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PRESENTATION

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

For their presentation here, the dispatches are classified by subject and ordered chronologically within each chapter, each heading indicating the relative saliency those issues had within the international economic agenda.

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

1) The midterm legislative elections in the United States led to the first Republican dominated Congress in forty years. However, a most hopeful signal of bipartisanship emerged, even before the inauguration of the new Congress, with the agreement to approve the results of the Uruguay Round. Only time can tell if such bipartisanship will prevail in the remaining two years of the present Administration.

2) The approval of the Uruguay Round results by the U.S. Congress was one out of a "triple play" accomplished during the year in international trade. The second out was the APEC summit in Jakarta, setting the distant but fixed date of the year 2020 for the achievement of trade and investment liberalization. The third out was the agreement to liberalize trade by the year 2005, from Alaska to Patagonia, that emanated from the Summit of the Americas, held in Miami from 9 to 11 December.

3) Finally, for the developing economies the most relevant events had to do with private capital flows, due to the substantial rise in these economies' direct access to increasingly globalized financial markets. This positive trend, characterized by growing foreign direct investment and long term portfolio investments in emerging stock markets, was due to both mutually supportive internal and external factors. Among these factors figures prominently the return of macroeconomic stability in Latin America and the Caribbean and the decline in interest rates in the industrialized economies.

Some of these issues were described in the weekly dispatches transmitted regularly by ECLAC Washington throughout the year. The purpose of gathering these dispatches is to make them available for easier consultation in a single volume, in case the Washington D.C. vantage point they present still has some testimonial value.

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

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[1] ECLAC Washington, International Economic Highlights 1987 (LC/WAS/L.2) 17 August 1988; 1988 (LC/WAS/L.4) 17 March 1989; 1989 (LC/WAS/L.8) 15 March 1990; 1990 (LC/WAS/L.11) 22 March 1991; 1991 (LC/WAS/L.14) 11 March 1992; 1992 (LC/WAS/L.17) 11 March 1993; 1993 (LC/WAS/23) 30 March 1994.

I. THE WORLD ECONOMY

I.1. THE JOBS SUMMIT
(WDW/10/94 23 March 1994)

When the Group of Seven announced in Tokyo last year that President Clinton would host a "jobs summit" this year in Detroit, John Maynard Keynes must have turned in his grave. Keynes asserted that markets by themselves are unable to achieve full employment, or to overcome "unemployment equilibrium," understood as a "condition of long-lasting joblessness."

Today, some of the remedies proposed by Keynes to overcome this "equilibrium" have been disproved, particularly by the inflationary pressures attributed to government spending. However, as suggested by Robert Heilbroner in the New York Review of Books, March 3, 1994), present circumstances in the industrialized countries can be characterized as "a state of persisting unemployment resembling that of the 1930s."

The figures prepared by the Organization for Economic Cooperation and Development (OECD), to serve as background to the Detroit summit, reveal certain contrasts in the behavior of the industrialized economies that support some of Heilbroner's concerns.

For instance, the unemployment rate in Europe last year stood at near 12 per cent. By contrast, while in the United States unemployment reached, in 1993, only 6.7 percent, the relatively mild reactivation experienced by the U.S. economy, at 2.7 percent, hardly is making a dent on that figure.

In the terms of the deputy director of the French Institute for International Relations Dominique Moisi, quoted by Thomas Friedman in The New York Times, such levels of unemployment are "the proof that governments are not effective." As described by Columbia University Professor Edmund S. Phelps, in The Wall Street Journal, "the unemployment rate ultimately returns to some basic level --dubbed the natural unemployment rate-- that is independent of the artificial forces of money, its supply and velocity."

From this perspective, Japan is exceptional with 2.9 percent unemployment. However, this figure disguises those workers kept in the payroll by the increasingly challenged tradition of lifetime unemployment.

Two of the explanatory factors offered by Professor Phelps to account for the "natural unemployment rate" are not susceptible to individual government management. There is little that an individual government can do to moderate "global factors," such as "world oil prices and world real interest rates." The one factor that individual governments control fully is "big increases in payroll and /personal income taxes," considered by Professor Phelps to be "a domestic source of much of the unemployment increase in several countries." This factor explains most of the difference that presently exists

between average manufacturing compensation in Germany and in the United States, at $26 and $16 an hour, respectively.

The United States is confronting a different situation. At issue is not job creation, since the United States in the last two decades created more than 36 million jobs, while Europe barely created one fourth of that amount in the same period. According to U.S. Labor Secretary Robert Reich, the problem in the United States is that most of these new jobs are low-paying jobs. Thus, the basic question before the Detroit summit was described by Secretary Reich, the summit's inspirer, as follows: "Are we condemned to choose between more jobs but greater inequality and insecurity as we have in this country, or better jobs but higher unemployment and a thicker social safety net, as in Europe?"

No wonder, great expectations were played down in advance by the hosts and not even a final communique was issued at the summit's closure. U.S. Treasury Secretary Lloyd Bentsen just read a summary statement highlighting the main points discussed. Among these, the attendance of "some 24 ministers" was seen as "a clear demonstration of the seriousness with which our nations view the jobs problem." Also, Secretary Bentsen emphasized that this was the first ministerial meeting of the G-7 that included the labor ministers, amounting to an expansion of the G-7's traditional agenda, beyond interest rates and exchange rates.

As described by Secretary Bentsen, the meeting was divided into the following "four structured discussions": 1) the world employment problem; 2) creating employment opportunities in the global economy; 3) technology, innovation and the private sector; and 4) labor markets, investment in human capital, and the social safety net.

The Detroit discussions, concluded the U.S. Treasury Secretary, were a "first step," that will be transmitted to the G-7 leaders, scheduled to meet in Naples during the summer, to help them decide how to "strengthen growth, create more jobs, better jobs, and reduce unemployment."

A good summary of the main conclusion was offered by Chancellor of the Exchequer Kenneth Clarke. He said that "during the discussions there was considerable agreement among the ministers that there is a problem of structural unemployment that won't be solved by growth alone."

In the more graphic terms of U.S. Secretary of Commerce Ronald H. Brown, "the old economic axiom that a rising tide raises all boats does not necessarily apply. There are a lot of people in our economies who don't have boats or whose boats have holes in the bottom."

I.2. <u>THE IMF'S FIRST WORLD ECONOMIC OUTLOOK (WEO)</u>
(WDW/14/94 25 May 1994)

The advanced copy of the first WEO was released to the press on April 20, as usual, just before the Fund-Bank Spring meetings. In two volumes, the first contains the

main report and the second the supplementary analyses, excluding only the full statistical appendix, which will be included in the WEO's final version, to be released sometime in May.

The main report contains the following chapters: I) overview; II) world economic situation and short-term prospects; III) fostering job creation, growth, and price stability in industrial countries; IV) why are some developing countries failing to catch up? and V) stabilization, reform, and the role of external financing in the countries in transition.

The second volume contains the following annexes: I) the Uruguay Round: results and implications; II) information content of the yield curve; and III) adjustment and recovery in Latin America and the Caribbean.

The world economy's recent performance is marked by "the nonsynchronous nature of the cyclical movements" that prevail among the industrial countries. These contrasting performances are found among two distinct groups of countries. The first group, comprising the United States, the United Kingdom and Canada, "entered into recession in 1990-91, and these countries are all now experiencing relatively robust recoveries." The second group, including Japan and the continental European economies, "did not fall into recession until 1992." In these last countries, the "downturns appear to have bottomed out but clear signs of recovery have not yet emerged." Except in the United States, among the industrial countries, "the recent recessions rank among the most severe in the postwar period and in most cases have been considerably more protracted than initially expected."

Contrastingly, the "robust economic growth" among the developing countries is seen as "one of the most encouraging aspects of global economic trends in recent years." However, this "pattern of growth is likely to remain very uneven," with many bright spots found in Asia and Latin America, while among the low-growth countries are "many of the poorest countries, especially in Africa, as well as a number of lower middle-income countries in other regions."

Finally, contrasts are also found among the so-called "economies in transition." First, countries such as the Baltic States, the Czech Republic, Mongolia, Poland, Albania and Slovenia "have achieved a reasonable measure of macroeconomic stability" and have begun to grow again. Second, those countries that "have not yet implemented appropriate stabilization policies have continued to experience high inflation and substantial output losses."

In the short-run, "world output is projected to expand by 3 percent in 1994 and by 3 3/4 percent in 1995," with the "cyclical disparities" among the industrial countries "expected to diminish between 1994-95." However, "with the exception of the United States, margins of slack in the industrial countries remain large, and indications of a turnaround are still tentative in many cases."

This contrasts with the prospects for the developing countries, where aggregate output "is projected to continue to advance at a rate of 5 1/2 to 6 percent--similar to the rate of increase in 1992-93." Among the developing countries of the Western Hemisphere, "overall growth is projected to be somewhat slower in 1994 than in 1993, but to return to a stronger pace thereafter."

In the separate appendix dedicated to "adjustment and recovery in Latin America and the Caribbean," it is recognized that "considerable economic progress has been achieved in the region." However, among the many challenges that remain "there are only a few countries in which per capita incomes are rising at rates higher than 2 percent a year."

Another challenge in Latin America is that "although there has been a significant improvement in public sector saving in the region as a whole, gross national saving declined to an average of about 18 percent of GDP in 1990-93, compared with 20 percent in 1987-89." The challenge is that "stronger economic growth requires an increase in domestic saving and investment." Additionally, "despite a reduced debt burden," external debt "remains high in many countries, and difficulties in debt management could return if interest rates in the industrial countries rise from their current low levels."

Large inflows of private capital have "complicated economic policy management." To counter the currency appreciation and higher interest rates that these flows are causing, fiscal adjustment is suggested as "an appropriate alternative to offset the effects of capital inflows that might not be available in the medium to longer run."

Finally, "a large number of people in the region continue to live in extreme poverty." Beyond the contribution that sustained growth will make to reduce poverty, the countries of Latin America and the Caribbean "need to continue their efforts to improve the targeting of social spending programs and to give priority to expenditure on social infrastructure such as education and preventive health care."

I.3. THE NAPLES SUMMIT
(WDW/22/94 20 July 1994)

Some observers hoped that President Clinton would accomplish in Naples similar results to those he attained last year in the Tokyo summit. However, there were no dramatic breakthroughs in Naples and the results were limited to those issues where there had been some degree of advanced preparation.

This was the case, for instance, with the issue of jobs and growth, because of the preparations carried out in the previous "jobs summit," held last March in Detroit (WDW/10/94). Consequently, the final communique issued in Naples reflects several conclusions brought over from Detroit.

First, the communique admits that "encouraging results are emerging. Recovery is under way. New jobs have been created, and in more and more of our countries people are getting back to work, inflation is now at the lowest levels in over three decades and the conditions are in place for strong and lasting non-inflationary growth."

Even so, there is no room for complacency, since "unemployment remains far too high, with over 24 million unemployed" in the G-Seven countries. Such levels of unemployment are characterized as "an unacceptable waste," that is "particularly damaging when . . . it is concentrated among young people and those who have been out

of work for a long time." This leads to adopting the activist stance to fight unemployment that emanated from the Detroit conference.

The communique confirms the actions identified in Detroit, regarding growth and stability and also job creation. Additionally, a set of "structural measures" was identified: first, increase investment in people, through developing "a culture of lifetime learning"; second, reduce labor rigidities; third, "pursue active labour market policies"; fourth, "encourage and promote innovation and the spread of new technologies"; fifth, "pursue opportunities to promote job creation in areas where new needs now exist, such as quality of life, and protection of the environment"; finally, "promote competition, through eliminating unnecessary regulations and through removing impediments to small and medium-sized firms."

By contrast with this very well-prepared issue, the introduction by the U.S. delegation of a less prepared initiative on trade, led to no concrete results. The heads of state and government of the G-Seven declared that they "are determined to ratify the Uruguay Round Agreements and to establish the WTO (World Trade Organization) by January 1st, 1995 and call on other countries to do the same." It was precisely the recent approval of the Uruguay Round that generated the opposition against the U.S. initiative to open markets in telecommunications, financial services and other issues not dealt with in the Round.

According to the notes taken by an "official note-taker" during the closed session of Saturday morning, published in the following Monday's Wall Street Journal, almost all the participants were against a new trade initiative. President Mitterand was perhaps the most outspoken. He was quoted as saying that those who proposed the new initiative were "like crusaders before the Holy Sepulcher. We have barely completed the Uruguay cycle . . . now we must add to it. Politically it's very difficult for us."

In the end, the communique said "on new international trade issues we encourage work under way in the OECD (Organization for Economic Cooperation and Development) to study the interaction of international trade rules and competition policies. We support the further development of international investment rules in order to remove obstacles to foreign direct investment." Also, the participants welcomed "the work on the relation between trade and environment in the new WTO." They called for "intensified efforts to improve our understanding of new issues including employment and labour standards and their implications for trade policies." To conclude, the communique did not close the door to discussing these new issues, since next year's meeting in Halifax "will review progress on these issues."

Almost unanimously, the U.S. media interpreted this as a setback. However, a "senior administration official" quoted in The Washington Post offered a different perspective. He said that it is the U.S. government's "responsibility to keep pushing -- even if that made the other summit attendees uncomfortable." He also said, "we see our role as provocateurs. If the United States did not take the initiative at the summits, nothing would happen. We are always kicking, prodding, pulling. That's our job."

Finally, a conspicuous absentee was the U.S. dollar. There was no mention in the communique about coordinated actions to stop the dollar's fall. By contrast, Russian President Boris Yeltsin was present as a "full participant" in the political discussions.

Looking toward Halifax, the communique says that two questions will be addressed: "(1) How can we assure that the global economy of the 21st century will provide sustainable development to the people of our nations and the world? (2) What framework of institutions will be required to meet these challenges in the 21st. century?" This last was interpreted as a call to "renew and revitalize" the Bretton Woods institutions.

I.4. THE IMF'S SECOND WORLD ECONOMIC OUTLOOK (WEO)
(WDW/28/94 5 October 1994)

This year's second WEO contains a chapter dedicated to "the postwar economic achievement," since the annual meetings of the World Bank and the IMF include a special conference to mark the fiftieth anniversary of the Bretton Woods institutions.

The world economy offers a positive background to the Madrid meetings, because "the recovery of world activity and trade became more firmly established during the first half of 1994." Also, "world output is projected to expand by 3 percent in 1994 and by 3 1/2 percent in 1995, twice as rapidly as in 1990-93."

