations, which will intensify in the weeks ahead."

As agreed during the mid-term review of the Uruguay Round, December 1989 is the deadline for the presentation of proposals and this is the first comprehensive proposal submitted thus far. Others presented by the European Community, Japan and the Cairns Group, address some, not all, the aspects of the negotiations.

Since it appears likely that no other comprehensive proposals will be submitted, as with services, the United States has also set the agenda for the negotiations about the far more controverted and crucial issue of the reform of world agriculture.

As emphasized by Ambassador Katz, "although agriculture is one of the 15 issues being negotiated in the Uruguay Round, most participants agree that the success of the entire negotiations will depend on the ability of the Contracting Parties to agree upon an acceptable agricultural package."

There seems to be consensus that this is one of the sectors of the international economy that badly needs reform, because of the impressive list of aberrations caused by blatant protectionist practices that world agriculture exhibits.

In the industrialized countries, for instance, current agricultural policies generate enormous burdens for taxpayers and consumers, estimated by the OECD to cost $275 billion annually. Also, present policies encourage levels of overproduction that generate well publicized "butter mountains." Such policies have made of the European Community the world's largest exporter of sugar and have resulted in Japanese self-sufficiency in rice, based on the subsidized operation of what are known as "the industrialized world's least efficient, part-time farmers." Meanwhile, Japanese consumers dedicate a record 20% of their personal consumption expenditures to the purchase of food, compared to 18% in France and Germany, 15% in the Netherlands and the United Kingdom, 13% in Canada and 11% in the United States. Finally, the U.S. federal government spends a yearly average of $60,000 in every full-time subsidized farmer, whose net worth is ten times greater than the average family. Moreover, these subsidies amount every year to an equivalent of almost one week of work of the average non-farm head of household.

The costs for developing countries are also staggering. It is estimated that a 50% reduction in the trade restraints applied against coffee and cocoa, in 1975-77, would raise the export earnings of developing countries, in 1985 dollars, by at least $600 million. Also, in 1975-77, a 50% reduction in the OECD tariff on sugar, as well as the equivalent relaxation of quantitative restrictions, would yield an annual increase of $1.5 billion in the export earnings of developing countries. Finally, the overall benefit of a 50% reduction in OECD tariffs on agricultural imports and the equivalent relaxation of quantitative restrictions, in 1985 dollars, would generate $3.5 billion a year of increased export earnings for developing countries.

Given these impressive aberrations exhibited by world agriculture, the negotiating proposal tabled by the USTR in the Uruguay Round is bound to generate friction and controversy among different negotiating groups.

The basic objective of the proposal is described as the achievement of "a fair and market-oriented agricultural trading system," by means of transforming "many existing internal support measure to policies that will be less trade distorting." In other words, the basic issue underlying the negotiations is the "decoupling" of assistance to farmers from prices and production levels, to grant such assistance in trade-neutral, welfare measures, instead of policies that encourage overproduction.

The United States negotiating proposal seeks to reform trade in agriculture in four key areas:

A) to improve market access by means of:

1) the conversion of all non-tariff barriers into bound tariffs;
2) substantial reductions in existing tariffs over ten years;
3) the adoption of tariff rate quotas and safeguard measures to facilitate the transition process.

B) to enhance export competition by:

1) phasing out export subsidies, including tax differentials, over five years;
2) prohibiting export restrictions for foodstuffs imposed because of short domestic supplies.

C) to avoid the trade distorting effects of internal support measures by:

1) phasing out those policies that are most trade distorting;
2) imposing discipline on policies that interfere less;
3) making policies that have relatively minor trade impact meet specific criteria.

D) to coordinate within GATT sanitary and phitosanitary standards by means of:

1) compulsory notification of national adoption of measures;
2) obligation to respond to requests for informal consultations;
3) procedures for the settlement of disputes.

Finally, as an indication of sources of resistance, an econometric study by the U.S. Department of Agriculture (USDA) has identified potential winners and losers if the proposal is adopted as presented by the USTR.

The study estimates the net welfare gain resulting from the abolition by the industrialized countries of subsidies and other trade distorting measures in almost $30 billion. Also the analysis of the distribution of these benefits by groups of countries reveals the following conclusions.

Contrary to common wisdom, the European Community appears as the main beneficiary, with net welfare gains of $14 billion. The EC agricultural balance would decline, while European producer welfare would drop sharply. Nonetheless, these losses would be more than compensated by the benefits to consumers and taxpayers.

By contrast, the gains for the United States would amount to $8.6 billion and for Japan to $6.3 billion. Additionally, for a group of developing countries classified as agricultural exporters, including Brazil and Argentina, the gains are modest, amounting to $700 million.

Among the losers the study identifies the centrally planned economies, incurring losses of $800 million; as well as the Asian Newly Industrialized Economies (NIEs), with losses of $900 million. Finally, a group of developing countries that are net importers of agricultural products, among which appear all Latin American and Caribbean countries other than Argentina and Brazil, as well as numerous African and Asian countries, incur losses estimated in $4.4 billion.

These estimates only indicate the degree of controversy that will surround the coming negotiations.

IV. INDEBTEDNESS

IV. 1. MOVEMENT ON THE DEBT FRONT (WDW/2/89 - 25 JANUARY 1989)

As soon as Secretary Baker left the Treasury Department, to coordinate the campaign of then Vice-President Bush, rumblings began to be heard indicating that there was movement on the debt front.

These events took the form of significant departures from standard operating procedures in the management of debtors difficulties. For instance, a split appeared between the multilateral financial institutions active on the debt issue. First, there was the approval by the World Bank of a $50 million structural adjustment loan (SAL) to Honduras, without requiring previous payment of the recipients' outstanding arrears with the International Monetary Fund (IMF). Second, during the IMF-World Bank September meetings, in Berlin, the World Bank granted a $1.25 billion loan to Argentina, without previously requiring the signature of an agreement with the IMF. Finally, the U.S. Treasury granted a bridge loan of $3.5 billion to Mexico, without clarifying the terms upon which the recipient had to come to an agreement with either the Fund or the World Bank.

On top of these events, came the appointment --the morning after the election-- of Mr. James Baker III, as Secretary of State, which immediately led to several conclusions. Given the experience he gained as Secretary of the Treasury, it was asserted that from the vantage point of the State Department Secretary Baker would address debt related issues from a more political perspective. Furthermore, Secretary Baker is said to be part of a triangle in a network of decision-makers who define themselves as "results oriented," or more pragmatic than ideological. (WDW/1/89).

Finally, the signals emanating from the biggest debtors indicate that they are reaching the most critical point in their fatigue with debt-servicing, foreboding that the time may have come for new departures on the debt front.

Three recent statements made by the heads of the most crucial banking regulatory agencies of the United States not only indicated that there was movement, but also pointed to the direction that this movement will take. These statements were made by three top banking regulators at the hearings on the prospects for the international economy and its effect on the LDC debt crisis, held by the Committee on Banking, Finance and Urban Affairs, of the U.S. House of Representatives, on 4-5

January 1989, less than 24 hours after the convening of the 101st. Congress.

Chaired by Congressman Henry B. Gonzalez (D-Texas), during these hearings statements were heard about the social progress of less developed countries; about the problems and prospects in the world economy; and about the prospects for the LDC debt crisis.

Nonetheless, as mentioned, the most relevant statements were those made about the U.S. financial system exposure to the LDC debt crisis, by the following officials from the most important U.S. banking regulatory agencies: the Chairman of the Federal Deposit Insurance Corporation (FDIC), Mr. W. Seidman; the Vice-Chairman of the Federal Reserve System (FED), Mr. Manuel Johnson; and the Comptroller of the Currency (COC), Mr. Robert Clarke.

Briefly, these statements basically coincide in concluding that the indebtedness of developing countries no longer threatens the banking system of the United States.

For instance, Mr. Seidman, from FDIC, concluded that "the LDC debt situation, in and of itself, poses no immediate discernible threat to the financial condition of the FDIC." Mr. Johnson, from the FED, said that "the potential effect on the U.S. banking system of the debt problems of the developing countries has been managed with some degree of success." He concluded that "U.S. banks today are in a better position to absorb the impact of any suspension of debt servicing by borrowers, domestic or foreign." Finally, Mr. Clarke, from the COC, said that "the vulnerability of the U.S. banking system has lessened significantly."

The responses to these statements did not make themselves wait. They came first and foremost from Mr. Henry Kissinger, who no longer speaks only as former Secretary of State, or as private consultant to some of the bigger banks, because of the recent appointment of two of his closest collaborators, Mr. L. Eagleburger and Mr. B. Scowcroft, as Deputy Secretary of State and National Security Adviser, respectively. The other response came from none other than the Institute of International Finance (IIF), the powerful Washington-based, umbrella organization that represents 146 commercial banks from 40 countries.

Mr. Kissinger supports the statement made by President Bush that the debt crisis is not only economic but also political and that it must therefore be solved in a political framework. He recognizes that the Baker Plan's reliance on growth remains central to any solution and considers that "to define the conditions of growth involves a highly political act for all of the countries concerned." He proposes that the "key element of such a solution will be a reallocation of the burden of debt

--both principal and interest-- between debtors, banks and governments." And concludes asserting that "the banks cannot carry the burden alone."

For its part, the IIF issued a document entitled The Way Forward For Middle-Income Countries, which basically asserts that the solution is to restore market access for these countries and that the responsibility "rests first and foremost with the debtor countries and depends on their economic policies." Second, in order to undertake new lending to middle income debtors, the banks demand from creditor governments and international financial institutions what they call "credit enhancement," or guarantees of repayment, both for new loans and debt conversions. Finally, the Institute warns that "outright mandatory debt cancellation would be an unconstitutional taking of property," which "would be contested in the courts."