Among the industrialized economies, "continental Western Europe and Japan have now begun to emerge from some of the deepest recessions in half a century. At the same time, upswings have gained momentum in the United Kingdom, Canada and Australia while in the United States a high level of capacity utilization has already been restored."

By contrast, the "continued strong performance" of the developing countries "masks considerable diversity." Still, "growth in the developing economies is expected to average 5 1/2 percent in 1994-95, close to the rate of expansion in 1992-93."

Finally, among the "transition economies," those that "first and most boldly implemented market reforms" are "now growing, or are expected to begin to grow in the near term." Meanwhile, "output continues to contract, or remains stagnant," among those transition economies that "have yet to contain government budget deficits and to reduce and stabilize inflation at low levels."

Briefly, "the marked slowdown in world trade and growth in the early 1990s -- which occurred despite the strength of economic activity in the developing countries as a group during this period -- appears to have run its course."

The average growth projections for the developing countries in 1994-95 remain almost unchanged. For instance, average growth in those countries of the Western Hemisphere "is projected to slow to 2 3/4 percent in 1994, with weaker than expected growth in Mexico and increased difficulties in Venezuela offset by upward revisions to the projections for Argentina and Brazil."

The medium-term projections for the industrial countries are based on the following assumptions: current structural, fiscal and monetary policies; constant real exchange rates; and stable real commodity prices.

Based on these assumptions, "real GDP growth in the United States is expected to decline in 1995 and beyond to levels consistent with potential output growth of 2 1/2 percent, and inflation is projected to stabilize at about 3 percent." In the other industrial countries "as a group, growth is projected to pick up from 2 1/4 percent in 1994 to more than 3 percent in 1996-99."

However, without the assumptions of "current fiscal policy and a noninflationary monetary stance," there are several risks. First, "the extent of the slack is, or will be overestimated." The other "related risk" is that "monetary policy will not be tightened sufficiently rapidly during the recovery phase of the cycle, either because the amount of slack is overestimated or because the stance of monetary policy is judged to be tighter than is actually the case."

A specific chapter is dedicated to analyze "the substantial rise in private capital flows to many developing countries in recent years." The internal and external circumstances that account for these capital flows are first, "the successful adjustment and stabilization efforts," added to the "sluggishness of activity, and hence of the demand for funds, and the associated decline in interest rates in the industrial countries."

By contrast with the experience of the previous decade, when the developing countries "attracted very little foreign capital," presently "a substantial part of total flows is now private, non-debt creating capital." Thus, "annual average net flows to developing countries, excluding exceptional financing, fell from $30 billion during the 1977-82 period to under $9 billion during 1983-89, but they have subsequently risen significantly to an average of almost $94 billion during the 1990-93 period."

The countries of the Western Hemisphere, "especially Mexico Argentina and Chile, have also benefited considerably from foreign direct investment, which has amounted to over $12 billion annually in the recent period." Portfolio investment flows "have averaged $25 billion a year, partially offset by an average outflow of over $7 billion a year over the period 1990-93."

The advance copy of the second WEO was released, on September 28, in two volumes. The first volume contains the main report, with the following chapters: 1) economic prospects and policies; 2) the world economy in 1994-95; 3) using the recovery wisely in the industrial countries; 4) the recent surge in capital flows to developing countries; 5) stabilization, transformation, and fiscal adjustment in the transition economies; and 6) the postwar economic achievement. The second volume contains supplementary analyses, including boxes and two annexes on: 1) European economic integration and 2) the medium term scenarios for industrial countries.

The final version of the WEO will be released by the end of October and it will also include the full statistical appendix.

I.5. THE APEC VISION
(WDW/33/94 9 November 1994)

Next week, President Clinton will go to Bogor, Indonesia, to participate in the so-called "leaders meeting," to avoid using the term heads of state, of the Asia-Pacific Economic Cooperation (APEC) forum. This will be the second summit of APEC, to provide encouragement and guidance to the process of trade and investment liberalization in the Asia-Pacific region.

The first meeting took place last year in Seattle and marked the initiation of a process aimed at providing APEC with a vision. In Seattle, the "Economic Vision Statement" issued by the APEC leaders, "welcomed the challenge . . . to achieve free trade in the Asia- Pacific." This challenge was the main thrust of the report presented by APEC's Eminent Persons Group (EPG), chaired by C. Fred Bergsten from the well known, Washington-based think-tank, Institute of International Economics (IIE).

This year's APEC Summit will review a second report, issued in response to the suggestion made to the EPG, by the Ministers that met in Seattle last year "to present further more specific proposals on how the recommended long-term vision might be realized."

The second EPG report responds to that suggestion by listing a set of principles, to guide the process of trade and investment liberalization. These principles are: free trade and investment, international cooperation, regional solidarity, mutual benefit, mutual respect and egalitarianism, pragmatism, decision-making based on consensus, flexibility in the implementation, and "open regionalism."

Based on these principles, the EPG's second report recommends to the APEC leaders meeting in Bogor, "to adopt a comprehensive program to realize the vision of free and open trade in the region." This program would initiate the process of trade and investment liberalization by the year 2000 and conclude it by 2020.

If adopted, this "top-down" commitment will mark a significant departure from the more modest procedures and objectives that were originally envisaged for the APEC forum. Consequently, it should not be a surprise that some profound, though apparently bridgeable, differences appeared among the EPG members.

The existence of these differences was confirmed by the Japanese member of the EPG, Hitotsubashi University Professor Ippei Yamazawa, in an article entitled "Regionalization of the World Economy: A Japanese View." According to Professor Yamazawa, "there were differences within the group that resulted in ambiguity in the report regarding such issues as the stress on APEC liberalization relative to multilateral and unilateral efforts, and whether APEC liberalization should be applied to non-members on unconditional MFN or reciprocal FTA basis."

Additional evidence exists that no solid unanimity lies behind the second EPG report on "achieving the APEC vision." From none other than within the ranks of the private sector in the United States has come out a call for skepticism.

The influential President's Advisory Committee on Trade Policy and Negotiations (ACTPN), on October 31, 1994, issued a set of "recommendations on APEC," proposing that "the United States support a three part agenda for APEC which would move towards a balanced, fair trade environment progressively." First, "set short-term, twenty four month, objectives for existing APEC working groups in areas that will make a tangible difference in private sector commercial dealings, such as investment, mutual recognition agreements, and customs facilitation." Second, "set equally short-term objectives for further progress in APEC on unresolved issues from the Uruguay Round, such as financial services and telecommunications." Third, "use Uruguay Round commitments and discussions as a point of departure for further APEC work on tariffs, non-tariff barriers, intellectual property protections, and other issues in the same time frame."

This evidently is a more modest agenda than the ambitiously distant goal of achieving free trade in the year 2020. On that goal, the ACTPN "believes that pursuit of free trade in the Asia Pacific is a laudable goal if it does not detract from progress toward intermediate steps that will advance U.S. and regional economic interests in the short term."

Concretely, the ACTPN says that it has "three principal concerns about making free trade by a date certain the linchpin of either U.S. policy or the APEC agenda." First, "any date that we have seen suggested is too far away. The U.S. private sector will have irrevocably lost too many opportunities if real progress takes decades. Second, if the Leaders were to shift the focus of APEC's efforts to such a broad agenda too soon, the resulting reallocation of APEC's limited resources could derail the useful progress being made in the working groups. Third, putting broad free trade negotiations at the top of the regional agenda may provide key members of APEC with an excuse to delay settling crucial, unresolved bilateral market access issues by deflecting such discussions to the APEC forum on a more protracted timetable."

Which of these two "approaches" will become the APEC "vision" will be known next week. The APEC leaders have to choose between the "top-down" approach of adopting a calendar for trade and investment liberalization, or the "bottoms-up" approach of achieving intrinsically justified "building block initiatives," as intermediate steps toward an undetermined goal.

I.6. THE APEC SUMMIT
(WDW/35/94 23 November 1994)

At the end of the summit in Bogor, Indonesia, the leaders of the Asia Pacific Economic Cooperation (APEC) forum issued "a declaration of common resolve," setting the group's vision (WDW/33/94) on "the long-term goal of free and open trade and investment."

In such a diverse grouping of "developed, newly industrializing and developing economies," now enhanced by Chile's admission as the eighteenth member, agreements have to avoid embarrassing details and be adopted at a very general level. Also, as revealed by the summit declaration, it must help to set distant and relatively ambiguous goals.

In these terms, the APEC leaders announced the "commitment to complete the achievement of our goal of free and open trade in Asia Pacific no later than the year 2020." Additionally, in recognition of diversity, the agreed "pace of implementation" is based on "the differing levels of economic development among APEC economies, with the industrialized economies achieving the goal of free and open trade and investment no later than the year 2010 and developing economies no later that the year 2020."

Having set the goal, the APEC leaders emphasize their "strong opposition to the creation of an inward-looking trading bloc." Thus, in APEC, free and open trade will be pursued "in a manner that will encourage and strengthen trade and investment liberalization in the world as a whole." Because "the outcome," according to the communiqué, "will not only be the actual reduction of barriers" within the group, "but also between APEC economies and non-APEC economies."

Without going into further details, for instance, about how this can be accomplished, if the aim is the creation of a free trade area, the APEC leaders declared that they will "give particular attention" to "trade with non-APEC developing countries to ensure that they will also benefit."

However ambiguous and distant, as is the achievement of free trade in the year 2020, just setting this goal is a major step for a grouping that represents almost 50 percent of the world's gross domestic product.

Setting the goal is also impressive. APEC was only established in 1989, in Canberra, Australia, as a loose association among Australia, Canada, Japan, South Korea, New Zealand, the United States and the six members of the Association of East Asian Nations (ASEAN)--Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand. It has grown to 18 members with the admission, in 1991, of China, Hong Kong, and Chinese Taipei; of Mexico and Papua New Guinea in 1993; and finally Chile, admitted during the Seattle summit. Probably in recognition of this rapid growth in membership, after Chile's admission, new admissions were closed for the next three years.

APEC is also evolving rapidly in the institutional domain. To the annual meetings of foreign and economic ministers have been added other meetings of ministers in charge of trade, of transportation, of finance, and of small and medium enterprises. Starting in Seattle, the summit of APEC leaders has now convened for the second consecutive year and it can be expected to meet again next year in Japan. APEC's chair rotates annually and it convenes the annual ministerial meeting. After Japan, the next ministerial meetings will be held in Philippines (1996), Canada (1997) and Malaysia (1998).

Since September 1992, a permanent secretariat for APEC was established in Singapore. Until 1 January 1996, the secretariat's recurrent expenditures, such as salaries and allowances of locally-recruited staff, utility charges, and charges for the

maintenance of buildings and office equipment, will be borne by the government of Singapore. Thus, the sixth ministerial meeting, held in Jakarta a few days before the last APEC summit, decided to form a task force to examine the secretariat's future.

APEC's ministerial meeting oversees the functioning of ten working groups and two committees. The working groups cover a wide range of topics: trade and investment data; trade promotion; industrial science and technology; human resource development; energy cooperation; marine resource conservation; telecommunications; transportation; tourism and fisheries. The two committees deal with trade and investment and economic trends and issues. In Jakarta, the last ministerial meeting decided to transform the last into an economic committee and added two subcommittees on standards and conformance and on customs procedures to the trade and investment committee. Also, the ministers created a budget and administrative committee, approved a budget for 1995 of $ 2,227,732, and agreed that, next year, they will review members' contributions.

Finally, the APEC leaders asked the Eminent Persons Group (EPG), who drafted the trade liberalization proposal, and the Pacific Business Forum of private sector representatives, to "continue with their activities to provide the APEC economic leaders with assessments of the progress of APEC and further recommendations for stepping up our cooperation."

In this manner, the distant and ambiguous goal of achieving free trade by the year 2020 becomes credible, considering the intense levels of interdependence that exist within the APEC and their rapid pace of institutionalization.

II. THE U.S. ECONOMY

II.1. MORE OF THE SAME IN 1994
(WDW/1/94 19 January 1994)

Based on the strong performance of the U.S. economy during the last quarter of 93, there exists wide consensus between government and private economists that 1994 will see at least a repetition of last year's results. According to Treasury Secretary Lloyd Bentsen, in 1993, "GDP went from 0.8 percent first quarter, to 1.9 percent second quarter, to 2.9 percent third quarter, and I think we'll see a stronger fourth quarter--something between 4 and 5 percent."

The expectation for 94 is that GDP will attain 3 percent real growth and that inflation will remain at approximately 3 percent. These results, according to Secretary Bentsen, "should allow interest rates to remain relatively low and reduce further the rate of unemployment."

Private forecasters agree with these projections. According to the semiannual survey carried out by The Wall Street Journal among 51 economists, "when comparing all of 94 with the year just ended . . . the growth rate comes in slightly better at 3%."

Even some of the administration's most severe critics are also in agreement. Former chairperson of President Reagan's Council of Economic Advisers and Harvard Professor Martin S. Feldstein, admitted to The New York Times that "it is hard to complain too loudly about an economy that is growing at an annual rate of 2.5 percent or better, has a 6.4 percent unemployment rate and inflation of only about 3 percent." However, he added, the "high marks" for such performance should go to the Republican-appointed chairperson of the Federal Reserve Board Alan Greenspan.

For these positive projections to hold, there exists agreement that inflation should remain low, accompanied by moderate economic growth and low interest rates. However, most of the economists surveyed in the Journal agree that, if the strength of last year's fourth quarter continues into this year's first quarter, the Federal Reserve will raise short-term interest rates "as a pre-emptive strike against inflation."

Even so, among private investors, this expectation of higher short-term interest rates in the near future has not influenced their propensity to invest in the stock market. According to a poll of 5,000 PaineWebber brokerage customers, reported in The Wall Street Journal, "most individual investors expect interest rates to spike up this year--yet 68% of them plan to buy stocks soon and are counting on fat returns."

A key indicator to watch is the rate of unemployment. Presently, at 6.1 percent, unemployment is seen by Professor Feldstein "as close as the nation can come to full employment without triggering a dangerous new round of inflation."

The reply came immediately from Professor Alan S. Blinder, a member of President Clinton's Council of Economic Advisers. "We definitely don't accept that . . . the unemployment rate could descend comfortably to 5.5 percent without igniting inflation."

For some observers, the administration is trying to remain in the center, facing the pressures of those pushing for more spending and those who favor the preemptive strike against inflation, by increasing short-term interest rates.

Not everything is assured. Some observers see several yellow lights in the horizon. By the end of the year, oil prices are expected to increase moderately to $16 a barrel, from the present level of less than $14 a barrel. Also, the effect of the tax increase on the wealthy is estimated that will be felt in the form of reduced spending during the second and third quarters. Thirty of the 51 forecasters surveyed, for instance, believed the tax increase will have a "significant" effect on the economy. Finally, during the fourth quarter of this year, GDP growth in the United States is projected to reach 3 percent, assuming that exports to Western Europe regain their strength, essentially as a consequence of the expected reactivation of the German economy.

However, other observers doubt that the reactivation of the German and the Japanese economies will come in time to generate an increase in U.S. exports. Meanwhile, the United States, in Secretary Bentsen's terms, remains "the world's economic leader -- the engine of growth in the world."

For instance, a comparison of unit labor costs in manufacturing reveals that, at current exchange rates, U.S. workers cost $16.70 an hour, Japanese $19.30 and Germans $25.50. For David Wessel, in The Wall Street Journal, "the U.S. has been working out at the health club for the past couple of years. And it has paid off. Germany and Japan have just finished a big lunch and are only now signing up at the local economic gym." More bluntly, MIT Professor Rudiger Dornbusch sees Germany as "overweight and overpaid."

Briefly, the prediction of a continuation of present trends this year in the U.S. economy is based on the persistence of low inflation, which will allow for interest rates to remain at the present low levels. This trend may obtain a little help from abroad if oil prices remain at their present low levels. It is also expected that the beginning of the reactivation in Germany and Japan by year's end will boost U.S. exports.

II.2. THE ECONOMIC STATE OF THE UNION
(WDW/6/94 23 February 1994)

Skeptics who still doubt if there has been change in the direction of U.S. economic policy should take a close look at President's Clinton Economic Report, sent to Congress on 14 February 1994. In the letter of transmission to the Congress, President Clinton asserts that "for 12 years a policy of trickle-down economics built a false prosperity on a mountain of debt."

In response to the demand for change, the President spells out "a comprehensive short-term and long-term strategy" of "renewal and reform" to "restore growth in the living standards of all Americans." This strategy is based on the following elements: 1) deficit reduction, or "laying the macroeconomic groundwork for sustained growth," is described as the "government's first responsibility;" 2) investment, because "Government also has a vital role to play in providing some of the critical raw materials for economic growth," such as science and technology, an educated and well-trained work force, and public infrastructure; 3) reform of the health care system, to confront "a health care crisis that demands a solution, both for the health of our citizens and for the health of our economy over the long run;" 4) to open foreign markets to U.S. exports, to adapt to an integrated world economy and because "export industries offer the kind of high-wage, high-skill jobs the country needs;" 5) to improve the efficiency of the federal government, or "to reinvent how the government performs."

To carry out this strategy the President foresees a moderately positive economic outlook. Therefore, "the Administration forecasts that the economy will grow at 3 percent in 1994 and will remain on track to create 8 million jobs over 4 years."

The annual report of the Council of Economic Advisers (CEA), that follows the President's message of transmission to Congress, expands on each one of the strategy's elements mentioned above and it is divided in the following chapters: 1) a strategy for growth and change; 2) the U.S. economy in 1993 and beyond; 3) trends and recent developments in the U. S. labor market; 4) health care reform; 5) microeconomic initiatives to promote efficiency and productivity; and 6) the United States in the world economy.

The first chapter links what is characterized as "the legacy of the past" with the strategy of economic change to overcome the legacy. Among the challenges confronted are, first, "the recovery that began in the second quarter of 1991 has been exceptionally slow by historical standards--so slow, in fact, that the unemployment rate was still rising more than a year into the 'recovery.'" The second challenge, of a longer-term nature, is the "troubling fact that growth in productivity has been anemic for the last two decades." Finally, since the late 1970s "income inequalities widened alarmingly." On top of these came large fiscal and trade deficits, with high interest rates, dollar overvaluation and a shortage of public investment.

To overcome this legacy, the economic strategy of the Clinton Administration aims at "reducing the deficit to promote capital formation," investing in people, in public infrastructure, and in technology, implementing health care reform and opening markets to U.S. exports.

Based on the performance of 1993, the CEA sees the U. S. economy overcoming some of the "headwinds" that were slowing down the recovery. For instance, "the credit crunch is fading," while "the other industrial countries will not remain mired in recession forever" and commercial construction "has also started to improve." There is only one exception to this positive outlook, defense cutbacks "seem almost certain to continue over the rest of the decade."

Therefore, "a credible deficit reduction plan and low long-term interest rates have set the stage for moderate but sustainable economic growth over the mid-1990s." The

Administration's forecast is that "GDP growth of 2 1/2 to 3 percent per year--in line with 1993 growth--seems likely to continue over the rest of the 1990s."

This moderately positive outlook will sustain the implementation of microeconomic initiatives to "improve worker productivity and increase earnings," to promote technological progress, to address environmental externalities and to create a more effective government. A prominent part of this package is comprehensive health care reform, based on the conviction that "piecemeal approaches. . .will not work." This proposal has already become one of the most controversial initiatives of the present Administration.

Finally, all these changes will have to take place in a world economy where the United States, in President Clinton's terms must "compete not retreat." The Administration "understands that expanding trade relations are not only inevitable but critical to the future health of the U.S. economy. It is determined to ensure that the growing interdependence with our trading partners brings benefits to the United States." For this purpose, the CEA forcefully concludes, "the United States Government is committed to act unilaterally, bilaterally, regionally, plurilaterally, and globally to open markets to maintain the ability of U.S. firms to compete around the world."

III. THE DEVELOPING ECONOMIES

III.1. PROSPECTS
(WDW/15/94 1 June 1994)

The recent performance of the developing economies has been uneven and it will remain so in the next decade, concludes the latest World Bank's Global Economic Prospects and the Developing Economies. Released by the International Economics Department, the analysis was prepared for the forthcoming World Development Report. Besides describing the prospects for the developing economies, the report deals with the specific issue of international trade in commodities, as did the first of these reports, released four years ago.

The study has three parts: 1) global conditions and prospects for the developing countries; 2) does dependence on primary commodities mean slower growth?, and 3) commodity price volatility: high, costly, and a challenge to manage.

The unevenness in the performance of the developing economies is attributed to the declines in output experienced by the transition economies of Eastern Europe and Central Asia and by the negative growth in income per capita experienced by the economies of Sub-Saharan Africa. By contrast, "despite recession and slow output expansion in the major industrial countries, growth of GDP and exports accelerated in Asia and Latin America."

Based on the assumption that economic recovery in the United States will spread to the rest of the Group of Seven (G-7) countries, the projection is that "most developing countries can on balance expect a marked improvement in the international economic environment over the coming decade." Thus, the forecast "focuses on five channels through which impulses in the global economy tend to be transmitted to developing countries--economic activity in industrial countries, inflation and interest rates, capital flows, commodity prices, and world trade."

An average of 2.7 percent growth a year is projected for the high-income OECD countries in the coming decade, which "remains low in comparison to past trends." However, "the negative effects this may have on the export prospects of developing countries are likely to be offset by four other favorable developments." First, "international interest rates are likely to remain low in the wake of continued fiscal consolidation in major industrial countries." Second, "the record surge in private capital flows to creditworthy middle-income developing countries will be sustained." Third, world trade will experience high growth, because of the Uruguay Round and the North American Free Trade Agreement (NAFTA). Finally, real commodity prices are expected to stabilize.

In these conditions, the performance of individual developing regions will diverge. For instance, "barring any major political upheaval, East Asia is likely to remain the fastest growing developing region over the next decade, but its performance will probably be less spectacular than in the past, partly as a result of infrastructural and environmental constraints." For East Asia, the baseline forecast projects annual growth of real GDP of

7.6 percent. By contrast, in South Asia, "growth prospects for the coming decade will depend on the spread and intensification of its reforms."

In Latin America, "the growth rate is likely to accelerate modestly, depending in part on the deepening of reforms and continued capital flows," with the baseline forecast projecting real GDP growth of 3.4 percent. "A key concern underlying the growth projections for Latin America is the sustainability of private capital flows. The assumption is that these flows will subside as a share of GDP but will continue to be fairly large for several more years."

The outlook in Sub-Saharan Africa is "sobering," because it can "improve its economic performance in the coming decade; nevertheless, average per-capita incomes and consumption are unlikely to increase significantly, and the number of poor is expected to increase both in absolute terms and as a proportion of the population."

The developing countries of Europe and Central Asia "remain the most uncertain of all: although market oriented reforms appear to be generating positive results in some countries, great uncertainties remain about the direction and speed of reforms in others." Finally, in the Middle East and North Africa "the outlook for the next decade is brighter -- in part because of the potential peace dividend -- but is fraught with a high degree of uncertainty."

However, a "low-case scenario" is based on the impossibility by the industrialized countries of "overcoming structural impediments to growth and in maintaining low inflation and interest rates." This less favorable scenario "would affect countries in Latin America currently receiving large capital inflows, as well as low income commodity producers in Sub-Saharan Africa." For Latin America, the low-case scenario projects growth in real GDP of 0.8 percent, because "exposure to higher interest rates and reduced capital flows, combined to less responsive exports, requires major import compression and stops growth." Thus, "the downside risk in growth (relative to the forecast) is larger than the upside, reflecting the underlying asymmetry of risks on interest rates and capital flows." By contrast, East Asian countries "are likely to show the greatest resistance." The projected growth of real GDP for East Asia in the low-case scenario is of 7.1 percent.

III.2. COMMODITY DEPENDENCE AND ECONOMIC DEVELOPMENT (WDW/16/94 8 June 1994)

It is highly significant that this year's Global Economic Prospects and the Developing Economies 1994 (WDW/15/94), produced by the International Economics Department of the World Bank, revisits the issue of international trade in commodities. Besieged for some time by an impressive set of bad news, the Bank tries to identify some good news from the bleak performance and outlook of world commodity markets.

The bad news is that "the 1980s were crisis years for commodity exporters." Thus, "the estimated annual loss to developing countries from the fall in commodity prices between 1980 and 1993 reached US$100 billion a year in 1993 -- or more than twice the flow aid in 1990." The Bank's "index for real non-oil commodity prices," measuring

"relative commodity prices vis-a-vis manufactures," fell by one half to the lowest point since 1945. "Between 1979 and 1992, real commodity prices virtually collapsed -- beverage prices fell by 74 percent, cereals by 44 percent, oils and fats by 57 percent, logs by 24 percent, and metals and minerals by 36 percent."

Worst still, "commodity exporters have been underachievers for longer than just the 1980s." Compared to those of all developing countries, average GDP growth rates for commodity exporters in the 1960s were below by 1.7 percent in the 1960s, 2.3 percent in the 1970s and 1.8 percent in the 1980s.

The evidence reveals that "non-oil commodity exporters were particularly unfortunate in the 1980s." These "underachievers" experienced terms of trade shocks that "reduced their real incomes by an average of 5 percent of GDP, with larger declines in countries such as Cote d'Ivoire (6 percent), Uganda (7 percent), Costa Rica (9 percent), Cameroon (11 percent), and Togo (13 percent)."

So much for the bad news, the good news is that there exist some outstanding examples that "commodity exporters can also be successful in maintaining high growth." Chile "expanded its fruit exports dramatically in the 1980s." Between 1974 and 1990, Chilean "exports of fresh fruit grew at an astonishing 25 percent per year. The share of fresh fruit in Chile's total exports rose to 10 percent by the late 1980s, with annual export revenues exceeding US$500 million." Also, "the fastest growing country in the world in the 1970s and 1980s" was Botswana, "a small country in Sub-Saharan Africa, where GDP grew by an annual 14.5 percent in 1970-80 and slowed to a breathtaking 9.8 percent in 1980-91." Botswana is "the quintessential commodity exporting economy, relying for 80 percent of its export revenues on one commodity. It helps, of course, when that commodity is uncut diamonds." Equally spectacular increases were achieved by Malaysian exports of palm oil and cocoa; Thailand's exports of shrimp; and Brazilian exports of frozen concentrated orange juice.

However, "a high share of commodities in total output or exports does not necessarily condemn a country to low growth." Unfortunately, no examples exist of countries that "have grown slowly and still substantially lowered the share of primary commodities in total exports. In fact, on the basis of data for eighty-seven countries, there appears to be a clear relationship between economic growth and the decline in dependence on primary exports."

Still, 29 out 49 countries in Sub-Saharan Africa and 18 of 38 Latin American countries "depend on primary commodities for more than 50 percent of their export earnings." Furthermore, "the major markets for most of these commodity producers are the industrial countries. Seventy-two percent of the world's commodity exports are bought by the industrial nations, more or less in proportion to their share in world GDP and world imports of manufactures."

The industrialized countries "account for about half of the world's exports of primary commodities," and these same countries "account for two-thirds of agricultural exports." For instance, the industrial countries dominate the world market of "timber (62 percent), fish (65 percent), vegetables (67 percent) energy exports (73 percent), tubers (75 percent), cereals (80 percent), sugar (65 percent), and dairy products (89 percent)." By

contrast, the developing countries predominate in "tobacco (60 percent), sugar (65 percent), coffee, cocoa, and tea (80 percent), and rubber (90 percent)."

In some commodities where the developing countries dominate, such as coffee, cocoa, and tea, there is the "adding up" problem, whereby export expansion lowers world prices. Due to the inelasticity of demand, "an increase or a decrease in the supply of a commodity leads to a larger percentage change in its price." However, even where the "adding-up" problem is present, "policies promoting efficiency in production, processing, and marketing are likely to achieve more lasting improvements in net revenues than curtailing production through export quotas or taxes."

Finally, "where a group of commodity exporters jointly wields significant market power, imposing export quotas or a uniform export tax could raise the welfare of each member of the group -- the example of OPEC shows that such welfare gains can be substantial. But similar attempts for other commodities other than oil have proved less successful, largely because it is difficult to coordinate restrictions on supplies among producers with diverse interests."

III.3. COMMODITY PRICE VOLATILITY (WDW/17/94 15 June 1994)

Of all the difficulties that characterize the performance of commodities in the world economy, no other stands out as the volatility of commodity prices. In recognition, this issue merits a separate chapter in the last report released by the World Bank's International Economics Department on the Global Economic Prospects and the Developing Countries 1994 (WDW/16/94).