These reactions were explained by "a Treasury official" quoted in The New York Times. He said that "the weight of the debt burden has now shifted in a large way to the borrowers." Furthermore, "the Governments have determined that the banks are out of the woods on loans to nations like Mexico, Brazil and Argentina and that they are healthy enough now to resume the lending that they largely abandoned after the outbreak of the debt problem in 1982."

In other terms, the much-awaited third stage of the debt crisis apparently has finally arrived, in the form of a modification of the Baker Plan, where "changes in policy with respect to banks emerge as an important revision," shifting the burden away from the wearied debtors and without a transfer of the risk to the creditor governments.

The specific ingredients of what President Bush called this "whole new look" to the debt issue remain unknown, but it cannot be denied that there is movement and that this time apparently it is in the right direction.

IV. 2. THE EXTERNAL DEBT OF DEVELOPING COUNTRIES IN 1988 (WDW/4/89 - 9 FEBRUARY 1989)

Perhaps because of the reanimation of the debate about the external indebtedness of developing countries, the World Bank did not wait until the end of the year to release the 1988-89 edition of the World Debt Tables. Just this past week, LDC debt returned to the forefront with a vengeance by way of its global treatment in the last meeting of the Group of Seven (G-7), held in Washington on February 3-4.

Based on the Debtor Reporting System (DRS), the Tables compile data for 111 developing countries and constitute one of the most authoritative sources for the quantification and analysis of this resilient issue.

This year, for the first time, the tables are issued in three volumes. The first volume contains an analysis of recent developments in international lending in reporting countries, selected regions and other groupings. The geographic regions are: Africa, south of the Sahara; East Asia and Pacific; Europe and the Mediterranean; Latin America and the Caribbean; North Africa and the Middle East; and South Asia. Other groupings are: the highly indebted countries (HICs), a group of 17 countries accounting for nearly half of all developing-country debt-- Argentina, Bolivia, Brazil,Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia; as well as low-income Africa; low-income Asia; middle-income oil importers; and oil exporters. Additionally, the first volume contains the following four appendixes: I) the emerging consensus on low-income Africa's debt; II) debt trends in 1988; III) debt rescheduling negotiations in 1988; and IV) the World Bank currency pooling and repayment system.

The second volume presents the statistical tables by country for 1970, 1975 and 1980-1987, while the third volume provides data for ten years, from 1970 to 1979. These tables contain reported or estimated data for public and publicly guaranteed long-term debt, short-term debt, as well as about the use of International Monetary Fund (IMF) credit.

Also for the first time, the Tables include information about the current market value of principal repayments and debt outstanding to the World Bank, as well as about the current account of each reporting country and workers' remittances.

Here are some of the highlights that appear in the analysis and summary tables, under the very suggestive title "the evolving debt strategy."

1) At the end of 1988, the external debt of developing countries increased by 3 percent, from $1,281 billion in 1987 to $1,320 billion, equivalent to almost half of their combined gross national product (GNP). This increase was smaller than the 11 percent registered in 1987.

2) The reasons for this slower growth are found in changes in the dollar value of external debt, resulting from exchange rate changes, as well as in voluntary debt reductions and in what is termed "the continued reluctance of commercial lenders" to provide new funds to the HICs, the largest group of debtors.

3) Two groups of developing countries are considered "debt-distressed," those of sub-Saharan Africa and the HICs, because in both growth was slower than the average rate for developing countries and their investment ratios suffered sharp declines.

4) Although in the HICs per capita income and consumption have decreased, "the adjustment burden has fallen mainly on investment," which has been reduced by roughly equal amounts to their net resource transfers.

5) In Latin America, the ratio of investment to GDP declined from 21.4 percent in 1980 to 14.9 percent in 1987, lowering investment ratios in some cases to levels barely sufficient to cover depreciation.

6) Net resource transfers from the HICs to their creditors amounted to $74 billion, during 1985-87, or about 3 percent of their combined GNP. In 1988, net transfers out of the HICs rose to $31 billion, an increase of about 50 percent over the preceding year.

7) Despite the Baker Plan's recommendations, net long-term lending by private creditors to the HICs declined, from $7.2 billion in 1984, to $1.3 billion in 1985 and to -$1.9 billion in 1986.

8) Meanwhile, the commercial banks reduced their exposure to HIC risks and strengthened their balance sheets. Between September 1985 and September 1987, U.S. banks reduced their aggregate exposure to the "Baker 15" countries by 12 percent, from $91 billion to $80 billion. Nonetheless, these more manageable levels of risk exposure, as well as sizeable loss reserves and the consequent enhanced capability to absorb losses on discounted loan sales, have not translated themselves into a willingness to go beyond limited concerted lending to problem debtors.

9) The shift to substantial negative net transfers out of the HICs, in the speed and magnitude recorded in recent years, represents a new and significant constraint on their expansion, at a time when they are attempting to grow out of their debt problems.

10) The HICs' debt overhang is considered a burden that "reduces incentives to undertake long-term adjustment and holds back the growth of these countries." It is also viewed as "a continuing threat to the world economy," particularly in a situation of rising interest rates and weak commodity prices.

Beyond the description, the World Bank arrives at some relevant conclusions. First of all, the failure of investment to recover in the HICs and the declining support from commercial creditors are said to be mutually reinforcing. To the point that "continued lack of growth and investment in the debtor countries are gradually leading to a consensus that new lending must be supplemented by voluntary debt reduction."

Second, toward the end of 1987, "it became clear that initial expectations about the debt workout strategy that was launched in 1985 had not been met." This is considered a result of "successive external shocks, failure to spur growth and debt fatigue in debtor countries."

Finally, the "strategy for the future" is depicted as blending, "into a cooperative framework, voluntary debt reduction by commercial banks, serious adjustment efforts by debtor countries, the catalytic role of the multilateral financial institutions, and changes in the tax and regulatory regimes of industrial countries."

To conclude, it is interesting to recall the evolution of the World Bank's position on this issue. The 1986-87 _Tables_ saw the solution to the indebtedness of developing countries as a "common good." Consequently, "the market, left to itself," was considered unable to provide "the level of financing needed to sustain the debtor countries in their commitment to growth-oriented adjustment."

The 1987-88 _Tables_ moved a step forward, because the issue was viewed from a developmental perspective, admitting that "the costs of incomplete adjustment and stalled growth have hitherto been borne largely by the debtors through foregone income and falling living standards."

Finally, in the 1988-89 TABLES the World Bank appears more conscious of the political dimension of indebtedness, recognizing the need for "a gradual reduction of the HICs' debt overhang." Otherwise, the alternative is depicted as "the erosion of political support for national governments and prudent economic policies and the radicalization of attitudes toward servicing debt."

IV. 3. A BRADY PLAN?
(WDW/9/89 - 15 MARCH 1989)

Ever since Secretary of State James Baker III, last year, left the Treasury to join the campaign of then Vice-President Bush, there was "movement on the debt front" (WDW/2/89). There were several significant departures from "standard operating procedures." There were also signs of increasingly worrisome debt fatigue among the main debtors. Finally, there were statements from several prominent participants that indicated the direction of the coming movement, with President Bush himself calling for a "whole new look" at the debt problem.

Expectations mounted partly because the Treasury Department was mandated by the Omnibus Trade Act of 1988 to submit on February 23, an interim report on the debt situation, that everybody expected would contain the new Administration's position.

Just one week before the deadline, the Treasury requested and received an extension of about three weeks for the presentation of the report. Of course, this only contributed to intensify the rumors that a thorough revision was under way.

In the beginning of March, the news of the Venezuelan riots tipped the scales in favor of making an early statement by the Department of the Treasury, even before the expiration of the extension of the deadline previously granted.

Thus, amidst insistent denials to assuage some of the mounting expectations, on March 10, Secretary of the Treasury Nicholas Brady went before the Bretton Woods Committee to announce the elements of an important shift in the position of the U.S. Administration with respect to the indebtedness of developing countries.

Secretary Brady began reviewing the fundamental principles of the prevailing strategy that, in his own terms, "remain sound," as well as some of its accomplishments. Nonetheless, Secretary Brady also admitted that there remained "serious problems and impediments to a successful resolution of the debt crisis." All these are called "realities" that cannot be denied and that demand a "strengthening of the current strategy," by means of the commitment and involvement of all parties.

The first mentioned are the "debtor nations," in a single paragraph that, rather unconventionally, contains very few demands. For instance, the debtors are asked to adopt policies to "encourage new investment flows, strengthen domestic savings, and promote the return of flight capital."

The "creditor community," --the commercial banks, international financial institutions and creditor governments--are asked "to provide more effective and timely financial support," by means of adopting the following measures.

First, in a major departure, commercial banks are asked to provide a broader range of alternatives to achieve both debt and debt service reduction and to provide new lending." This is one of the more innovative aspects of the proposal.

The second "key element" deserves to be fully quoted. It proposes "the negotiation of a general waiver of the sharing and negative pledge clauses for each performing debtor, to permit an orderly process whereby banks which wish to do so, negotiate debt or debt service reduction transactions." The reason for this specific recommendation is spelled out also very clearly. It is considered that "the sharing and negative pledge clauses included in existing loan agreements are a substantial barrier to debt reduction."

Obviously, it is very difficult to anticipate the potential of this crucial ingredient. Even so, suffice it here to say that it may contribute to relax the rather strict discipline that apparently has prevailed among the commercial creditors. Among others, this has been one factor that has stunted the flourishing of the secondary debt market.