The prices of primary commodities "are notoriously volatile," for several reasons. Because of "unanticipated weather disturbances," that affect the production of food and beverages; the "long gestation between new planting and production," that characterizes tropical beverages; or due to "unforeseen, usually cyclical, changes in industrial demand that cause the "high price variability" of metals. Anyway, "commodity prices in the aggregate have typically been much more volatile than prices of manufactures."

Because of price volatility, exporters of primary commodities experience "revenue instability" and "farmers and workers suffer variability in incomes," while "governments find that their fiscal position and foreign exchange reserves change substantially over short periods as a result of a sudden change in international prices."

Evidence reveals that "the degree of volatility has differed greatly over time." For instance, during the 1970s, turbulence in commodity prices, "with two oil shocks and a range of severe macroeconomic disturbances affecting the prices of all commodities," resulted in "a level of volatility not seen since the interwar period."

The Report also shows that "when export prices or export earnings of a country are unstable, it is highly probable that incomes and consumption are unstable. The correlation between the volatility of export revenues and the volatility of private consumption is

positive and high." For instance, between 1961 and 1992, losses in income due to price volatility amounted to 20 percent for Malaysian tin producers, 15 percent for Brazilian coffee growers, and 6 percent for Egyptian cotton farmers.

Direct losses caused by falls in commodity prices result in a "decline in export revenues." Indirect costs are reflected in depressed exchange rates that cause a "shift of productive resources from nontraded to traded goods production." By contrast, an abrupt commodity price increase will cause a costly shift "back to the production of nontraded-goods sectors." Also, volatility in commodity prices generates "uncertainty, making long-term investments riskier and complicating the task of macroeconomic management."

More relevant is that "commodity exporters are subject to bigger shocks than are other countries." Therefore, "it is not unusual for developing countries to experience shocks that exceed 4 percent of GDP." As did Brazil, "suffering negative shocks equivalent to 4 percent of GDP in 1981 and 1982 from a combination of commodity price declines, reduction in world trade volumes, and rises in interest rates."

Another casualty of commodity price volatility is investment, which "invariably declines more than consumption when countries experience a sharp deterioration in their terms of trade." For example, in eighteen oil-exporting economies "a sustained decline of 1 percent in the terms of trade was found to lower investment spending by 0.6 percent, a much larger decline than the 0.35 percent for consumption."

All these reasons "make the management of commodity price risk an important challenge for exporters." The conclusion is that "nonmarket schemes, such as compensatory financing, international commodity agreements, and domestic price stabilization schemes, have met with limited success." By contrast, "market based techniques, notably commodity-linked financial instruments, appear to offer new opportunities and approaches for managing commodity price risk."

The Report reveals that "the use of commodity-linked financial instruments as a means of hedging risk is growing rapidly." There is enough evidence available of the successful use by several developing countries of financial instruments, such as forward, futures, options and swaps, to protect their export revenues. For instance, the Mexican oil company has used futures contracts to protect its crude oil export earnings, and coffee exporters in Brazil, Costa Rica and El Salvador have also used futures contracts to protect themselves from the risk of price variability. Only one example of a "disastrous situation" is mentioned. To illustrate that "some risks remain," the Report mentions "the loss of more than US$200 million experienced by CODELCO in late 1993."

However, the question remains of "why is the use of market-based financial instruments not more widespread among developing countries?" Among the reasons are lack of familiarity with their advantages; adverse government policies; absence of instruments with longer maturity than two years; and difficulties in locating appropriate instruments. To "help developing countries better manage commodity price exposure through the use of commodity-linked financial instruments," the World Bank has started a technical assistance program, in Algeria, Colombia, Costa Rica, Nigeria, Mexico, Trinidad and Tobago, and Venezuela.

III.4. GOVERNANCE
(WDW/20/94 6 July 1994)

Development activities are characterized by certain catchwords that become dominant throughout distinctive periods. For instance, at the World Bank, "basic needs" dominated during the McNamara years, as "structural adjustment" characterized the decade of the eighties. Perhaps it is a bit premature to identify the catchword of the nineties, but in the present World Bank's agenda "governance" already may be gaining the upper hand.

How these catchwords, that dominate the World Bank's agenda, end up becoming part of the global development agenda is fairly simple. The World Bank is rapidly becoming the agenda setter in the development field, because it is the single main source of development finance, far ahead of individual bilateral agencies and of the commercial banks.

Furthermore, other official and private development agencies, regardless if they accept it or reject it, recognize this agenda-setting role of the multilateral financial institutions (MFIs). Therefore, these catchwords are more than fads, they become relevant because they are part of the lending program of the agenda-setting development institution.

For this reason, the release of a study on Governance: The World Bank's Experience, reviewing recent lending activities in this field, should not pass unnoticed. Even if only two years have passed since the Bank published its first report on Governance and Development, "the record shows that the Bank's work on governance has greatly expanded."

For instance, "in fiscal 1993, total lending classified as PSM (public sector management) was US$609 million." This still represents a relatively small percentage of total lending of around US$25 billion per year. Even so, an analysis of 455 development projects, executed during the 1991 to 1993 fiscal period, revealed that "governance topics pervade World Bank lending operations," as a major component. Out of all these lending operations 68 percent included decentralization and capacity building, 49 percent comprised economic management and about one third had an influence on the reform of state-owned enterprises.

The Bank understands by governance "the manner in which power is exercised in the management of a country's economic and social resources for development." This is an essentially political concept, because of the centrality of power in its definition. However,"the World Bank draws a clear distinction between the concept's political and economic dimensions."

Formally, the Bank recalls, its "Articles of Agreement explicitly prohibit the institution from interfering in a country's internal political affairs and require it to take only economic considerations into account in its decisions." Thus, "the Bank's call for good governance and its concern with accountability, transparency, and the rule of law have to

do exclusively with the contribution they make to social and economic development and to the Bank's fundamental objective of sustainable poverty reduction in the developing world."

However, despite this rather artificial separation between the economic and social from the political, the report employs four essentially political "subheadings" to describe the Bank's activities in governance: 1) public sector management (PSM); 2) accountability; 3) legal framework for development; and 4) transparency and information.

Public sector management, the first of these four subheadings, "is the most readily identified dimension of the Bank's governance work." This is based on the "conviction that an efficient government is a sine qua non for sustainable economic growth." The other three dimensions "underpin PSM," which traditionally has covered "categories such as civil service reform, public expenditure management, and public enterprise reform."

Avowedly, the "emphasis on PSM has been influenced by changing perceptions in the role of the state." Nonetheless, contrary to some commonly held assumptions, the objective is not circumscribed to the simplistic reduction of the state. This "new model requires a smaller state equipped with a professional, accountable bureaucracy that can provide an 'enabling environment' for private sector led growth." It is also a state characterized by the capacity to "discharge effectively core functions," such as "macroeconomic management, selective intervention, greater use of indirect means for the delivery of public services, and a capacity to regulate where private providers enjoy a monopoly." All these as instruments "to pursue sustained poverty reduction."

Finally, the report also describes "other issues that are related to Bank activities," such as participatory approaches to policy making and implementation, military expenditures and human rights. The promise is that in the future the Bank's activities on governance will also "underscore the importance of institutions in the development process." In the coming years, among the "central objectives of the Bank's economic and sector work" will be "how to assist countries in building strong institutions and to explore further the relationship between institutional development, public sector management, and the other dimensions of governance."

III.5. INSTITUTIONS AND DEVELOPMENT
(WDW/24/94 7 September 1994)

Until the Nobel Prize in economics was granted to Ronald Coase in 1991 and to Douglass North in 1993, it could be safely said that "institutions" were among the "poorest relatives" of the discipline, always coming last and given the least attention.

As it can be recalled, this residual nature of institutions in economics was pervasive throughout the different shades of economic theory. For instance, at the most, some thought that institutions became necessary in instances of market failure. Even Marxists were no exception, institutions were part of a "superstructure" determined by the underlying interplay of the almighty "forces of production."

Today's recognition of the role of institutions in development manifests itself in what is known as the "New Institutional Economics" (NIE). The term was coined by University of California, Berkeley Professor Oliver E. Williamson some twenty years ago, but it gained full recognition only recently.

For instance, R.H. Coase's Nobel acceptance lecture, titled "the institutional structure of production," describes his seminal articles on "the nature of the firm" and "the problem of social cost" as aimed at clarifying how transaction costs are affected by the legal system.

Also, Douglass C. North's Nobel lecture titled "economic performance through time," describes how economic history, or the study of how economies develop, needs to focus on the evolution of institutions, understood as the incentive structure of society.

Even this year's World Bank Annual Conference on Development Economics, held last April, in Washington, D.C., had a special segment dedicated to the "new institutional economics." This portion of the conference included presentations by Professor O. Williamson on "institutions and economic organization" and by University of Chicago Professor Jon Elster on "the impact of constitutions on economic performance."

What are some characteristics of the "new institutional economics"?

First, the NIE does not aim at the construction of some global, comprehensive analytic framework. This is in accordance with Elster's assertion that "explanations in the social sciences should be organized around (partial) mechanisms rather than (general) theories." Williamson points out that, in this manner, "hypothetical ideals give way to the comparative analysis of alternative feasible forms." In Williamson's terms, instead of declaring "this is the law here," the purpose is more modestly characterized as to discern "what is going on here?"

Second, therefore, instead of proceeding from the top down, the NIE follows a "bottom-up" approach, "mainly concerned with "the microanalytic logic of economic organization." The purpose is "that the transaction be made the basic unit of analysis," which "shifts the attention away from the orthodox focus on price and output to consider the attributes of transactions." Additionally, "because institutions do not, as it were, speak for themselves, a lens is needed. That is where and why transaction cost economics comes in."

Third, by contrast to "the older institutional economics," that according to Coase only had "a stance of hostility to the standard economic theory," Williamson asserts that "the NIE bears a mainly complementary relationship to orthodoxy." Even so, "there are also real differences" between them. "The neoclassical concept of the firm-as-production function, for example, has gradually given way to or made way for the idea of the firm-as-governance structure." Other examples of differences given by Williamson are that "the study of economic organization is viewed less in technological/production cost and more in comparative contracting/transaction costs." Briefly, Coase says "what distinguishes the modern institutional economists" is that "they use standard economic theory to analyze the working of these institutions and to discover the part they play in the operation of the economy."

Fourth, Williamson describes how the NIE has developed in two complementary parts. As defined by Lance Davis and Douglass North, this two-part definition comprises:

1) "the institutional environment," understood as the set of fundamental, political, social and legal ground rules that established the basis for production, exchange and distribution. Rules governing elections, property rights, and the right of contract are examples.

2) "an institutional arrangement," understood as "an arrangement between economic units that governs the ways in which these units can cooperate and/or compete."

Finally, quoting Coase, Williamson adds the individual, as a third level. "Modern institutional economics, concludes Coase, should study man as he is, acting within the constraints imposed by real institutions."

To conclude, according to Kenneth Arrow, "the New Institutional Economics movement . . . does not consist primarily of giving answers to the traditional questions of economics -- resource allocation and the degree of utilization. Rather it consists of answering new questions, why economic institutions have emerged the way they did and not otherwise." As Coase says, "modern institutional economics is economics as it ought to be."

IV. CAPITAL FLOWS TO DEVELOPING COUNTRIES

IV.1. TRENDS
(WDW/2/94 26 January 1994)

It is a sign of the times that Michael Bruno, World Bank's Chief Economist and Vice President of Development Economics, recognized at the presentation of this year's World Debt Tables 1993-94, that it will be necessary next year to issue this publication with a new title. The subtitle of this year's two volumes, released on December 15, 1993, is external finance for developing countries. This amounts to a recognition that the issue of the indebtedness of developing countries has in great measure become, for some of these countries, a matter of access to international capital markets.

The contents of the Tables' first volume recognize this turn of events. Part I covers first, financial flows to developing countries and second, developments and trends in external debt. Part II contains a special feature dedicated to trends in foreign direct investment for developing countries and Part III presents summary statistical tables for selected regional and analytical groups comprising 148 developing countries.

Volume two contains statistical tables showing the external debt of each of the 129 countries that report public and publicly guaranteed debt under the Debtor Reporting System (DRS), maintained by the staff of the Debt and International Finance Division of the Bank's International Economics Department.

Here are some of the highlights contained in the first volume of Analysis and Summary Tables:

1) By the end of 1993, the debt of all developing countries is projected to rise to US$1,770 billion, an increase of 6.5 percent from the $1,662 it reached at the end of 1992.

2) For all the developing countries, the debt-to-exports ratio is projected to increase in 1993 to 180 percent, from 174 percent in 1992, while the debt service-to-exports ratio is expected to remain unchanged at around 19 percent.

3) Total debt stocks owed by Latin America and the Caribbean, in 1993, are expected to increase slightly, by 3.4 percent, to $512.9 billion, from $496.2. These stocks represent 40.8 percent of GNP, down from 41.7 percent in 1992, or 263.8 percent of total exports of goods and services, down from 272.2 percent in 1992. In these terms, the total debt service-to-exports ratio declined slightly from 29.8 percent in 1992 to 29.5 percent in 1993.

4) Aggregate net resource flows to all developing countries, understood as net flows on long term debt, grants excluding technical assistance, and net flows on equity investment, including foreign direct investment (FDI) and portfolio equity investment, are projected to increase by 13 percent in 1993, to $177 billion from $158 billion in 1992.

5) Aggregate net resource transfers, understood as net resource flows, less interest on debt and profits on equity investment, are projected to rise to $92 billion in 1993, from $80 billion in 1992.

6) The strongest growth in capital flows in 1993 will take place in East Asia and the Pacific, with a large proportion going to China. Also, Latin America and the Caribbean will show a sizable increase in capital flows in 1993, expected to result in positive aggregate net transfers for the third consecutive year, amounting to almost 1 percent of GNP in 1993.

However, the best news is found in what is characterized as "the remarkable turnaround in private capital flows" mostly to middle-income developing countries. These flows "have risen more than two and a half times since 1990." Also, "for the first time in a decade, the volume of private flows has been larger than the volume of official flows, and, in real terms, private flows are now about the same as they were in the early 1980s."