Third, besides promoting "sound policies" and catalyzing new financing, the international financial institutions are asked "to support and encourage debtor and commercial bank efforts to reduce debt and debt service burdens." This is to be done by means of providing funds, "as part of their policy-based lending programs, for debt and debt service reduction purposes."

Fourth, a quota increase for the IMF constitutes a major breakthrough, as well as a victory for its Managing Director --whose relations with Secretary Brady apparently experienced a bad start. To dismiss any speculation, it is hoped that "a consensus can be reached on the quota question before the end of the year."

Fifth, a single line on creditor governments, as Japan and other surplus governments, "which are in a position to provide additional financing in support of this effort may wish to consider doing so."

Sixth, the initial disbursements of the international financial institutions should not be delayed "until firm, detailed commitments have been provided by all other creditors," because often this has "served to provide a false sense of security rather than meaningful financial support." This last ingredient also contributes to a greater degree of flexibility.

Finally, Secretary Brady states that the proposal's overall objective is "to rekindle the hope of the people and leaders of debtor nations and their sacrifices will lead to greater prosperity in the present and the prospect of a future unclouded by the burden of debt."

Evidently, all these ingredients do not amount to "a Brady Plan," but they do represent a major departure from the prevailing "strategy." The mention for the first time of the need for debt reduction, as well as the elements contributing to greater flexibility, together with the IMF's quota increase and the more active participation of surplus countries, by themselves, do not constitute a strategy. They are only meaningful steps in the right direction, whose details still have to be worked out.

IV. 4. MR CAMDESSUS AND THE BANKS (WDW/17/89 - 7 JUNE 1989)

Ever since Secretary of the Treasury Brady outlined the new proposals making debt reduction the central trait of the debt saga, it has become increasingly clear that, this time, the commercial banks are under the limelight.

The events have clustered around the ongoing negotiations between Mexico and its private creditors. Thus, the intense and variegated posturing, presently taking place, has to be pondered through the prism of the customary ritual that surrounds these negotiations.

One of the most recent and detailed descriptions of what can be expected, particularly from the IMF and the commercial creditors, was presented by the Managing Director of the IMF, in a timely speech made at the Institut d'Etudes Financieres et Bancaires, in Paris, on May 31, 1989.

That Mr. Camdessus now is at the forefront of the new orientation constitutes in itself an auspicious change. Gone seem to be the days when the debtor governments were advised to spouse "a new realism." Only a year ago, Mr Camdessus asserted --of all places, in Caracas-- that "the urgency of action lies first and foremost, of course, with the indebted countries themselves," because they "need to be more steadfast in their efforts to deal with their imbalances and structural weaknesses." Debtors were then urged "to summon up the courage and determination to embark on stronger programs and to hold unswervingly to them."

Attempting to draw a balance between the accomplishments and the shortcomings of the prevailing strategy, nonetheless, Mr. Camdessus recognizes that "the case-by-case approach" needs to be "set in motion again." For this purpose, he describes some of the main partners' responsibilities.

For the indebted countries, "there is no credible alternative to growth-oriented adjustment," but on the condition that it "must be financed." Otherwise, the Managing Director judges as "a mistake to ask these countries, implicitly or explicitly, to reduce their growth below potential in order to meet their debt commitments solely from their own resources." Furthermore, Mr. Camdessus considers "essential that while countries maintain service of their debt, they are not prevented from achieving satisfactory rates of investment by a lack of suitable financing." Because, in the end, "depressing investment merely serves to undercut the capacity to service debt in the future."

An enumeration of IMF's responsibilities leads Mr. Camdessus to recall something that is often forgotten. Under "the very first article of its charter," the Fund makes its resources available temporarily to its members "to correct maladjustments in their balance of payments <u>without resorting to measures destructive of national or international prosperity</u>."

A summary of the most recent adaptations experienced by the Fund's main instruments follows:

-Financing can now be granted for longer terms, "if necessary over four years," as well as "up to 270 or 330 percent of quota."

-"Access to Fund's resources might extend beyond those limits in exceptional cases," as it was recently done with Mexico.

-Special financing is now available for unforeseen situations or external shocks, such as terms of trade deterioration or interest rate increases, as with the case of the Philippines.

-Parallel financing from surplus countries, as agreed with Japan, is particularly welcome.

-Financial support will be provided "expeditiously," even if this means that the Fund will be the first disbursing party, as with Venezuela, the Philippines and Mexico. Furthermore, it is expressly recognized that this can lead to the unprecedented situation that the Fund's first disbursement is made while there still are outstanding arrears with the commercial banks. In such situations, "the lesser of two evils" is preferred, "to tolerate some accumulation of arrears on a temporary basis in the absence of bridging finance." The search for so-called "critical mass," is thus discarded, because the "concern to proceed with all caution has, with the passing of time, turned against its objectives." In other words, programs have failed when "significant time" elapsed before the debtor and the banks agreed on a package.

-Finally, Mr. Camdessus offers six arguments in support of using some of the Fund's resources for debt reduction: 1) "beyond a certain point, a debt overhang becomes a structural obstacle to growth;" 2) support can be granted for debt reduction when it is linked to medium-term adjustment programs; 3) since the Fund cannot provide guarantees against its resources, "reducing the stock of debt, rather than the interest burden," might be preferable, "because of its greater transparency and permanent nature;" 4) a ceiling of 40 percent of a country's quota can be "set-aside," without representing an increase in access, for financing reductions in the stock of debt; 5) subsequent disbursements can be contingent on the satisfactory performance of debt reduction; and 6) as mentioned, initial disbursements will be made without delay, in the absence of full financing assurances from other creditors.

Having spelled out what the Fund stands ready to do, Mr. Camdessus requests from the commercial banks:

-More expeditious provision of bridge financing.

-Active participation in debt reduction.

-Those who want to disengage from sovereign lending should do it, at around market values.

-The large international banks are asked specifically "to increase their contribution to the strategy and to adjust their negotiating methods by complying with three conditions: 1) delaying negotiations will no longer "induce the public sector to increase its contributions;" 2) the decision-making process should be "speeded-up;" and 3) the practice of observing the "lowest common denominator," should be forsaken.

No wonder, the powerful Chairman of Citicorp, Mr. John Reed, recently stated that this time the banks "are being asked to take a hit which will be their last... the next trip will be to the Fed."

V. ADJUSTMENT

V. 1. ONE DECADE OF ADJUSTMENT LENDING
(WDW/13/89 - 10 MAY 1989)

The World Bank has issued an evaluation of ten years of adjustment lending, to serve as the basis for a discussion held during the Spring meetings of the Development Committee, in Washington from March 31 to April 4 (WDW/10/89).

Introduced in 1980, as a response to the balance of payments problems of developing countries caused by what is known as "the second oil shock," adjustment lending has become increasingly important for World Bank operations. By the end of 1988, it accounted for more than 10 percent of the whole Bank portfolio and for 25 percent of new annual lending commitments. Through FY 1988, adjustment lending operations amounted to US$19.9 billion, distributed in loans to fifty five countries.

These loans have been granted primarily to low-income, sub-Saharan countries, as well as to highly-indebted, middle income countries. For instance, during FY 1988, 53 percent of the World Bank's total adjustment lending commitments were for highly-indebted, middle income countries. Furthermore, Latin America is the region that has received the highest proportion of adjustment loans, representing 42 percent of total lending commitments. By contrast, sub-Saharan Africa has received 33 percent, while Asia only amounted to 10 percent.

To confront an adverse external shock, the Bank sees at least two basic types of policy response. The first, called adjustment, seeks to attain stabilization, understood as "managed reductions in expenditures" to bring about orderly reductions of domestic demand to the levels of available external resources. The other policy response is called structural adjustment, understood as "changes in relative prices and institutions designed to make the economy more efficient, more flexible, and better able to use resources and thereby to engineer sustainable long-term growth."

Additionally, the Bank recognizes that other responses may also be available to confront adverse external shocks. First, the need to adjust can be postponed by borrowing abroad, which was the response that prevailed during the seventies. A second option is described as "to increase domestic controls and the inward orientation of the economy," but this is dismissed as "likely to be costly in terms of efficiency and growth."

The differences between traditional project lending and structural adjustment lending were specified since the beginning, in a memorandum dated 5 February 1980. Adjustment lending was viewed as "a fundamental instrument for the dialogue between the Bank and the country on various aspects of development policy." Also, finance would be provided "over a number of years in direct support of specific policy reforms." Finally, foreign exchange would be made available, "to finance imports not linked in advance to specific investment programs."

There are two main instruments of adjustment lending: structural adjustment loans (SALs) and sector adjustment loans (SECALs). The main difference between them is "more by the breadth of policy and institutional reforms in a particular operation than by the nature of the reforms themselves."

On one side, SALs are said to have "generally supported programs to increase domestic resource mobilization and to improve efficiency, through reforms of trade policy, changes in prices and regulations in key productive sectors, increases in government revenues, and changes in the size and composition of government recurrent and capital expenditures."

By contrast, SECALs are focused on a single sector and support "policy reforms with considerable macroeconomic impact," such as trade or financial sector reforms; reforms of sectoral pricing, institutions, and public expenditure composition; as well as "more narrowly focused programs such as input pricing (for instance, the elimination of fertilizer subsidies)."

In the end, all SALs and SECALs provide balance of payments support, by means of quick disbursements to finance general imports. The conditions basically consist of meeting the agreed policy targets within certain time periods. Thus, to facilitate monitoring and to ensure that the conditions are met, all the disbursements are tranched.

The main objective of any structural adjustment program is "to restore sustainable economic growth and make progress in poverty alleviation." Also, admittedly, "many adjustment programs need a stabilization component to restore the internal macroeconomic balance." And even when "economic performance is what ultimately matters," the conditionality of these loans "does not directly specify economic performance but rather calls for policy changes and institutional reforms that are under the direct control of the borrower."

The Bank admits that several concerns and criticisms have been voiced in different quarters about adjustment lending, as follows: 1) inadequacies in program design, as well as in their poverty impact; 2) difficulties in program implementation; 3) over-optimistic assumptions about the external environment and about burden sharing by commercial lenders; 4) the impact of adjustment lending on the Bank's portfolio; and 5) the need for greater diplomacy and coordination among all parties involved --the borrower, the Bank, the IMF, and other creditors.

To address these issues, the study focuses on the following three topics: performance under adjustment; an evaluation of policy reforms; and the design and implementation of adjustment operations.

Briefly, it is found that the average performance --measured by GDP growth, investment/GDP, export growth, real exchange rate, current account balance/GDP, budget balance/GDP, inflation, external debt/exports, and debt service/exports-- of 30 countries, out of 55 recipients of adjustment lending, has been better than that of those that did not receive such support. Within this group, the performance of 12 countries that have received three or more adjustment loans was the most successful.

Regarding policy reforms, the general conclusion is that "external sector policies and price policies have been reformed in significant measure. Progress has been less visible in institutional and non-price areas, as well as in aspects of pricing policies that require institutionalization of the changes."

The Bank finds that "there has been considerable success in implementing conditionality." On the basis of the data gathered for 15 countries, it is found that "60 percent of all conditions were fully implemented during the loan disbursement period." If the category "substantial progress" is added to "full implementation," this percentage increases to 84 and 89 percent. Nonetheless, degrees of implementation vary significantly across different policy areas, ranging from 53 percent in fiscal policy to 79 percent in energy policy. Furthermore, the most crucial factors for implementation are: tranching, government commitment, the quality of Bank advice, and the external economic environment.

As an overall conclusion, in comparison with traditional project-investment loans, the Bank admits that since "the potential benefits from structural adjustment lending are great, the losses can also be substantial when it is poorly executed." In these terms, adjustment lending is characterized as "a high risk as well as a high reward activity." This feature is offered, "together with the continued need for physical and human infrastructure investment in developing countries," to justify "the Bank's continued reliance on projects for the majority of its development lending."

V. 2. <u>FINANCIAL SYSTEMS AND DEVELOPMENT</u>
(WDW/21/89 - 5 JULY 1989)

The second part of this year's <u>World Development Report</u> is dedicated to the role of financial systems in development, the first part was reviewed separately (WDW/20/89).

In eight chapters, this lengthy second part of the <u>Report</u> is full of colorful pie charts and bar diagrams, to illustrate subjects such as financial savings and the real deposit rate in Argentina and Thailand, or central government borrowing by source, as well as sleek boxes describing financial swindles, life without money, trade financing in Renaissance Italy, how good bankers become bad bankers, or credit and income distribution in Costa Rica.

The <u>Report</u>'s breadth can be better appreciated in the chapter titles: why does finance matter?; the evolution of financial systems; financial sector issues in developing countries; financial systems in distress; foundations of financial systems; developing financial systems; issues in informal finance; and toward more liberal and open financial systems.

The justification given in the foreword by President Barber Conable for focusing on this subject is that "the decline in foreign capital inflows means that countries will need to rely primarily on domestic resources to finance investment."

The <u>Report</u>'s central message is that the financial systems of developing countries, although some more than others, are in need of reform and liberalization. This is considered an essential step, to enable their participation in the gradual process of integration between domestic and world financial markets, already taking place throughout the world.

This central message rests on the underlying assumption that, from those experiences of financial reform already undertaken, several lessons can be withdrawn that allow for the clear identification of the different stages of what in effect amounts to a process of universal liberalization. This blueprint for the reform of financial systems, is contained in the concluding chapter of the Report, dealing with how to evolve "toward more liberal and open financial systems."

From recent experiences, such as those of the Latin American Southern Cone, the Philippines and Turkey, as well as in other countries such as Australia, Japan, Malaysia, New Zealand and the United States, a list of so-called "lessons of reform" is derived. This serves as the basis for identifying the main "components of financial reform," as well as the sequencing of different stages to move "from a regulated to a more liberal financial system."

First of all the lessons: 1) the "clearest lesson" is that "reforms carried out against an unstable macroeconomic background" may worsen instability; 2) where "prices are distorted owing to protection or price controls, financial liberalization may not improve the allocation of resources," it may even "make matters worse by causing the financial system to respond more flexibly to bad signals," consequently, "exchange rate realignments and reforms in trade and public enterprise should precede, or at least happen along with, financial liberalization;" 3) regulation and supervision "by bank management, by market forces, and by public authorities are all necessary to reduce recklessness and fraud," this amounts to replacing "direct intervention" with "adequate prudential regulation;" and 4) "the authorities must anticipate how reforms will change relative prices and how these changes will affect different groups."

These lessons allow for the identification of the main components of financial liberalization and reform. First, macroeconomic stability demands "reducing public deficits to a level that can be financed by means other than inflation or other taxes on the financial sector." The conclusion is derived that "to the extent that a government finances its deficit domestically, borrowing from a securities market is therefore preferable to forced borrowing from financial institutions, which in turn is preferable to borrowing from the central bank."

Second, progress has to be made in "establishing macroeconomic stability, liberalizing industry, and restructuring the financial system" before moving into a "thoroughgoing liberalization of interest rates."

Third, directed credit should be at least gradually dismantled by means of limiting the number of priority sectors and eliminating the difference between subsidized and market interest rates. In the end, "sectors that require large subsidies should be dealt with in the budget, not through credit allocation."

Fourth, institutional restructuring, besides the privatization of public banks, "should not be limited to the reform of the banking system but should seek to develop a more broadly based financial system that will include money and capital markets and nonbank intermediaries."

Lastly, external financial policy should be part of the process of reform, focusing particularly on the entry of foreign financial institutions and the scale and intensity of capital flows.

The sequencing of these components of financial liberalization leads to the identification of three stages in the path toward reform.

The initial stage starts by "getting the fiscal deficit under control and establishing macroeconomic stability." Simultaneously, directed credit should be scaled down and the level and pattern of interest rates should be brought "into line with inflation and other market forces." Also, during this stage, some improvement should be accomplished in what are called "the foundations of finance --that is, the accounting and legal systems, procedures for the enforcement of contracts, disclosure requirements, and the structure of prudential regulation and supervision." Finally, it is suggested that "measures to improve efficiency in the real sector --that is, more liberal policies toward trade and industry-- also ought to be taken at an early stage."

The intermediate stage should see the promotion of "a greater variety of markets and institutions and to foster competition." Also, on the external side, "foreign entry into domestic financial markets should be encouraged to increase competition and efficiency --but perhaps with restrictions until domestic institutions are able to compete fully." Nonetheless, "it will probably be necessary to maintain controls on the movement of capital."

The final stage is characterized as "full liberalization of interest rates, the elimination of the remaining directed credit programs, the relaxation of capital controls, and the removal of restrictions on foreign institutions."

Finally, the suggested sequence of these changes advises that "trade transactions should be liberalized first and capital movements later." Additionally, "external reform should wait until internal reform and the domestic financial system have been liberalized and deepened."

Even when it is recognized that quickness, as well as gradualism, may impose heavy losses, the cost of "undue delay" is higher because it leads to "perpetuating the inefficiencies of financial repression." Nonetheless, instead of venturing into suggesting an optimal pace for reform, the Report asserts that "the appropriate balance must be judged in each case." Because, admittedly, "here, at any rate, generalization is not helpful."

This conclusion is rather surprising, because it allows the reader to wonder if the implementation of financial liberalization, according to a single blueprint supposedly valid for all developing countries, in itself, is not extremely resilient to generalization.

V. 3. SOUL SEARCHING ON ADJUSTMENT LENDING (WDW/26/89 - 13 SEPTEMBER 1989)

The World Bank has published a follow-up to its evaluation of "a decade of adjustment lending" (WDW/13/89), originally presented at this year's spring meetings of the Development Committee.

On 19 September 1988, an internal conference was held to discuss the results of this evaluation. A summary of the discussion was published, in July 1989, under the title Adjustment Lending, How It Has Worked, How It Can be Improved, by Vinod Thomas, chief of the Trade Policy Division of the Country Economics Department and by Ajay Chubbier, a senior economist in the Office of the Vice President for Development Economics.

Some of the concerns about adjustment lending, expressed by different participants in the conference, are summarized under five headings.

First, in the design of adjustment programs, the following flaws should be avoided: 1) conflicting goals in different areas, such as seeking simultaneously domestic demand cuts, shifts to tradables and reductions of inefficiencies; 2) excessive austerity that frequently hurts the poorest; and 3) ideologically driven, instead of tailor-made policy packages.

Second, the implementation of adjustment programs should avoid: 1) inadequate follow-up arrangements, which undermine the credibility and sustainability of reforms; as well as 2) over-optimistic expectations about the willingness of interest groups to give up their rents in pursuit of national efficiency.

Third, the following external conditions should be carefully assessed: 1) global economic projections should not be overestimated; 2) inadequate burden sharing arrangements among creditors, because they may lead to under-funding; and 3) World

Bank disbursements should not be used to repay and bail out commercial banks.

Fourth, Bank lending should avoid: 1) open-ended sectoral and structural operations that transfer resources to countries that are not adjusting; 2) weak conditionality, because it does not improve economic performance and hence creditworthiness; and 3) increased risks to the Bank's portfolio.

Finally, on the coordination with other lenders, the Bank should: 1) promote a non-confrontational and effective process of coordination among lenders; and 2) arrive at a clearer division of labor with the International Monetary Fund (IMF).