This "striking growth in private flows" exhibits several key characteristics:

-in flows from private sources, there is a shift from bank to non-bank sources, such as bonds, FDI and equity portfolio investment;

-FDI accounts for nearly one-third of the net flows to developing countries and it has been concentrated in services;

-also, there is a shift from predominantly sovereign mainly to private borrowers, with private-to-private flows now accounting for almost 60 percent of total flows to developing countries;

-the predominance as recipients of middle-income countries, with the notable exception of low-income China.

By contrast, there is a virtual stagnation in net resource flows to the low-income countries, that still rely heavily on official (mainly concessional) financing, which has remained stable in real terms over the past three years. Within this low-income group, there are about two dozen severely indebted countries (SILICs), mostly in Sub-Saharan Africa and including Honduras and Nicaragua, whose debt stock has tripled over the past decade. These countries have seen negative net flows from private sources, which have been offset by large official inflows, mostly on concessional terms.

In these conditions, a dichotomy has emerged among the developing countries. A small group of middle-income countries is attracting most of the rising private capital flows, while several low-income countries have not yet benefited from this recent surge in private investment.

IV.2. INFRASTRUCTURE AND DEVELOPMENT
(WDW/18/94 22 June 1994)

This is the topic of this year's World Development Report (WDR), released by the World Bank on June 19. President Lewis Preston recalled that, as with the previous two Reports dedicated to health and to the environment, "infrastructure is an area in which government policy and finance have an important role to play because of its pervasive impact on economic development and human welfare." Thus, having focused on some key global aspects of development, such as poverty and development strategies, the World Bank continues setting the development agenda by focusing on certain key sectors. Evidently, these yearly agenda-setting exercises represented by the WDR, are relevant not only because of the saliency of the topics discussed, but also and perhaps even more so due to the influence they exercise on lending activities.

The term infrastructure comprises the following three categories: public utilities, public works and other transport sectors. A diagnosis of "the performance of infrastructure" concludes that it depends not from "general conditions of economic growth and development," but from "the institutional arrangements for providing infrastructure services and the incentives governing their delivery."

An evaluation of performance, based on the "institutional environment" that prevails in the delivery of these services, leads to the three main conclusions around which the Report is organized. Poor infrastructure performance is accounted by: 1) "absence of competition"; 2) lack of "managerial and financial autonomy"; and 3) scarce participation by users. "Individually," the Report concludes, "each of these three points is important. Together, they go a long way toward explaining the disappointing performance of much infrastructure."

In these terms, the challenge is characterized as "creating the institutional and organizational conditions that oblige suppliers of infrastructure services to be more efficient and more responsive to the needs of users."

Three "converging forces" are contributing to the possibility of responding to this challenge. First, "new technology and changes in the regulatory management of markets," for instance, in telecommunications and power generation. Second, "new perceptions of the role of government," particularly, "awareness . . . that government provision has been inadequate" has led to privatization, with the "most dramatic" examples found in the Mexican telephone system and the Chilean power system. Finally, "increasing regard for environmental sustainability of development strategies and deepening concern for poverty reduction after a decade of stagnation in many regions of the world also give impetus to infrastructure reform."

The proposed reforms aim at "the wider application of commercial principles to service providers, the broader use of competition, and the increased involvement of users." These basic goals "apply whether infrastructure services are provided by the public sector, the private sector or a public private partnership." Thus, the main proposal consists of "a menu of main options for ownership and provision" comprising first, "public ownership and public operation"; second, "public ownership with private operation"; third, "private ownership and private operation"; and fourth, "community and user provision."

Any of these options requires financing for their implementation. Presently, "developing countries invest $200 billion a year in new infrastructure -- 4 percent of their national output and a fifth of their total investment." Private financing "accounts for about 7 percent of total infrastructure financing in developing countries," while "bilateral and multilateral foreign aid accounts for around another 12 percent." Even if the increased share of the domestic savings needed to finance infrastructure provision could come from private sources, "governments will continue to be a major source of funds for infrastructure, as well as a conduit for resources from the donor community."

To conclude, "reform will produce three types of gains: reduction in subsidies, technical gains to suppliers, and gains to users." From "the reduction in the fiscal burden-- costs not recovered from users," based on "a conservative estimate for three sectors (power, water and railway), the total savings are nearly $123 billion annually." This amount represents approximately "10 percent of total government revenues in developing countries, 60 percent of annual infrastructure investment, and approximately five times annual development finance for infrastructure." The "savings to service providers... are estimated at around $55 billion a year." These are "equivalent to 1 percent of all developing countries' GDP, a quarter of annual infrastructure investment, and twice annual development finance for infrastructure."

Finally, the Report mentions, in the "bibliographical note," approximately one hundred "contributors and consultation meeting attendees" from outside the Bank. However, despite the frequent reference to Latin American successful and failed examples of infrastructure services, only one government official from Mexico, one staff member of the Inter-American Development Bank, and one academic from the Universidad de Chile are listed among the very impressive group of individuals consulted.

IV.3. SUBSTANTIAL INCREASE
(WDW/29/94 12 October 1994)

The last World Economic Outlook (WEO), released by the staff of the IMF (WDW/28/94), contains a chapter dedicated to the "substantial rise" in private capital flows to several developing countries. It includes a description of present trends, explanatory factors, an analysis of policy responses and of alternative medium-term scenarios.

The "recent surge" in capital flows to developing countries is different, quantitatively and qualitatively, to the experience of the mid-1980s and that of the 1970s. Quantitatively, annual averages "mask considerable variations." For instance, "the net inflow in 1981 was just under $52 billion, in 1989 it was minus $14 billion, whereas in 1993 it exceeded $130 billion." Qualitatively, a positive trend in recent flows is a steady increase in foreign direct investment. Also, short term inflows and long-term portfolio investments in emerging stock markets have "increased sharply."

The developing countries of Asia "have been by far the main recipients of capital inflows in the form of portfolio and foreign direct investment." Some developing countries of the Western Hemisphere, such as Mexico, Argentina, and Chile, "have also benefited

considerably from foreign direct investment, which has amounted to over $12 billion annually in the recent period." Also impressive, portfolio investment flows to the developing countries of the Western Hemisphere "have averaged $25 billion a year, partially offset by an average outflow of over $7 billion a year over the period 1990-93." The exception are the African countries, because "net flows to Africa of short-term and other long-term capital . . . have been negative in recent years, primarily reflecting flows out of Nigeria and South Africa."

Both external and domestic factors explain the recent increase in capital flows to developing countries. Externally, cyclical factors have played important roles, such as "the downturn in economic activity and the decline in interest rates in the large industrial countries during recent recessions." Empirical studies have estimated that "external factors may have accounted for some 30 to 50 percent of the variation in capital flows to developing countries." In some Latin American countries, such as Bolivia, Chile, Colombia, and Peru, "external factors typically explained about 50 percent, while in Asia, particularly in China, India, Indonesia, and the Philippines, external factors typically contributed about 30 percent."

Other external factors have to do with long-term trends, such as the "globalization and international diversification of industrial country investments," reinforced by "the extent of financial deregulation in industrial and developing countries, which has resulted in greater competition in financial markets and has increased international capital mobility."

Domestic factors also played a key role, particularly in those countries of Latin America and Asia that "made substantial progress in fostering macroeconomic stability." In countries such as Argentina, Chile, Mexico, and Thailand, "significant reductions in fiscal deficits preceded the surge in capital inflows." However, other countries such as Brazil, India, and Turkey, "that have made much less progress toward fiscal sustainability . . . have also attracted relatively large inflows." Here, "large fiscal deficits have exerted upward pressure on domestic interest rates" and short-term capital inflows "have been attracted by the resulting interest rate differentials." The non-debt- creating nature of recent capital flows has generated concerns among policymakers about "the impact on domestic monetary conditions, the possibility of an intensification of inflationary pressures, and an excessive appreciation of the real exchange rate." The performance of Asia and Latin America reveals that in Asia, the ratio of private investment to GDP, which was already relatively high during the 1980s at over 30 percent, has risen by a further 2 percentage points in the recent period compared with the mid-1980s." In Latin America, "investment-to-GDP ratios have remained broadly constant, indicating that higher capital inflows have been associated with declining domestic saving and can therefore be said to have largely financed higher consumption."

Due to "the lack of flexibility of fiscal policy to deal with short-term fluctuations, much of the task of managing capital inflows has therefore fallen on monetary policy." A quick response has been "sterilized intervention to contain the monetary effect of the increase in foreign exchange reserves." However, intervention may be costly "to the extent that domestic interest rates are higher than the return on foreign reserves." For instance "in Chile and Colombia, these costs were estimated to be around 0.8 percent of GDP in 1991."

Looking ahead, "two alternative scenarios" are based on "different assumptions about capital inflows and policy reforms as well as the external environment." A scenario of "downside risks," projects that "output growth in the developing countries would be reduced by almost 3 percent by the third year of the simulations." Another scenario "assumes a continued deepening and broadening of policy reforms in the developing countries and improvements in the external environment." The results are that "growth in the developing countries would rise by about 1/2 of 1 percent a year over the next three years."

IV.4. FINANCING PRIVATE INFRASTRUCTURE
(WDW/31/94 26 October 1994)

The new trends in financing infrastructure are a consequence of the profound transformation that is taking place in infrastructure management in developing countries. By contrast with the recent past, the privatization of infrastructure has now become a dominant trend in both developed and developing countries. According to the International Finance Corporation (IFC), the private sector lender of the World Bank Group, infrastructure privatizations in the developing countries, between 1988 and 1992, amounted to $ 61.6 billion.

A recent survey carried out by the IFC found several factors behind this trend. First, there is growing dissatisfaction with the performance of publicly owned infrastructure services, such as urban power and water shortages; lengthy waiting times for telephone connections; and road congestion and deterioration. Second, this poor performance has been mainly caused by underinvestment, resulting from fiscal constraints present among governments and external suppliers of official development finance.

Third, technological breakthroughs have punctured the "natural monopoly" positions of traditional utilities and infrastructure services. This phenomenon, known as "unbundling," allows for the efficient fracturing of the production, the market or the geographic performance of a service. For instance, different companies can participate in the generation, transmission and distribution of electricity; telephone services can be split into cellular, international, long distance and local; and gas and electricity distribution can be broken down geographically by regions.

Fourth, globalization of financial markets and innovations in financial instruments have led to increases in volumes and to the diversification of instruments. For instance, bonds issued by large, publicly listed firms, purchased by long term institutional investors, such as pension funds; or revenue bonds based on cash flows and assets to repay debt and for security. Finally, a "demonstration effect" has allowed for learning from the experiences of others, particularly from the trend-setting precedents initiated in developed countries. For instance, the United States Public Utilities Regulatory Policy Act of 1978, allowed independent producers to supply power to existing utilities. The split of AT&T, in 1984, showed how "unbundling" increased competition in telecommunications and it was immediately followed in England and Japan. Among the developing countries, in Latin America, Chile and Argentina were the trend-setters.

This global privatization trend, is described in a recent IFC discussion paper (number 23), titled "Financing Private Infrastructure Projects," by Gary Bond and Laurence Carter. This paper analyzes the experience gained by the IFC in financing "economic infrastructure," including power generation, transmission and distribution; ports; telecommunications; railways; roads; water supply and distribution; waste management and disposal; mass transit; and airports.

IFC's infrastructure financing has recently "widened rapidly," almost "90% of approvals" date from 1990, "with a sharp acceleration evident" since 1992. Out of "88 infrastructure operations with a total project cost of nearly $15 billion," undertaken by the IFC from 1966 until June 1994 in 26 countries, Latin America dominates with 45, particularly Argentina (15), Chile (10), and Mexico (5). Asia follows, with India and the Philippines leading with 11 projects each. Finance for IFC approved infrastructure projects has come from different sources: 35 percent from private foreign finance accounts, including suppliers' credits; 25 percent from private domestic financiers; 20 percent of internal cash generation; 9 percent from official/public; and 11 percent contributed by the IFC.

Out of a total of 78 projects approved by IFC, between 1966 and June 1994, with a total cost of $14.6 billion, IFC contributed "$1.58 billion from its own funds, and mobilized a further $1.12 billion directly via participations and syndications."

The study draws several conclusions from IFC's "relatively recent experience": 1) "large amounts of private non/limited recourse finance can be mobilized for infrastructure projects." 2) "private financing and management of infrastructure can deliver better service performance than under public sector management." 3) "private financiers and managers can provide rapid responses and innovative solutions to infrastructure requirements." 4) "the most difficult hurdle is the initial project: once the process starts, it can quickly gather momentum." 5) "infrastructure financing, access to international capital markets and the development of domestic capital markets are occurring in parallel in several countries." 6) "accessing capital markets is crucial for infrastructure financing." 7) "private companies (and their financiers) treat environmental risks in infrastructure projects like other risks--they assess, mitigate and allocate them."

Finally, "the main conclusion is that despite the risks, private financiers are responding to emerging opportunities and are providing large amounts of at-risk capital to invest in infrastructure services in developing countries."

V. DERIVATIVES

V.1. DEFINITION
(WDW/3/94 2 February 1994)

As junk bonds became the symbol of the eighties in financial markets, there is increasing evidence that derivatives may become the symbol of the nineties.

In recent years, financial derivative markets have experienced "phenomenal growth." According to a recent study by Eli M. Remolona, published in the Winter 92-93 issue of the Federal Reserve Bank of New York's Quarterly Review, "the stock of financial derivatives outstanding worldwide . . . multiplied fivefold in five years to approach $10 trillion by the end of 1991." For instance, "in organized exchanges, open interest in financial derivatives rose an average of 36 percent a year from 1986 to reach $3.5 trillion at the end of 1991." This spectacular expansion was "surpassed by the growth of financial derivatives in over the counter (OTC) markets . . . an estimated 40 percent a year during the period to soar above $6 trillion by the end of 1991."

What are derivatives? A study released by a study group of the Washington-based, prestigious Group of Thirty (G-30) defines a derivatives transaction as "a contract whose value depends on (or 'derives' from) the value of an underlying asset, reference rate or index." Remolona explains that these instruments "derive their prices from the performance of underlying cash markets, specifically money and bond markets, the foreign exchange market, and stock markets." For the G-30 study group, "while the concept underpinning derivatives is simple, it is also flexible and powerful: a party exposed to an unwanted risk can pass that risk to another party and assume a different risk, or pay cash, in return."

Also, according to the G-30, "every derivative transaction can be built up from two simple and fundamental types of building blocks: forwards and options." Thus, the main types of derivatives contracts can be classified under two headings: forward-based and option-based.