The discussion about the impact of adjustment programs dealt with measurement difficulties. For instance, it was admitted that comparisons between the performance of adjustment lending countries (AL) and non-adjustment lending countries (NAL) can be biased, because differences in performance may be a result of differences in starting positions.

Furthermore, it is necessary to distinguish between the impact of an adjustment program and the contribution made by Bank operations associated with such program. To claim credit, more precision is needed to identify and assess the mechanisms through which Bank operations directly contribute to positive results.

Finally, it was concluded that adjustment programs have been "moderately successful," although because "definite conclusions are not possible," admittedly, such a "claim is a matter of judgment." Doubts were also raised about what was seen as "the most convincing evidence," that AL countries "have performed significantly better than average, despite their larger external shocks." An alternative explanation was suggested, because sometimes "the Bank has been willing to maintain its lending only to the countries that are doing well."

The extent of policy reforms reveals that "countries suffering similar external shocks may perform quite differently under adjustment programs," and also that policy reforms have "varied across policy areas."

Briefly, the trade balance of most adjusting countries has "improved substantially," although "in some cases, this improvement was attributable mostly to the lack of import financing." Also, in several countries the exchange rate was "depreciated significantly," with a "strong" response in export volumes. In general, the conclusion was drawn that "external sector policies and price policies have been reformed," while "less visible" progress was found in institutional and non-price areas and in aspects of price policies that require institutional changes.

Three prerequisites were identified for adjustment lending: 1) the country must have an overall adjustment program; 2) the government must own the program; and 3) the program must be politically and financially realistic.

The program's ownership was questioned because "opposition to reform programs usually exists both inside and outside the government," hence, it was judged more relevant to answer the question of "how to strengthen the hand of reformers." Also,if these prerequisites are "applied too rigidly, the Bank might miss the opportunity of supporting policy changes that sometimes develop in hesitant steps before the benefits of the program are revealed." In these matters, "subjective judgments, therefore, are often necessary."

To conclude, certain areas of broad agreement were enumerated: 1) the three prerequisites received broad support, as principles applicable to the consideration and actual practice of adjustment lending; 2) "so far," adjustment lending "has been reasonably successful," although it was also admitted that "much more emphasis on monitoring and evaluation will be needed if the effectiveness of such lending is to be judged;" 3) admitting that "the social costs of adjustment deserve greater attention," it was specifically recognized that "government programs that clearly benefit the poor should be protected during adjustment;" 4) lending conditions should be more focused, simpler and realistic; 5) given "the risks of adjustment lending and the limited capabilities for design and implementation, some limits on lending levels are desirable." Consequently, for purposes of "portfolio management," 25 percent as an overall limit was judged "reasonable."

VI. MULTILATERAL FINANCIAL INSTITUTIONS

VI. 1. THE WORLD BANK-IMF SPRING MEETINGS (WDW/10/89 - 19 APRIL 1989)

This year, the Bank-Fund Spring meetings, held in Washington from March 31 to April 4, were dominated by the indebtedness of developing countries. In this way, the meetings responded partially to the mounting expectations generated by Secretary Brady's presentation, on March 10 before the Bretton Woods Committee, of what was immediately recognized as an important shift in the orientation of the prevailing strategy (WDW/9/89).

In effect, the Bank-Fund Spring meetings were seen as the most adequate opportunity to clarify several details about how the objective of debt reduction would be achieved.

Admittedly, several important details remained deliberately unspecified. Among others, Leonard Silk, in The New York Times mentioned the following: first, how debt reduction would take place and how much would be reduced; second, from where would come the money for debt reductions; third, how would the burden of risk be distributed among the different participants; fourth, which debtor countries would qualify; fifth, what would be the role of each one of the four participants--the debtor governments, the commercial banks, the creditor governments and the multilateral financial institutions.

Obviously, as expressed in the rather arcane communiques solemnly issued at the conclusion of the different meetings, the results remained far short of fulfilling most of these expectations. Nonetheless, some important results were attained.

First of all, the most important outcome consisted in the mandate issued by the Interim and the Development Committees to the Executive Boards of the Bank and the Fund. Both were instructed to consider as "a matter of urgency," as well as "to move expeditiously," to design and implement "specific proposals" to achieve the objective of "debt alleviation."

Secretary Brady's remarks at the Interim Committee meeting had anticipated that this would be as far as the present meetings would go. He said that "in order to move ahead to strengthen the debt strategy, it is vital that the Interim and Development Committees give clear direction to the IMF and World Bank Executive Boards." He also urged "both Boards to consider promptly needed changes in Fund and Bank policies in order that new mechanisms could be put in place."

This was the conclusion finally adopted, despite the unprecedented emergence, in the open, of differences among the industrialized countries, in the form of a rift within the Group of Seven, integrated by the Finance Ministers and Central Bank Governors of Canada, France, the Federal Republic of Germany, Italy, Japan, the United Kingdom and the United States.

On one side, the proposals of France, Japan and the United States were lumped together. The Interim Committee "welcomed the fact that new proposals had been made by several countries --including France and Japan, and most recently by the Secretary of the U.S. Treasury-- designed to strengthen the debt strategy and to place greater emphasis on debt and debt service reduction."

In almost the same terms, the Development Committee "welcomed the fact that new proposals had been made by France, Japan and, more recently, by the U.S. to review and strengthen the current strategy through stronger emphasis on a broader-based approach to voluntary debt and debt service reduction, new investment, adjustment measures, the repatriation of flight capital, together with new lending by commercial banks."

On the other side, the Federal Republic of Germany, the Netherlands and the United Kingdom questioned certain aspects of the new proposals. As Paul Blustein said in The Washington Post, the representatives of these countries "played the role of skunks at a picnic." For instance, the Chancellor of the Exchequer, Mr. Niger Lawson, voiced concern that "taxpayers would end up holding the bag for the banks' bad loans." Also, the Dutch Finance Minister, Mr. Onno Ruding, said the risk was that the proposal would cost the Fund and the Bank "staggering amounts of money."

In the end, this rift was patched up, as revealed by the wording of the two communiques. Although it may only mean that some of these differences were left to be resolved down the road.

The second major achievement of the meetings was the announcement that the Japanese Government is ready to offer $4.5 billion in parallel financing to Fund arrangements arrived at within the new framework for debt reduction. Although, this amount was less than rumored, its announcement constitutes the most concrete expression of support thus far received by the new proposals.

Thirdly, there was an apparent solution to the differences existent between the Fund and the Bank in their lending activities to heavily indebted countries. For instance, the Interim Committee "emphasized the central part that continued to be played by the Fund in finding solutions to the debt problem." Even so, it was also added that it considered "important that the World Bank play its commensurate role in the strategy," concluding that both institutions should "work in close collaboration on these matters."

Before jumping to the conclusion that this statement marks the end of the latest skirmishes that have flared among the Bank and the Fund, it is necessary to have access to the yet unreleased agreement between the staffs of both, which still has to be submitted to the ratification of the two institutions' Executive Boards.

Another important result was the agreement reached about the Fund's Ninth General Review of Quotas. Secretary Brady, in the Bretton Woods speech, expressed hope that "a consensus can be reached on the quota question before the end of the year." In almost the same terms, the Interim Committee "urged the Executive Board to complete its work on the Ninth Review with a view to a decision on this matter by the Board of Governors before the end of this year."

Japan, with the second largest economy in the world, holds only 4.53% of the voting shares at the IMF, ranking fifth behind the United States, with 19.14%, Great Britain, West Germany and France. Apparently, the Europeans raised no objection to Japan's accession to the number two position in the Fund--a position it already holds at the World Bank. Thus, the Interim Committee agreed that "the size and distribution of any quota increase should take into account changes in the world economy since the last review of quotas as well as members' relative positions in the world economy and the need to maintain a balance between different groups of countries."

To sum up, the indebtedness of developing countries topped the agenda of this year's Bank-Fund Spring meetings, with the mandate given to the Executive Directors of both institutions to implement the general guidelines as their most concrete result. Other results consisted in Japan's offer to contribute to debt reduction activities and the agreement about the quota increase for the IMF, as well as the undisclosed terms of the settlement of differences agreed between the Bank and the Fund.

VI. 2. THE IDB'S SEVENTH REPLENISHMENT
(WDW/11/89 - 26 APRIL 1989)

After three years of intense, protracted and sometimes acrimonious negotiations, on March 22, at the conclusion of the thirtieth annual meeting of the Board of Governors, it was announced that agreement had been reached on the seventh general increase in resources of the Inter-American Development Bank (IDB).

These lengthy negotiations, in the middle of a decade of dismal performance by the Latin American and Caribbean economies --only comparable to the thirties-- took a severe toll on the Bank's performance.

For instance, 1988 was the fourth consecutive year of decline in loan authorizations by the Bank. These reached a record low of US$1.6 billion, after the peak of $3.5 billion attained in 1984, representing the lowest level since 1976.

Not all the results in these years have been negative. In 1988, disbursements increased from $1.9 billion in 1987 to $2.3 billion. Also, 217 projects of grant and contingent technical cooperation were approved in 1988, amounting to $55.7 million, by contrast to the $47 million approved in 1987.

Two positions emerged when the negotiations on the seventh replenishment began, during the twenty seventh annual meeting of the Board of Governors, held in San Jose, Costa Rica, on 20-26 March 1987. On one side were those who favored a smaller bank, but less tied to the conditions set by the largest contributor, with fewer resources and consequently less lending capability. On the other side were those who considered necessary the approval of the replenishment and thus favored a larger and more vigorous bank for the next decade.

The confrontation between these two positions led to a deadlock that resulted, at the beginning of 1988, in the resignation of the previous President, Mr. Antonio Ortiz Mena. In the end, apparently, everybody agreed with the need for a larger and better endowed institution, although profound differences persisted about the conditions.

The succeeding President Enrique Iglesias reflected this consensus in his address to the annual meeting of the Board of Governors, held in Caracas from 21 to 23 March 1988. He said that the alternative of a small Bank, nourished only by the repayments of previous loans, did not constitute a viable hypothesis in the medium term, because the Bank should not become a net financial burden for the region. He concluded that "nobody should forget that the essential goal of the institution should be to facilitate the net transfer of resources from the industrialized countries to the developing countries of the region."

The divergence about the conditions for the seventh replenishment pitted the United States, as the Bank's largest contributor, against the four relatively more developed countries of Latin America --Argentina, Brazil, Mexico and Venezuela. The negotiations were conducted within the committee of the Board of Governors, with the rest of the members assuming a relatively less active role.

The results accomplished, only until the last moments of the annual meeting of the Board of Governors, held in Amsterdam, from 20 to 22 March, illustrate the main points of contention.

First of all, on the amount of the resource increase, it was agreed that the Bank's capital will increase by $26.5 billion, to enable lending amounting to $22.5 billion, during 1990-1993. Despite its magnitude, the resource increase itself was not the most contentious issue.

Second, it was agreed that the Bank would incorporate a new kind of lending operation to its portfolio, with 25 percent of the Bank's total resources dedicated to sector lending. Since the IDB has never performed policy lending, during a transition period of two years, sector loans will be made jointly with the World Bank, at the initiative of either. The purpose of sector lending has been described as to improve economic efficiency in an entire sector of a country's economy, rather than the execution of individual projects. Among the targets of these loans are policy improvements, institutional strengthening, new operational approaches and technological development.

Third, operational guidelines were also agreed about the foreign exchange component allocated to specific projects, differentiating among groups of countries, as follows: for the most developed countries--Argentina, Brazil, Mexico and Venezuela--50 percent; intermediate countries--Colombia, Chile and Peru--60 percent; countries with limited markets--Bahamas, Barbados, Costa Rica, Jamaica, Panama, Trinidad and Tabago and Uruguay--70 percent; and the less developed countries--Bolivia, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Nicaragua and Dominican Republic--80 percent.

Fourth, during 1990-1993, 65 percent of total Bank lending will be available for the group of the most developed and intermediate borrowers, while the rest will go to those borrowers with limited markets and the less developed countries.

Fifth, the lending priorities agreed specify that the Bank will continue ensuring that one half of its lending will benefit lower income groups. Also, environmental protection, the role of women in development and small entrepreneurs were singled out as priority sectors.

Sixth, new decision-making rules for loan approvals were also agreed, as follows: the vote of one executive director can delay for two months the consideration of a loan by the Board of Directors; two votes are required for a delay of seven months; and the votes of three executive directors are necessary to delay the consideration of a loan for twelve months.

Finally, the recommendations of a report presented by a High-Level Review Committee, in May 1988, guided the implementation of a process of basic reforms in the Bank's internal structure and organization. One of the main consequences of this process was the early and voluntary retirement of around 150 professional staff members, or almost 10 percent of the whole staff.

Looking ahead, it is projected that Latin America and the Caribbean will grow, between 1990 and 1993, at an estimated yearly rate of between 4.5 and 5.5 percent. This assumes that the region will have access to net external financial resources amounting to between $20 and $25 billion yearly, of which external borrowing will amount to between $14 and $19 billion per year. Within these parameters, it is expected that the IDB will accomplish an average level of net lending of between $1.8 to $2.25 billion a year, corresponding to gross annual lending levels of $3.2 billion to $3.6 billion.

In these terms, the proportion of multilateral bank lending provided by the IDB should not be less than the historical figure of 40 to 50 percent. However, in order to attain approximately 9 to 16% of the net foreign credit disbursements required by the region, according to the lending projections mentioned previously, the total approval of loans by the IDB, during the 1990-1993 period, would have to amount to between $20 and $25 billion.

Given the magnitudes involved, the complexity of the negotiations, as well as the duration of the deadlock, the results were considered a personal triumph for the Bank's President. He was credited with achieving a compromise that satisfied some of the demands of the largest contributor to the Bank's capital, without affecting the institution's multilateral character.

Asked to compare the IDB negotiations with those that launched the Uruguay Round, where he also played a pivotal role, President Iglesias declared that the replenishment had been "more difficult" and "more emotional," because "it was like husband and wife."

VI. 3. <u>THE BANK AND THE FUND MAKE UP</u>
(WDW/14/89 - 17 MAY 1989)

As it was hinted by the Interim Committee, have at the conclusion of its Spring meetings, the Bank and the Fund patched up their most recent differences (WDW/10/89).

The new guidelines for "enhanced collaboration" are contained in a memorandum addressed jointly by the Managing Director and the President, on March 30, to the Executive Board of the IMF and the Board of Executive Directors of the Bank. The purpose of these guidelines is "to avoid administrative friction and facilitate orderly resolution of differences of views." This is not the first time that it is necessary to arrive at an explicit settlement of differences between these two international financial institutions that, theoretically, are expected to lead more than a harmonious existence.

The first set of guidelines dates from 1966, with additional procedures approved in 1970, as well as new guidelines agreed by the managers in 1980 and by the Boards, in 1984 for the Fund and in 1985 for the Bank. This only proves that these procedures periodically demand revisions and realignments.

Before getting to the details of the new procedures, there is a description, in accordance with existing guidelines, of each institution's "primary responsibility." The Bank is entrusted with the composition and appropriateness of development programs and project evaluation, including development priorities." The Fund is responsible for "exchange rates and restrictive systems, for adjustment of temporary balance of payments disequilibria, and for evaluating and assisting members to work out stabilization programs."

Admittedly, "in between these two clear-cut areas of responsibility," there is "a broad range of matters which are of interest to both institutions." Among them, the following are specifically mentioned: financial institutions, money and capital markets, domestic savings, the financial implications of economic development programs and foreign debt problems.

An obligation of mutual information about their respective areas of primary responsibility has also existed, with the specific provision that both institutions will not "engage in a critical review of these matters with member countries without the prior consent" of the other.

Despite these rules, "growing contiguity," as well as "overlap of activities," have taken place. Another way of saying that the dividing line between both institutions has become increasingly blurred.

The Fund, for instance, "increased its consideration of structural issues in stand-by agreements; extended the repayment period of certain arrangements for 10 years; and introduced the concessional and relatively long-term Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF)."

For its part, the Bank "introduced Structural Adjustment Loans (SALs) in 1980 that provided financing in support of policies to promote structural, economy-wide changes and, subsequently, Sector Adjustment Loans (SECALs), which focused on structural changes in specific sectors."

As a result, significant differences have emerged "about country priorities and policy," and perhaps more worrisome "they have spilled into discussions by the staff with country authorities." These differences have appeared in the following areas: exchange rates; the level of external assistance; the speed of adjustment; the levels of public sector development expenditures; the trade-off between efficiency and balance of payments and budgetary impacts.

In conclusion, it is deemed "essential to strengthen collaboration, to ensure that conflicts of views are resolved at an early stage, do not surface in contacts with country authorities, and do not result in differing policy advice to member countries."

Accordingly, the following "procedures for enhanced collaboration" are spelled out:

1) Regular meetings between Bank Regional Vice Presidents and the corresponding Fund Area Department Directors will try to settle major differences. For those that remain unsolved, the Deputy Managing Director of the Fund and the Senior Vice President, Operations, of the Bank will chair senior level meetings on countries of common concern. If necessary, the Managing Director and the President will deal with any other differences, during their monthly and ad-hoc meetings. Also, the Fund's Director of Research and the Bank's Vice President, Development Economics, will direct "ad hoc study groups to examine analytical issues which may arise in the areas of common work."

2) The policy framework paper (PFP) discussions with low-income countries will "continue to be handled jointly," with "a single mission chief and on the basis of pre-agreed terms of

reference." Additionally, parallel missions in the field are expected "to cooperate fully and meet jointly with the country authorities, following positions clearly agreed on in advance." Finally, if eligible countries agree, staff members from the other institution will be attached to missions involving the use of Fund SAF/ESAF or Bank SALs/SECALs.

3) Since "adjustment lending operations are not normally undertaken, unless an appropriate Fund arrangement is in place," the Bank will continue including "a discussion of the Fund's financial relations, the status of any negotiations for the use of Fund resources and the results of any recent Fund reviews in the President's Report to the Bank's Executive Board on a proposed adjustment loan." Even so, the need to strengthen coordination is considered "particularly strong," in those cases where there is no outstanding agreement with the other institution.

4) Regarding the suggestion that a "policy framework paper" be drafted for some middle-income countries, it was agreed that "this matter would be presented to the Executive Boards for consideration after further consultations between the two staffs and managements."

5) The case of a country with overdue obligations to one or both institutions should be reviewed in light of its capacity to discharge its obligations to the other institution.

6) Since the Executive Directors of both institutions have stressed "the need to avoid cross-conditionality," the ultimate decision about access to the resources of both rests with the Executive Board of each institution. If, in spite of reservations about policies or of outstanding arrears with the other institution, a program is submitted for approval, the case will be presented to an informal meeting of the Executive Board, before communicating the decision to the country concerned.

7) To avoid "conflicting views from being expressed" to other organizations, such as the OECD, or the UN, "to the maximum extent feasible, the draft report prepared by either institution will be sent to the other well in advance of the circulation date for review and comments."