These transactions can take place in organized exchanges, such as the Chicago Board of Trade (CBOT), or the London International Financial Futures and Options Exchange (LIFFE). According to Remolona, the main feature of the transactions that take place in organized exchanges is "the interposition of a clearinghouse as a counterparty to reduce the credit risk in each transaction." Remolona also points out that "the primary economic function of exchange-traded derivatives appears to be the provision of liquidity in excess of the liquidity in the cash markets."

Additionally, these transactions can take place in over the counter (OTC) markets, "without the interposition of a clearinghouse." By contrast to those that take place in organized exchanges, concludes Remolona, "OTC derivatives are designed primarily to reconfigure market risk rather than to provide liquidity."

The main contracts that have experienced the most spectacular expansion in recent years are those based on interest rates, as well as those based on the global foreign exchange market and on the major stock markets, known as equity index contracts.

Who are the end-users of derivatives? Several main users were identified by a Survey of Industry Practice, carried out for the G-30 study group and conducted among a representative group of 80 dealers and 72 end-users. Among these, corporations, governments, institutional investors and financial institutions use derivatives to lower funding costs through arbitrage, to diversify funding sources through funding operations in multiple countries at lowest cost, and to hedge the cost of issuing fixed-rate and floating-rate debt.

Since 1985, Remolona found that, outside the United States, "at least eighteen new derivative exchanges have been organized around the world, including already established stock exchanges that only recently began trading derivatives."

Among the recently created, one of the most active is the Marche a Terme International de France (MATIF), established in 1986; the Tokyo International Financial Futures Exchange (TIFFE) created in 1989; the Deutsche Terminborse (1990) and the Swiss Options and Financial Futures Exchange (SOFFEX) (1986). In the same years, the only derivatives exchange established in Latin America was the Bolsa de Mercadorias & Futuros (BM&F) of Brazil, established in 1986.

The main factors, identified by Remolona, to explain the growth and geographical diffusion of financial derivatives are: "First, sustained shifts and temporary surges in market volatility . . . Second, the emergence of important cash markets for government bonds . . . Third, interest rate risks faced by financial institutions and nonfinancial corporations . . . Finally, the global diversification of institutional equity portfolios."

According to the G-30 study, "the development of derivatives has occurred in response to a search for higher yields and lower funding costs and a demand for tools to manage risk. The broad demand for derivatives arises from the diverse and changing financial needs of a wide array of users, some hedging current or future risks, some taking market risk positions, and some exploiting inefficiencies between markets."

V.2. PROLIFERATION
(WDW/4/94 9 February 1994)

The "phenomenal growth" experienced by financial derivative markets, in the last five years (WDW/3/94), poses challenges particularly to central banks. According to Alan Greenspan, Chairman of the U. S. Federal Reserve System, in remarks made to the London's Bankers Club on 1 February 1994, "derivative instruments . . . have generated an elaborate web of financial interrelationships that recognize no national borders. These instruments heighten the interdependencies of markets and market participants. Disturbances in one country or sector are rapidly transmitted throughout the world

economy. They pose challenges to central banks now clearly recognized responsibility for the stability of the world's interdependent financial system."

In other words, while the growth in derivatives has generated important benefits, it is also generating new risks that sometimes are not yet adequately understood.

Eli M. Remolona, in the Winter 92-93 issue of the Federal Reserve Bank of New York's Quarterly Review, has described the three different types of contracts that are most widely used in financial derivative transactions.

First, "growth in derivatives has been dominated by contracts based on interest rates," such as contracts on short-term interest rates that "have as their underlying cash markets the various money markets around the globe." Also, there are contracts on long-term interest rates that have as underlying markets "the world's major bond markets, most notably the U.S. Treasury bond market."

Another major contributor to the growth in derivatives after interest rate contracts, "in a comparatively small way," are currency contracts. "The underlying cash market for these contracts is the global foreign exchange market." Just to have an idea of the magnitude of this market, according to Chairman Greenspan, "a 1992 survey conducted by the major central banks found that normal turnover in foreign exchange markets alone approximated $1 trillion a day." Additionally, it has been estimated that only less than 5 percent of these transactions are related to trade or tourism.

Finally, the smallest part of the derivatives market is represented by equity index contracts. However, Remolona observes that "their recent growth has been so explosive that they promise to become a major part of the market in the near future." The underlying markets for equity index contracts are "the major stock markets around the world, most notably the New York, Tokyo and Frankfurt stock markets."

Remolona also found that there is a "life cycle composed of different stages," that characterizes the acceptance and spread of these new financial products. Based on the trading experience of U.S. Treasury bond futures, "the world's most actively traded contract," the cycle exhibits an "S shaped pattern," that "begins slowly, then surges as the contract becomes popular, and finally slows down as the contract matures and saturates the market."

There are several factors influencing this cycle. On the supply side, Remolona finds "advances in communication and information-processing technologies and the development of option pricing and simulation models." However, "the derivatives' spread was rooted in specific demand forces that largely determined the direction and speed that the spread took."

These "powerful forces of demand played a decisive role in shaping the spread of derivatives in recent years." Remolona identifies four broad developments that have contributed recently to the demand for financial innovations. First, "the volatility created by shifts in policy regimes," such as the system of floating exchange rates that started in 1973 and brought volatility to the foreign exchange market." Also, the U.S. Federal Reserve shift in October 1979 to targeting monetary aggregates, rather than interest rates, "lifted interest rate volatility to unprecedented levels."

Second, the increased demand for liquidity in new government bond markets, according to Remolona, explains "the strong growth of exchange-traded futures on long-term interest rates." This has been the case particularly in the French and German government bond markets.

Third, "demands by both financial and nonfinancial firms for new ways of dealing with interest rate movements help explain the huge expansion in interest rate swaps." For instance, these swaps consist of the "exchange of two notes paying two different types of interest streams--most commonly a floating-rate note and a fixed-rate note--without an exchange of principal amounts." The purpose of such swaps is "to allow a transfer of interest rate risk that entailed no credit risks associated with the principal."

Finally, the global diversification of equity portfolios "contributed to the growth of OTC (over-the-counter) equity index option market." The purpose of diversification is to "reduce risk without sacrificing return" and it was fueled by the issuance of equity linked Eurobonds by Japanese corporations. The "demand for these options surged when volatility began to beset the Tokyo stock market in 1990." Based on the experience gained with the Japanese contracts, investors have turned toward "other major stock markets, notably the New York and Frankfurt markets.

V.3. REGULATION
(WDW/5/94 16 February 1994)

As pointed by the Chairman of the U.S. Federal Reserve Board, Alan Greenspan, the proliferation of financial derivatives "poses challenges" to the central banks' role of "ensuring the stability and integrity of national financial systems and, to the extent possible, the international financial system." (WDW/4/94).

This concern is not based solely on the increase in risks. Because, as Chairman Greenspan recalled, "the taking of risks is an integral part of banking and our market economies." At stake is that "problems that arise are contained and do not evolve into systemic crises."

These "systemic risks" were the central focus of a presentation made, on September 27, 1993, by the President of the Federal Reserve Bank of New York, William J. McDonough, to the Group of Thirty (G-30) commenting on the Group's recent report on Derivatives Practices and Principles (WDW/3/94).

According to President McDonough, the "first line of defense against disruptions to the derivatives markets is the risk management capabilities of all firms active in these markets." For this reason, he welcomes the twenty detailed recommendations for the management of derivatives, spelled out in the G-30 study, such as the active involvement in risk management by top managers; "a comprehensive approach to risk management and control;" valuation procedures that avoid "underpricing of sizable risks;" management information systems that "measure and monitor risks in the real time frame of the trading desks;" national steering committees and international mechanisms to promote harmonized accounting practices and standards to enhance firms and system exposures.

However, a divergence exists between operators and regulators in the perception of the systemic risks generated by the proliferation of derivatives.. According to Paul Volcker, who signs the foreword of the G-30 study now as Chairman of the Group, "derivatives by their nature do not introduce risks of a fundamentally different kind or of a greater scale than those already present in the financial markets. Hence, systemic risks are not appreciably aggravated, and supervisory concerns can be addressed within present regulatory structures and approaches."

By contrast, President McDonough declares that "the section of the G-30 report about which I have the most significant reservations is that on systemic risks. While the report identifies many of the potential sources of systemic problems, the discussion, perhaps inadvertently, appears to understate these concerns." In fact, Michelle Celarier reported in Global Finance (October 1993) that "many observers view the industry-written Group of 30 report on derivatives. . .as an attempt to slow down the regulatory process."

For President McDonough there are two broad categories of systemic risks associated with derivatives. First, "disruptions which have their origin in derivatives activities at the individual firm level." Some of these risks are covered by the G-30 report, such as "underpricing of credit, market liquidity," and the difficulties of "senior management in detecting fraud in the internal reporting of complex derivatives positions."

The second category of risks "is less well understood" and it has to do with "the ways in which the spread of derivative instruments, coupled with advances in technology and telecommunications, have altered the susceptibility of the financial system to shocks." For President McDonough, "the decreased transparency of firms' exposures can contribute to the development of a financial crisis." For instance, "if a major market maker in derivatives instruments were to fail, it could prove difficult to find other firms willing to take over or unwind a complex derivatives book whose risks are difficult to assess quickly." Chairman Greenspan admits that the "potential for systemic risk arises from the nature of internationally active banks." As reported by Celarier, the complication is that "global derivatives business is a highly concentrated one, with a mere 50 banks reporting any activity at all."

Another example is known as "positive feedback," understood as "mechanisms that have the potential to exacerbate an already sharp price move." Therefore, "written options, as a matter of course, tend to be dynamically hedged and hence require selling into a falling market." Again, President McDonough notes that the G-30 study holds that "academic research has shown that derivatives trading does not increase volatility in underlying markets." The problem is that "econometric studies do not shed much light on the experience with volatility in times of stress, because these episodes occur infrequently and tend to differ greatly in character, making them difficult to summarize empirically."

Finally, beyond these risks, President McDonough mentions two questions raised by the way the "expanded use of derivatives" is affecting the "channels of influence of monetary policy." First, have derivatives altered bank's liquidity and interest rate management practices, and might these alterations affect the channels of transmission of monetary policy? Second, has the improved ability of corporations to hedge interest rate and exchange rate risks altered the sensitivity of their investment decisions to interest rate and exchange rate movements?

V.4. TURBULENCE
(WDW/11/94 30 March 1994)

Recent events at both the policy and the micro levels have confirmed some concerns that regulators have been voicing about the volatility and risks inherent in derivatives markets.

At the policy level, the decision by the Federal Reserve (FED), of Friday, February 4, to increase interest rates by a fraction and the consequent sales in stock markets, had immediate repercussions. As described in The Wall Street Journal, the FED tightening led to "an electrifying day for U.S. derivatives markets."

On that day, prices for derivatives transacted in organized exchanges "gyrated wildly in contracts based on stocks, interest rates, foreign currencies and precious metals." The leader was the Chicago Mercantile Exchange (CME), "trading more than 2.3 million futures and options contracts -- about a million more contracts than any derivatives exchange has ever traded in a single day." In the terms of a stunned trader, "I just know that this market goes down a heck of a lot faster than it goes up."

At the micro level, in January, MG the U.S. subsidiary of a German giant corporation, experienced losses amounting to $1.96 billion, trading in oil futures at the New York Mercantile Exchange. An emergency package amounting to $2 billion, to rescue the conglomerate Metallgesellschaft AG, which employs 58,000 persons, was put together by its major shareholders, led by the Deutsche Bank and the Dresdner Bank.

The operation started last spring with MG's offer of fixed price contracts of up to 10 years of refined oil products. These long-term commitments were hedged against a rise in oil prices by means of short term energy futures and over the counter derivatives. The hope was that if the prices of oil rose above those committed in the long-term contracts, the losses would be offset by the price increases in the prices of the short-term futures. However, instead of rising, in the short-term, oil prices dived to a five-year low.

By contrast, profits can also be as impressive. Merrill Lynch, the U.S. biggest brokerage firm, recently disclosed that its 1993 revenue from trading swaps and derivatives amounted to $761 million in 1993, a 57 per cent increase from 1992. This is the first time that the revenue from derivatives exceeds revenues from stocks and also the first time that the company has disclosed such information to its shareholders.

These disclosures are in part a response to the increasing concerns voiced by some regulators (WDW/5/94) about the risks generated by the "phenomenal growth" (WDW/3/94) that is taking place in derivatives markets.

An intense debate is taking place among regulators about the degree and kind of supervision that should be exercised over these activities. Some lines of this debate were openly discussed at a conference on financial markets, sponsored by the Federal Reserve Bank of Atlanta, in Coconut Grove, Florida, last February 24-26.

Susan M. Phillips, member of the Board of Governors of the FED, made a keynote presentation on Derivatives and Risk Management: Challenges and Opportunities. One of the most quoted paragraphs presented by Ms. Phillips referred to "the concerns that have been expressed about derivatives by legislators, regulators, and even senior executives of financial institutions."

Ms. Phillips thinks these concerns "can best be understood as symptoms of broader anxieties about changes in financial markets and, in particular, the roles that banks are playing in those markets." She also supported the proposal to allow banks "to use their own internal models to determine capital requirements for interest rate risk." However, she recognized that "regulators will be reluctant to implement such an approach unless reliable methods can be developed for examiners to validate banks' internal models." Ms. Phillips closed her presentation admitting that while more work still had to be done, "the persistence of what appear to be exaggerated fears of the risks of derivatives activities makes it essential that this work be completed expeditiously."

Also invited to make a presentation was William McDonough, head of the influential Federal Reserve Bank of New York, who has been voicing some of these concerns about the "systemic risks" generated by the proliferation of derivatives. President McDonough presented the more cautious position and warned that banks would have to face more intense scrutiny "if they don't take seriously the systemic risks that come with the fast-growing derivatives market." However, Mr. McDonough admitted that some of these warnings "have a nagging quality because we have not specified a concrete approach to controlling and managing the risk."

Even so, President McDonough reacted angrily when University of Rochester Professor Clifford W. Smith said "it's hard to get people to get precise about what they mean by systemic risk." The response by Mr. McDonough was that "it is the role of the central bank to worry about a possible catastrophe."

As described in the Wall Street Journal, an intense debate is taking place within the FED. Some Board members have a more supportive attitude toward derivatives, while the New York FED appears more concerned with the risks.