8) Finally, for the long-term promotion of mutual understanding and "to better acquaint staff of the two institutions with the thinking practices and constraints within which each institution operates," an exchange program was agreed for two or three year secondments of senior professionals.

This is a brief summary of the terms of understanding for the enhanced coordination of the activities of these multilateral financial institutions. There remains to be seen how long they will last this time, before "growing contiguity" demands another revision.

VI. 4. RESEARCH ACTIVITIES AT THE WORLD BANK (WDW/15/89 - 24 MAY 1989)

During fiscal year 1988, the World Bank devoted $23.5 million to economic and social research. Of this amount, $18.4 million accounted for 89 staff-years of research, with the remaining $5.1 million dedicated to finance support activities, such as consultants, travel, computer time and research assistance. Also, as in 1986 and 1987, research activities represented 3.1 percent of the Bank's overall administrative expenses.

Under "research," the Bank includes centrally funded, as well as departmentally funded activities, that differ from "economic and sector work," because they are "not driven primarily by the immediate needs of Bank operations."

The breakdown between these categories remained almost unchanged. Centrally approved projects are those reviewed by the Research Committee and funded from the Central Research Budget, amounting to 49 percent of total research expenditures. Departmentally approved projects are those that departments undertake with their own resources, amounting to 51 percent of the total.

By subject, the breakdown of research activities funded throughout FY 88 was as follows: human resource development (22%); natural resource development (20%); public and private sector policies, as well as adjustment programs (13% each); financing development, as well as external sector and debt management (10% each); finally, technology and development (2%). The remaining was dedicated to coordination, publication and dissemination (5%).

The Bank broadly defines research as those activities destined to the creation of new knowledge, with the dual purpose of "improving the Bank's operations and policy advice" and "increasing understanding of the process of economic development."

The accomplishment of these objectives demands the performance of several tasks, such as those of a consulting firm, a think tank, an academic institution, a statistical office and an information service.

Consulting activities consist of analytical work in support of Bank operations, that generates new knowledge about the economies of member countries.

As a think tank, the Bank undertakes studies of operations that yield "best practice" advice, as well as "the development and implementation of specific tools," such as models of adjustment and growth or of the consequences of current global economic trends.

Academic research at the Bank expands understanding of the development process, without necessarily yielding specific and immediate operational advice or guidance. It differs from strictly academic research, because it is "clearly directed toward a recognized policy issue that eventually will yield improved policy advice."

Finally, data gathering activities correspond to those of a statistical bureau, while the dissemination of research products entails the activities of an information service.

The Bank's operational needs basically demand consulting and think-tank types of research. Nonetheless, the Bank attempts to go further. Striving "to provide intellectual leadership in the field of development economics," leads it "to compete on an even footing with the larger academic community." Thus, endowed with what is described as "the largest single group of development researchers in the world," the Bank claims to be "a leading center, perhaps the leading center, for development economics."

Furthermore, two main activities promote the interaction between academic and Bank researchers. First, a Visiting Research Fellow Program for outstanding researchers. And second, an annual Bank conference on development economics, the first of which was held only two weeks ago. The purpose of these activities is "to increase the intellectual traffic on the two-way street between Bank staff and the outside academic community, exposing each to the work and research issues of the other."

Specific research priorities are reflected in the activities of the two vice-presidencies that exist under the Senior Vice-president for policy, planning and research (PAR). Under the development economics Vice-presidency the priorities are: macroeconomic adjustment and sustainable growth; institutional capacity and economic growth; international trade; and the debt problem. Under the Vice-presidency for sector policy and research the priorities are: ecological sustainability; poverty reduction; the role of women in development; competition and the private sector; and technology and development.

The personnel requirements to perform these activities generate a "typical career pattern" for Bank staff members, characterized as to "enter research when young and then move off to Operations."

Even so, admittedly, "bureaucratic structure and management control," at the Bank, "are not entirely friendly to academic research." Neither is "the Bank able to match the salaries that the best academics in North America and Europe earn." Specifically, in fields such as finance, the Bank "does not compete even at entry level."

Wide dissemination of research results, within and outside the Bank, is assured by several means: books published through university presses; journals on applied, policy-oriented development economics; an atlas, two sets of tables, as well as country briefs are issued to disseminate data; as well as the widely read World Development Report (WDR), based on research working papers.

Finally, a primary goal of these dissemination activities is described as "getting the results of Bank research to Operations staff," which demands "something more than sending draft research papers. . . or filling the week with research seminars." Avowedly, "many research papers present methodological or statistical results effectively but stop short of showing how such results can be used to improve policy or project design." Thus, "often missing is a translation of research findings into operational recommendations."

VI. 5. THE IMF'S ANNUAL REPORT
(WDW/27/89 - 20 SEPTEMBER 1989)

In the annual report the Executive Board reviews the performance of the International Monetary Fund (IMF), during the financial year ending April 30. It is divided in two parts, the first examines the principal developments in the world economy during 1988-89, based on the staff's World Economic Outlook (WEO), originally published in april 1989 (WDW/12/89). An updated and forward-looking examination of the world economy will be available until the release of the second issue of the WEO, expected for October 1989.

The second part constitutes the Report's core, because it contains a detailed review of policies and activities, presented under the following five headings: surveillance; external debt situation and strategy; trade policy; support of adjustment programs; Fund-Bank collaboration; and financial operations and policies.

The activities performed under surveillance are described by groups of countries. Among the industrial countries, the members of the G-7 --Canada, France, Germany, Italy, Japan, the United Kingdom and the United States-- are examined individually and separate sections deal with the developing countries and the newly industrializing economies.

Besides a congratulatory tone to signal positive events, such as "the healthy growth in industrial countries and the narrowing of trade imbalances among them," the Executive Board voices concern about the following aspects of the global economic situation: 1) in the developing countries, growth of output and investment is considered "inadequate;" 2) in the industrial countries, "fiscal deficits need to be reduced, and adjustment of external imbalances must be reinforced;" and 3) all countries "require vigorous structural reforms to reduce trade distortions and to improve efficiency."

On the external debt of developing countries the conclusion is mixed. It is recognized that "considerable progress has been made by a number of indebted countries," while in many others "debt problems continue to hamper stable economic growth."

Also, the following conditions are specified to obtain the Fund's support and participation in case-by-case operations of debt reduction: 1) a medium term adjustment program, including strong elements of structural reform; 2) "voluntary, market based operations" that contribute to regaining access to credit markets and achieve external payments viability with economic growth; and 3) "a determination that support for the reduction of debt and debt service represents an efficient use of scarce resources."

On trade policy, concern is voiced about the persistence of protectionist pressures, granting strong support to the Uruguay Round of multilateral trade negotiations.

Out of a total of 46 ongoing adjustment programs, the Report reveals that 24 are new arrangements approved during the last financial year. The most recent revision of these operations indicates that there still is a need for: 1) appropriate program design and a strong commitment by national authorities; 2) protection of adjustment programs from external shocks; and 3) increased attention to the impact on income distribution and on the poorer segments of society.

The difficulties experienced by member countries, during the eighties, generated greater overlap between the functions of the World Bank and those of the Fund. Thus, a new set of principles was approved "to promote closer collaboration" between both institutions (WDW/14/89).

Finally, a review of the Fund's operations indicates that: 1) commitments of Fund resources "increased substantially," by SDR 1.6 billion to SDR 4.6 billion; 2) drawings declined to SDR 1.9 billion from SDR 2.6 billion; 3) repayments were relatively large, amounting to SDR 6 billion; 4) the negative transfer of resources to the Fund remained approximately at the same level of the previous year, SDR 4 billion; 5) overdue obligations rose from SDR 2 billion to SDR 2.9 billion, of which SDR 2.8 billion was due from 11 members that were in arrears by six months or more; 6) holdings of usable ordinary resources stood at the "near record level" of SDR 42.9 billion; 7) finally, to perform these activities, in financial year 88-89, the Fund employed 1691 persons and its administrative and capital expenses amounted to SDR 171.7 million, up from SDR 170.1 million in the previous year.

This brief overview reveals an institution endowed with plentiful resources to perform its catalytic role, at the center of most international financial rescue operations.

Nonetheless, the IMF's Managing Director has proposed a doubling of Fund quotas, if possible before the year ends. Mr. Camdessus has mentioned the following reasons to justify the proposal for a quota increase: 1) the Fund "must be kept at a credible size and should grow broadly in line with the size of the world economy;" 2) demands on the Fund's resources are "expected to be relatively high in the coming years;" 3) the Fund's reliance on borrowed resources should be reduced; and 4) the liquidity of the institution should be protected.

Even so, opposition to the quota increase is coming mainly from the United States, citing the buildup in IMF arrears and the "near-record" level in usable resources. Some opposition is expected as well from Great Britain, because a doubling of quotas will make it cede its number two spot in the IMF pecking order to Japan. Also, Saudi Arabia remains skeptical about the proposed size of the quota increase.

In these terms, the size of the quota increase promises to become one of the most controverted issues that will have to be tackled during the coming annual meetings, to be held next week in Washington.

VI. 6. <u>THE WORLD BANK'S ANNUAL REPORT 1989</u>
(WDW/28/89 - 27 SEPTEMBER 1989)

This year's <u>Annual Report</u> of the World Bank--covering the fiscal year from July 1, 1988 to June 30, 1989-- is divided in seven sections: 1) the activities of the Bank's Executive Board; 2) a global perspective on the economic scene; 3) lending areas; 4) finances; 5) policies and operations; 6) finally, regional perspectives, containing a segment dedicated to Latin America and the Caribbean.

The world economic scene is described from the vantage point of the industrial and the developing countries. In 1988, the "global economy" is said to have "staged a strong performance." In the industrial countries GNP grew by 4 percent, while in the middle-income and low-income countries the corresponding figure was 5 percent.