VI. TRADE

VI.1. U.S. TRADE POLICY REVIEWED
(WDW/7/94 2 March 1994)

Within the framework of its Trade Policy Review Mechanism (TPRM), the Secretariat of the General Agreement on Tariffs and Trade (GATT) released, on 19 January 1994, the biannual review of the trade policy of the United States. The review consists first, of the report submitted by the U.S. government and second, the report by the GATT Secretariat. Together, these two reports constitute the most thorough review of the trade policies applied by what still is, according to the GATT Secretariat, "the world's largest trading nation, with imports and exports at 14 and 12 percent of world trade."

The government report contains the following chapters: 1) objectives of U.S. trade policy; 2) overview of the import and export system; 3) trade policy framework; 4) implementation of trade and investment policies; 5) sectoral aspects of trade policy and 6) the external environment. The GATT Secretariat report describes the following topics: 1) summary observations; 2) the economic environment; 3) trade policy regime: objectives and framework; 4) trade related aspects of the foreign exchange and investment regimes; 5) trade policies and practices by measure; 6) trade policies by sector; 7) trade disputes and consultations.

According to the GATT Secretariat, "U.S. trade laws remained largely unchanged during the two years to October 1993." Also, "since the last review of its trade policies in the GATT Council, the United States has continued to affirm its adherence to the principle of free trade." Evidence of this is found in the "major role" played by the United States in "bringing the Uruguay Round to a successful conclusion," as well as in its "regional trading interests notably through the completion of negotiations on, and subsequent ratification of, the North American Free Trade Agreement."

These were among "the highest priorities" of what the U.S. government characterizes as "a multi-track strategy of multilateral, regional and bilateral negotiations, and the effective enforcement of multilateral, regional and bilateral trade agreements." The other priorities of this strategy, besides the completion of the Uruguay Round and the approval of the North American Free Trade Agreement (NAFTA), are "the strengthening of the Asia Pacific Economic Cooperation organization (APEC); and the bilateral negotiation of improved access to the Japanese market under the so-called U.S.-Japan Framework Agreement."

However, certain exceptions remain to this "adherence to liberal trading principles, with high tariffs and other measures in place" in agriculture and textiles. Also, the United States "maintained bilateral pressures for the opening of external markets."

The GATT Secretariat hopes that the "implementation of the Uruguay Round will begin to redress this situation," because "given the size of the U. S. economy, and its importance in world trade, any distortions stemming from trade intervention have significant adverse effects on world trade and the international economy."

The description of policies and practices by measure concludes that "the United States has not significantly modified the level and structure of its tariffs since the last review." Furthermore, "the average tariff rate remains low, at 6.7 percent," but "dispersion persists across the range." For instance, the "highest protection through tariffs is found in sugar, preserved tuna, beverages and tobacco, textiles and structural mineral products such as glass and ceramics."

However, "in 1992, just over 60 per cent of U.S. imports came from purely m.f.n. sources, i.e. from trading partners not eligible for any form of preferential treatment. Some 19 per cent of imports into the United States in 1992 derived from partners with whom the United States has free trade agreements and almost 20.5 percent of imports was from other sources eligible for preferential treatment."

Additionally, "import quotas, licenses or voluntary export restraints restrict U.S. imports of dairy products, cotton, peanuts, sugar and sugar-containing products, and beef and veal," as well as textiles, machine tools and passenger cars.

The GATT Secretariat finds that despite "its efforts to open public procurement markets abroad," the United States still has "a number of trade restrictive measures at home." In 1991, U.S. public purchasing "amounted to over US$1,100 billion, or 19 percent of GDP, of which federal procurement was in the order of US$450 billion."

The GATT Secretariat registers that "the number of anti-dumping and countervailing duty orders in force rose from 204 and 70 respectively in June 1991 to 268 and 86 in 1993." Also, there still is "no sunset provision in U.S. anti-dumping legislation." The secretariat's report points out that "many contracting parties have expressed concern about unilateralism in U.S. trade policy." To this, "the U.S. authorities stress that the operation of these laws is subject to multilateral dispute settlement procedures."

All in all, the GATT Secretariat concludes that the United States is in a "favorable position to face the competition that will result from the Uruguay Round and the NAFTA, but will remain vulnerable to domestic protectionist pressures."

VI.2. SUPER 301 REACTIVATED
(WDW/8/94 9 March 1994)

Like two sumo wrestlers positioning themselves for the first clinch, last week, the United States adopted several measures to signal its displeasure with the pace and results of the ongoing negotiations with Japan. The reactivation of the much dreaded Super 301 was the last step in a succession of events that went from the suspension of negotiations on the eve of the Japanese Prime Minister's visit to Washington, on February 11, to the unprecedented admission by Prime Minister Hosokawa and President Clinton, at the conclusion of their talks, that they were unable to agree.

Thus came to a non conclusion the last attempt by the United States to find a negotiated solution to its persistent trade deficit with Japan, which has complicated the relations between the two most powerful players of the international economy. As

described by the United States Trade Representative Michael Kantor, "we have had an annual minuet with the Japanese for the last twenty years: we would reach agreement after agreement that sounded good, but little changed and Japan's trade surpluses kept growing." In confirmation, Japan's surplus rose 17 percent in January, to $6.11 billion from $5.22 billion a year earlier. With the United States, Japan's surplus grew 7 percent from a year earlier, to $3.13 billion, less than the 17 percent it grew in December.

Last summer, the Clinton Administration hailed, as reflecting a new approach, the last minute agreement arrived at the Tokyo Summit creating a framework for negotiations, containing "objective criteria" that would result in "tangible progress." The most recent failure of the conversations was due to the Japanese refusal to accept such "objective criteria," to measure market openness in autos and auto parts, insurance, and government procurement of medical and telecommunications equipment.

Japanese negotiators consider these benchmarks are a violation of free market principles and an attempt at managed trade. For Ambassador Kantor, "this dispute can be seen as a significant maturing of our relationship. For the first time, both sides are openly and honestly admitting the differences between us." We are no longer willing to look the other way when key American interests are at stake. We will no longer tolerate Japanese barriers to U.S. exports."

Several factors are mentioned to explain that this time the U.S. posture is different. First, the author of the "results oriented" trade policy is former Berkeley Professor of economics Laura D'Andrea Tyson, now head of President Clinton's Council of Economic Advisers (CEA). Professor Tyson wrote the textbook on Japanese trade barriers on imports of cellular phones, titled Who's Bashing Whom?

Second, this time the U.S. negotiating team is made up of business persons, who have learned to deal with Japan in the trenches. For instance, Deputy Secretary of the Treasury Roger Altman advised the Duracell Holdings Corporation on how to fight for shelf space in Tokyo against Matsushita and Hitachi. Undersecretary of State for Economic Affairs Joan Spero was in charge of securing for American Express the right to issue credit cards in Japan. Commerce Undersecretary Jeffrey Garten fought a long battle to gain a seat on the Tokyo Stock Exchange for Shearson Lehman Brothers. The chairperson of the National Economic Council (NEC) Robert E. Rubin was co-chairperson of Goldman Sachs, an investment bank partly owned by Sumitomo Bank. Moreover, Mr. Rubin's deputy, W. Bowman Cuttler, as a consultant for Coopers and Lybrand, advised U.S. companies on how to penetrate Japan's telecommunications market. Also, Deputy USTR Charlene Barshefsky, who leads the U.S. negotiating team, has represented several U.S. companies in litigation against Japanese competitors. Finally, Ambassador Kantor is displaying a "tough cop" negotiating style, described as "we are going to have a results-oriented agreement or no agreement."

Other pressures are also present because the yen is approaching the 100 to a dollar mark, despite the statement by the U.S. Treasury that "we do not believe in artificially manipulating exchange rates." Nonetheless, as described by the influential C. Fred Bergsten, from the Washington-based Institute for International Economics, the U.S. Treasury "will just sit back and let the markets push the yen up." In the terms of Robert Hormats, of Goldman Sachs International, "Washington can afford to wait, and let the yen do their talking."

However, the reactivation of Super 301 does not immediately lead to the adoption of sanctions. The first step is to identify those countries that impose barriers on U.S. exports, to be done on March 31, when the USTR releases the inventory of trade barriers confronted by U.S. exports throughout the world.

The Super 301 target list will be announced until September 30, and such identification unleashes a review period of eighteen months. As Thomas Friedman described it in The New York Times, Super 301 is like "locking and loading a rifle, but without pulling the trigger," which may partially explain the restrained initial reaction from Japan.

Be it as it may, in Ambassador Kantor's terms, the bottom line is that recent events constitute "a transition into a new way of doing business with Japan. There is no more status quo."

VI.3. THE U.S. TRADE POLICY AGENDA FOR 1994
(WDW/12/94 6 April 1994)

To judge by the Clinton Administration's outstanding achievements in international trade during 1993, what should come now is a time for consolidation. As described by U. S. Trade Representative (USTR) Michael Kantor, in the introduction of this year's Agenda, "last year, the United States enjoyed the most successful--and important--year in trade in our history."

Be it as it may, Section 1641 of the Omnibus Trade and Competitiveness Act of 1988, mandates "the President shall submit to the Congress during each year (but not later than March 1) a report on A) the operation of the trade agreements program ... and B) the national trade policy agenda for the year in which the report is submitted." Both requirements are contained in a single volume, issued by the USTR, titled 1994 Trade Policy Agenda and 1993 Annual Report of the President of the United States on the Trade Agreements Program.

Ambassador Kantor in the introduction to the volume mentions briefly the following accomplishments: 1) the conclusion of the Uruguay Round, "the most far-reaching, most comprehensive trade agreement in history"; 2) the negotiation of supplemental agreements to the North American Free Trade Agreement (NAFTA) and its approval by Congress; 3) at the Tokyo Summit, a market access agreement "which provided a jump-start for the Uruguay Round" and a Framework for a New Economic Partnership with Japan; 4) a summit in Seattle of Asia-Pacific Economic Leaders; 5) key bilateral agreements to open "previously closed markets," such as electrical equipment with Europe, construction with Japan, and telecommunications with Korea; finally, 5) dozens of bilateral agreements were negotiated "that help ensure that U.S. workers and companies can compete fairly in the global economy."

One of the main features of the strategy proposed, to consolidate and build upon these achievements, is an emphasis on reciprocity. In Ambassador Kantor's terms, "the United States is still the most open major trading nation in the world, but trade must be a

two-way street... Now other nations must accept responsibility and open their markets. There can be no something for nothing."

The "major priorities" of the 1994 agenda are:

1) The implementation of the Uruguay Round, including "wrapping up the final details of the Round and securing Congressional approval, establishing the new World Trade Organization (WTO), and implementing a system to ensure that agreements will be fully enforced."

2) Under the "expansion of regional trade," first comes the "implementation and monitoring of the various provisions" of the NAFTA; second, "deepening trade and investment ties" through the Asia Pacific Economic Cooperation forum; and third, toward Latin America, the Administration's approach is under review "to determine with which countries the United States should seek to negotiate free trade agreements."

3) Bilateral initiatives include first, Japan under the Framework for a New Economic Partnership; second, China will be asked to "adhere fully to its trade agreements," including those on shipments of textiles and apparel, intellectual property and to expand market access; third, with the European Union (EU), to "implement the results of the Uruguay Round and to address those problems not resolved by the Round," such as the Broadcast Directive, imposing quotas in the audiovisual sector, the Utilities Directive, covering telecommunications, water energy, and transport, and copyright legislation. Also, EU enlargement will be monitored to make sure it "does not result in the impairment of U.S. trade rights." Finally, in Russia, Eastern Europe and the Newly Independent States, "U.S. trade policy supports political and economic reforms."

4) Three specific areas are singled out as part of the agenda. On investment, a multilateral agreement on high level standards, and also bilateral and regional negotiations, will be pursued. On services, three multilateral negotiations will be initiated by mid-May on maritime, basic telecommunications, and movement of persons, with continuation of the ongoing negotiations on financial services. Finally, in intellectual property, "the major unresolved issue" in the Uruguay Round is characterized as "the application of the national treatment standard."

5) Under the enforcement of existing trade agreements and standards, Japan and China are the only countries singled out. Also, trading partners that discriminate in telecommunications and government procurement, will be announced on April 30, as will be those that will be submitted to "Super 301" investigations on intellectual property protection. The USTR anticipates "a similarly active Special 301 season this year." Also, Section 301 will be used "to identify cases which should be taken to the WTO and on a bilateral basis, in cases "for which there is no recourse under the Round agreement."

6) Finally, a "post-Uruguay Round agenda" includes several so-called "new issues." To deal with them, the creation of two committees within the WTO has been proposed: a permanent committee on trade and the environment, and second, an "interim committee" to deal with antitrust and competition policies, labor standards, illicit payments harmful to U.S. exporters and due process in GATT/WTO proceedings.

VI.4. BARRIERS TO U.S. EXPORTS
(WDW/13/94 13 April 1994)

The release by the United States Trade Representative (USTR) of this year's National Trade Estimate Report on Foreign Trade Barriers to U.S. Exports, as mandated by law, took place on March 31. Section 1304 of the Omnibus Trade and Competitiveness Act of 1988 requires "to submit to the President, the Senate Finance Committee, and appropriate committees in the House of Representatives, an annual report on significant foreign trade barriers." The issuance of this kind of Report has set a precedent, because other trading partners of the United States, such as Canada, the European Union, Japan and most recently Latin America and the Caribbean, now issue their own reports on U.S. barriers.

The Report contains "an inventory of the most important foreign barriers affecting U.S. exports of goods and services, foreign direct investment by U.S. persons, and protection of intellectual property rights." This year's objective of such an inventory is two folded. First, it "may facilitate negotiations aimed at reducing or eliminate these barriers." Second, it is "a valuable tool in enforcing U.S. trade laws, with the goal of expanding global trade, which benefits all nations."

However, this last objective is what makes this year's Report different from the mostly descriptive aim attribute to previous Reports. For instance, in 1992 the Report was aimed at "tracking barriers to U.S. exports and for reporting progress in eliminating them."

This year's Report is different because of President Clinton's reinstatement of the much dreaded 301 and "super 301" investigations (WDW/8/94). It is among those cited in the Report that will be selected, on September 30, the "priority foreign country practices" that will be submitted to investigation, to decide if they discriminate against U.S. exports.

The definition of trade barriers remains unchanged, it includes "government laws, regulations, policies, or practices that either protect domestic products from foreign competition or artificially stimulate exports of particular domestic products."