Nonetheless, "these aggregates mask significant differences among country groups." While in the industrial economies strength was "broad-based," in developing countries "there were striking differences between fast-growing economies mostly in Asia, and the poor performance of the highly indebted, middle-income countries, largely in Latin America." As a result of this poor performance in highly indebted countries, the <u>Report</u> signals that "there was a growing general acceptance of the need to lessen the debt burdens of developing countries in order to improve their prospects for sustained growth."

The Bank's lending activities supported several "key areas." First, there was a greater focus on the reduction of poverty in country-assistance strategies. Second, a set of guidelines was approved to permit the Bank to support debt and debt-service reduction, with the first loans approved in June 1989, containing provisions for specific amounts of debt reduction. Third, the Special Program of Assistance to Sub-Saharan Africa was expanded, bringing the number of countries assisted to twenty two. Fourth, environmental concerns were incorporated to policies and operations, with a third of all projects approved during the fiscal year containing significant environmental components and Environmental Issues Papers prepared for about 70 borrowing countries. Fifth, an action program was formulated to provide for an increased role of the private sector in the development process. Finally, the Bank's reserve position was strengthened, through an increase in the level of reserves and changes in the currency composition of reserves.

In FY 1989, commitments by the Bank and the International Development Association (IDA), amounted to US $23.0 billion, 13 percent higher than the previous year. Adjustment lending from both the Bank and IDA increased to $6.4 billion, up from $5.0 billion in FY 1988. Also, lending for energy led all sectors by volume, amounting to $3.8 billion, followed by agriculture and rural development at $3.5 billion.

Combined IBRD and IDA lending to the poorest countries --those with per capita incomes of $480 or less-- increased to slightly more than $10 billion. In seventeen highly-indebted developing countries --Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela, and Yugoslavia-- net disbursements amounted to $8.8 billion, while interest and charges amounted to $10.9 billion, leading to a negative transfer of resources from these countries to the Bank of almost $2.1 billion. This increase in the dollar value of repayments resulted from "amortization payments on a growing volume of outstanding debt, as well as the effects of exchange-rate adjustments on the currency pool used in Bank lending."

In the segment dedicated specifically to Latin America and the Caribbean it is said that economic growth has slowed, "further delaying the process of restoring per capita output." In 1988 and early 1989, per capita GDP declined at an annual rate of 0.6 percent, with this decline accelerating in the first half of 1989.

The Bank finds that in most Latin American countries, "the decline in output per capita has been accompanied by increases in export earnings and acceleration of inflation," with most of the trade surplus "used to pay interest on external debt, although some countries managed to accumulate international reserves."

Also, over the 1986-88 period, the net transfer from eight highly indebted countries --Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Uruguay and Venezuela-- "amounted to 4.4 percent of GDP."

The <u>Report</u>'s analysis of Latin American export earnings and resource transfers highlights three issues. First, "export earnings have increased enough to ease the foreign-exchange constraint." Second, "the trade surplus has been increasingly responding to domestic policies rather than to the availability of foreign capital and to debt-service strategies." And third, "debt reduction schemes have taken care of most of the private sector's long-term external debt and contributed to focus the debt problem on the capacity of the public sector to generate a surplus to service its debts." Consequently, "the public sector has effectively transferred resources to foreign creditors in an amount equivalent to 3 percent of GDP over 1986-88."

The most active borrower from the Bank in the last fiscal year was Mexico, $2.2 billion, followed by India, $2.1 billion, and Indonesia, $1.6 billion.

By sector, in Latin America and the Caribbean in FY 1989, non-project lending was the most important, amounting to almost $1.5 billion, followed by lending to development finance companies, $864 million, industry, $860 million, energy, $830 million, and urban development, $675 million.

Finally, to perform these operations, the Bank's budget for the fiscal year ending June 30, 1989 amounted to $786.0 million, of which $535.0 for the Bank and $251.0 for IDA. In the present fiscal year ending June 30, 1990, the budget amounts to $899.6 million, of which $593.8 million for the Bank and $305.8 for IDA.

VI. 7. HIGHLIGHTS OF THE BANK-FUND ANNUAL MEETINGS (WDW/29/89 - 4 OCTOBER 1989)

By contrast with the Bank-Fund spring meetings (WDW/10/89), no single issue dominated the last annual meetings, held in Washington, from 22 to 28 September 1989.

Despite Hobart Rowen's dismissal, in The Washington Post as "an expensive and meaningless social event," several highlights can be identified. Although most of them took place offstage and have to be found behind the esoteric language of the communiques, as well as behind the technically restrained rhetoric of the formal speeches.

In a certain way, this confirms the foresight that something has to happen wherever 3,500 government delegates, 5,000 financiers and 1,000 journalists gather to discuss the state of the world economy.

The main events were: 1) President Bush's meeting with the commercial bankers; 2) the strength of the dollar 3) the IMF's quota increase; 4) President Conable's emphasis on the environment and on defense expenditures; and 5) the separate announcement of a stand-by to Argentina and of an agreement between Venezuela and its commercial creditors.

The dollar's strength was addressed in the communique issued, on Saturday, September 23, by the Ministers of Finance and Central Bank Governors of the Group of Seven (G-7) --Canada, France, the Federal Republic of Germany, Italy, Japan, the United

Kingdom and the United States-- in the following terms: "the Ministers and Governors considered the rise in recent months of the dollar inconsistent with long run economic fundamentals." Furthermore, "they agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely in exchange markets."

By Tuesday, September 26, the dollar obediently tumbled, although by the end of the week it became evident that something more than jawboning is going to be necessary to counter the strength of the dollar.

The IMF Managing Director mounted an intense campaign for a 100% quota increase, with a view of accomplishing this goal at the most by year's end, Nonetheless, he confronted an important obstacle (WDW/27/89). The U.S. Secretary of the Treasury, Mr. Nicholas Brady, in an address to the Interim Committee, stated that "a fully persuasive case has not been made that there is a pressing need for additional resources at this time." Also, Secretary Brady reminded that in previous statements he had emphasized that "a decision on quotas must be based on an agreed vision of the role of the Fund in the 1990s and on fundamental progress being made in resolving the arrears problem in order to strengthen the revolving, monetary character of the institution." This was interpreted as meaning that even when there is overall agreement about the quota increase, there remains to be decided the amount that will be acceptable to everybody.

In accordance with the new division of tasks agreed between the IMF and the World Bank (WDW/14/89), President Barber Conable underlined longer-term issues, such as the environment and the reduction of arms expenditures in developing countries.

Reacting to relentless pressure from environmental activists, as well as to certain apprehensions from developing countries, the communique of the Development Committee "noted that the integration of environmental considerations into development projects could result in increased costs as well as benefits and could require technological transfers to the developing countries."

Additionally, in an unprecedented statement, President Conable raised the issue of the reduction of military expenditures in developing countries. Mr. Conable noted that "as a group low-income countries allocate around 20 percent of central government budgets to defense." Also, these expenditures "exceeded spending on health and education combined," emphasizing that "the $200 billion which the developing world spends annually on the military has largely been protected" from pervasive budget cuts. Finally, Mr. Conable reminded an audience that habitually skirts around such issues, that "arms are often a prime source of external debt: military debt accounts for a third or more of total debt service in several large developing countries."

The other highlights of the meetings were in the realm of the indebtedness of developing countries. Among these, probably the most intriguing had to do with the role of the commercial banks in the debt strategy.

Rumblings were heard before the meetings indicating that a certain malaise existed among the commercial banks regarding their expected role in debt reduction operations, one of the central elements of the new debt strategy. Some of them were contained in the already traditional letter addressed to the Interim and Development Committees by the manager of the banks' advocate, the Institute of International Finance.

More to the point were previous decisions adopted by some of the big money-center banks, such as Chase and Manufacturers Hanover, increasing their loan loss reserves. The high point came when J. P. Morgan decided to add $ 2 billion to its loan loss reserves, increasing them to 70%, from 20%, of its total loans to developing countries.

This was immediately interpreted as an indication that these banks were unwilling to participate in new lending operations. It also made evident that a fracture had opened in the otherwise solid front presented by the commercial banks. Particularly because Citicorp's President John Reed had stated his preference for new lending, as an alternative to debt reduction.

The climax came when, in an "unprecedented effort," President Bush summoned leading bankers to the White House, to rally their support for the debt strategy. Such direct involvement by the U.S. President in the debt issue had never happened before. It was later interpreted, by Richard Feinberg, from the Overseas Development Council, as a manifestation of a "very unusual moment in international finance," by which "the U.S. Treasury in a Republican Administration is having a public spat with the money-center banks."

Finally, on the side of the debtors, there were two important events. First, after meeting President Bush at the White House, President Menem disclosed that agreement had been reached with the IMF for a $1.5 billion stand-by for Argentina. This stood in marked contrast with the Berlin annual meetings, when the World Bank announced that it had reached an agreement to lend to Argentina $1.25 billion, without previous agreement with the IMF. This time, the order was reversed.

The other event was the announcement by the Venezuelan government that it had dropped its demands of a 50% debt reduction and that agreement was near on a $600 million interim loan from the banks, enabling Venezuela to meet some of its arrears in interest payments. This was interpreted as a signal that negotiations could now begin on debt reduction, or as stated by the Minister of Planning of Venezuela, Mr. Miguel Rodriguez, "to create the atmosphere so the negotiating process could speed up."

These few highlights illustrate how beyond the usual ritualistic manifestations, such as the constrained speech-making and the cryptic communiques, the annual Bank-Fund meetings constitute one of the main locus or decisions available within the process of international economic policy-making.