The barriers are also classified this year in the following eight categories: 1) import policies; 2) standards, testing, labeling, and certification; 3) government procurement; 4) export subsidies; 5) lack of intellectual property protection; 6) services barriers; 7) investment barriers; 8) barriers that encompass more than one category or that affect a single sector.

Included in the Report are "the largest export markets for the United States," including 36 nations, with the Newly Independent States of the former Soviet Union as one unit, Taiwan, and three regional bodies -- the Arab League, the European Union and the Gulf Cooperation Council.

By contrast with last year's Report, the number of Latin American countries cited this year has increased from ten to eleven, due to the addition of three newcomers -- Dominican Republic, Honduras and Peru -- and the elimination of two -- Ecuador and Paraguay. Therefore, cited again this year are Argentina, Brazil, Chile, Colombia, El Salvador, Guatemala, Mexico and Venezuela.

The exclusion of some countries is "due to the relatively small size of their markets or the absence of major U.S. industry and agriculture trade complaints." However, absentees are cautioned that this "does not imply that they are no longer of concern for the United States."

Measured by the length of their citations, Japan appears in the first place with 44 pages, followed by the European Union with 26; China is third with 15 pages, while Canada and Korea appear with 12 pages each.

The countries are listed alphabetically and the enumeration of the barriers is preceded by ranking each country according to its relative importance as an export market for the United States. Also mentioned is the amount of the U.S. trade deficit or surplus with each trading partner, the amount of U.S. imports, exports and investment, and estimates of the impact on U.S. exports of specific foreign trade barriers.

Not all the citations are negative. For instance, almost all the Latin American countries are commended for the unilateral reduction of tariff barriers. However, all of them are criticized for lack of adequate intellectual property protection, with Brazil, Argentina, Colombia, Peru and Venezuela also cited for government procurement and services barriers.

By contrast, Mexico's citation is briefer than last year's, because it includes mainly a description of how some existing barriers and obstacles will be removed with the implementation of the North American Free Trade Agreement (NAFTA).

Chile preserves its relatively clean record, except a new citation for using "animal health and phitosanitary requirements in a non-transparent manner that has the effect of impeding imports."

Finally, El Salvador and Guatemala are again cited for import restrictions on poultry and a price band mechanism for basic grains, while Guatemala is also cited for allowing wheat imports by permit only.

VI.5. PRESIDENT CLINTON REQUESTS FAST TRACK AUTHORIZATION
(WDW/19/94 29 June 1994)

In a bold move, last week, President Clinton sent to the U.S. Congress a request for fast track authority, to negotiate free trade agreements for seven years, until December 2001.

The request has several components. First, it covers any kind of trade agreement, be it bilateral, regional or multilateral. Second, it covers both overall and principal negotiating objectives. Finally, the trade agreements can include barriers and non-tariff barriers.

One key point of the proposed legislation deals with the negotiating objectives. The overall negotiating objectives are the same as those included in previous legislation. Three

of them come from the Omnibus Trade and Competitiveness Act of 1988, to obtain more open, equitable, and reciprocal market access; the reduction or elimination of barriers and other trade distorting policies and practices; and to strengthen the system of international trading disciplines and procedures. The last of these objectives, to foster economic growth and full employment in the United States and the global economy, comes from both the Trade Acts of 1988 and 1974.

Principal negotiating objectives include the elimination and reduction of barriers to trade in services, in financial services, and to foreign direct investment. Also, included is the effective protection of intellectual property and market access for those protected.

However, the most controversial of these principal objectives refer first, to "the promotion of internationally recognized labor standards and ensuring that their denial is not used to gain competitive advantage in trade"; and second, "the compatibility of international trade rules with environmental protection."

The last objective is a broader application of the "principle of transparency," covering public access to information regarding trade issues; clarity in the costs and benefits of trade policy actions; and the observance of open and equitable procedures in trade policy matters.

It is revealing that the battle lines regarding the proposed legislation are drawn along the inclusion of environmental and labor standards. The President's proposal draws a fine line between the proposals from his own Party and the Republican opposition.

From within the ranks of the President's own party, the House Majority Leader Richard Gephardt and other influential Democrats proposed, on May 9, the "Chile Free Trade Agreement Act of 1994." This bill grants fast track authority to the President, if "acceptable" labor and environmental conditions "are included in the basic text of the FTA that the President presents to Congress." Therefore, the decision to approve the negotiated agreement in fast track would only be made if it is judged that the proposed legislation contains these "acceptable provisions." Otherwise, "the legislation would be considered under the regular order in the House and the Senate." This amounts to conditioning the President's authority until the result is judged satisfactory, instead of the initial delegation of negotiating power that traditionally entails the fast track authorization.

To add weight, the announcement includes two letters of support from the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) and the Sierra Club. The letter from AFL-CIO's President Lane Kirkland reveals that "in March of this year, the AFL-CIO reached an agreement with its counterpart organization in Chile, the Central Unitaria de Trabajadores (CUT), which called for bilateral negotiations between the two countries that would result in, among other things, enforceable provisions on labor rights and standards."

The response from the opposition came in a letter from all 44 Republican senators to President Clinton, stating that they "cannot support inclusion of a broad extension of fast-track negotiating authority," because "the broad negotiating objectives. . .link trade to labor and environmental issues." The Republican senators also express that raising these issues "will further jeopardize consideration of the Uruguay Round implementing legislation this year."

Initially pessimistic assessments of this confrontation perceive the Administration "trapped between Republicans and Democrats." In the terms of an unidentified congressional aide, "it is very difficult to convince Republicans to go along with anything on labor and the environment, and Democrats say they have to have something on labor and the environment.

However, the Administration's position, between the pressure from its own party and the Republican opposition, leaves it solidly placed in the middle. By occupying the middle ground, the Administration has flexibility to recruit the moderates from both sides. Additionally, since the request for fast track is part of the legislation to approve the Uruguay Round, a broad centrist coalition can be built around its approval. Therefore, the President can probably repeat the adept move that led to the approval of the North American Free Trade Agreement (NAFTA).

VI.6. WHY "FAST TRACK" WAS DROPPED
(WDW/26/94 21 September 1994)

Last week, the Clinton Administration dropped the request, presented to the Congress by mid June, to negotiate trade agreements under "fast track" authorization (WDW/19/94).

Under this authorization, the President negotiates trade agreements that the Congress can only approve or reject, but not modify. Without this authorization, trade agreements negotiated by the executive branch may be subject to additions and substractions when they are presented to Congress for approval. The "fast track" authority enhances the credibility of U.S. trade negotiators, because negotiating partners can be reassured that trade agreements will be approved or rejected as negotiated, without amendments.

The request for "fast track" authority was presented by the Administration as part of the implementing legislation required to approve the results of the Uruguay Round. The authorization was deemed necessary in view of the forthcoming summit meetings of the Asia Pacific Economic Cooperation (APEC) forum and the Summit of the Americas, to be held by the end of this year in Jakarta and Miami, respectively. The authorization was expected to strengthen President Clinton's hand in the discussions on trade relations that figure prominently in the agendas of both summits.

However, these justifications did not prove sufficient to bridge the distance that exists between the Democrats and the Republicans on the issue of including labor and environmental standards in free trade agreements (FTAs).

The Administration's original request, presented on June 15, contained among other "principal negotiating objectives," first, "the promotion of internationally recognized labor standards and ensuring that their denial is not used to gain competitive advantage in trade," and second, "the compatibility of international trade rules with environmental protection."

Searching for a middle course, the Administration's proposal spelled out both of these objectives in less strong terms than those that appeared in a bill presented on May 9 by the House Majority Leader Richard Gephardt (D-MO).

According to Congressman Gephardt's proposal the decision to approve a negotiated agreement in "fast track" would only be made if "acceptable" labor and environmental provisions "are included in the basic text of the FTA that the President presents to Congress."

However, even the more moderate terms presented by the Administration were too strong for business groups and Republican legislators, particularly in the Senate. Their position was that any linkage between labor and environment with trade negotiations should be scrapped, otherwise they threatened to delay the approval of the whole package of Uruguay Round implementing legislation.

Given this strong opposition, the Administration tried to find a solution and went as far as to modify the reference to labor and environmental standards. This led to an agreement with Republican legislators in the House of Representatives that was unable to overcome the mounting opposition from both sides. In effect, this compromise increased the already strong opposition from core Democratic constituencies, such as several environmental organizations and a group of pro-labor legislators, led by House Majority Whip David Bonior (D-MI).

In these conditions, the proposal to exclude the fast track request from the Uruguay Round legislation, originally made by the powerful head of the Senate Finance Committee Daniel Patrick Moynihan (D-NY), gained ground and finally prevailed. Even the American Federation of Labor and the Congress of Industrial Organizations (AFL-CIO) had threatened to join the Citizens Trade Campaign against the Uruguay Round legislation, if the fast track proposal remained in the bill.

Thus, the Administration this time was unable to place itself in the middle of the pressures from its own party and the Republican opposition. No middle ground could be found on labor and environmental standards to build a centrist coalition of both Democrats and Republicans, as the one that approved the North American Free Trade Agreement (NAFTA).

Unidentified "congressional sources characterized the deadlock as "a vicious circle," whereby the Administration finds it "impossible to move far enough to satisfy the Republicans without alienating Democratic support."

As declared by Representative Robert Matsui (D-CA), acting chairman of the Trade Subcommittee of the House Ways and Means Committee, "I think a clean fast track (without labor and environmental negotiating objectives) would have been a better way to start things out."

At issue now is if the Administration will be able to build the support necessary to approve the implementing legislation of the Uruguay Round. According to White House Chief of Staff Leon Panetta, "our primary objective is to get GATT passed . . . We're not going to let GATT go down."

The other issue is if the Administration's agenda of linking trade negotiations to labor and environmental objectives will not hurt the bipartisan consensus that exists on trade liberalization. On that point Representative Matsui said, "I hope not, but only time will tell."

VI.7. TRADE AND THE NEW U.S. BALANCE OF POWER
(WDW/34/94 16 November 1994)

Paradoxically, an issue that failed to become a hot topic, during the last political campaign, will be the first test of the new balance of power that emerged from the November 10 midterm elections in the United States.

The voter backlash, threatened by Ross Perot against those in favor of freer trade, did not materialize. During the debate on the North American Free Trade Agreement (NAFTA), Ross Perot, who according to the Journal of Commerce has now become "the country's leading protectionist," threatened those legislators who voted in favor of the NAFTA with the "little song . . . we'll remember in November."

On November 29 and 30, the departing 103rd Congress will convene in a lame duck session, to vote on the implementing legislation approving the Uruguay Round, signed by 123 governments after more than seven years of negotiations.

According to an observer, in the ranks of the outgoing legislature, 82 members of the House of Representatives are "either retired or fired," while "11 senators are lame duck." Still, the vote on the Uruguay Round will show if there can be bipartisan cooperation on certain issues, between the first Republican dominated legislature in forty years and the Executive branch.

The lame duck session was the result of a bipartisan compromise between the Republican and the Democratic congressional leadership. Until the last minute, there were disagreements about the scope of the powers of the new World Trade Organization (WTO) and about how to finance the loss of revenue caused by the tariff reductions envisaged by the Round. Also, the Republican refusal to approve the Uruguay Round was seen as a denial to President Clinton of a bipartisan victory before the November elections.

With the results of the elections giving the Republicans solid control of both the House of Representatives and the Senate, the calls for bipartisanship from the Executive branch have intensified. In the first speech after the election, at Georgetown University, President Clinton said "the United States has been leading the world in pushing for the adoption of GATT. Now we've got to follow through and lead once again. We should not delay GATT. That would jeopardize our leadership and our prosperity."

Failure to approve the Uruguay Round, according to Treasury Secretary Lloyd Bentsen,"would be a turning point in the history of our country. It means we would be turning inward." Also, the President's chief of staff, Leon Panetta said after the election, "if we can have both the Democrats and the Republicans working together to get GATT passed, it could set, certainly, a better framework for the next session."

The new speaker of the House, Rep. Newt Gingrich (R-Ga.) has already said that he will support the Uruguay Round implementing legislation. The remaining doubts have been voiced by the new Senate Majority leader Robert Dole (R-Kan.). For instance, on the new World Trade Organization (WTO), Senator Dole has said that "the President needs to get out front and tell the American people what the World Trade Organization is and what it isn't."

Also lingering is the issue of how to finance the reductions in revenue caused by the lowering of tariffs agreed in the Uruguay Round, estimated to amount to $40 billion in the next ten years. The implementing legislation mandates $12.7 billion in spending cuts and new user fees that still fall short of the $31 billion in cuts required by the Senate. For this reason, the legislation includes a waiver of these budgetary rules that requires a majority of 60 votes for its approval in the Senate.

Even the Director General of the GATT has joined the debate by releasing, according to The Wall Street Journal "with a canny sense of timing," a new evaluation of the benefits that will generate the implementation of the Uruguay Round. According to GATT's Director General Peter Sutherland, "it seems inconceivable that the United States with so much to gain from the trade pact would fail to ratify it." For Sutherland, "even postponing a decision would be a mortal blow to the world trading system."

The new study by the GATT secretariat, taking into account the dynamic effects of the implementation of the Uruguay Round, doubles the static estimates that had set global income gains after ten years at around $250 billion.

According to the recently released figures, the United States would gain $122 billion annually in net income, from an increase of 21.7 percent in exports by the year 2005. The European Union (EU) comes out as the biggest winner, with net income gains of $164 billion annually by the year 2005, from an increase in exports of 19.4 percent. By contrast, Japan's gains are far more moderate, at $27 billion a year from an increase in exports of 18 percent during the same period. The developing countries and the economies in transition are projected to benefit together by an increase in yearly income of $116.1 billion by the year 2005. In all, the enforcement of the Uruguay Round is expected to increase annual world income by $510 billion by the year 2005.

With so much at stake, the coming vote in the U.S. Congress will determine if these impressive gains will become real. The House of Representatives will vote on November 29, while the Senate is scheduled to do so the next day. Then, it will also be known if the U.S. economy remains open to international trade and if such openness still enjoys bipartisan support, within the new power balance that has emerged in the United States.

VII. TRADE LIBERALIZATION IN THE WESTERN HEMISPHERE

VII.1. THE SUMMIT OF THE AMERICAS
(WDW/9/94 16 March 1994)

President Clinton formally announced, last Friday, that a "meeting of democratically elected heads of state and government" of the Western Hemisphere "will be held in early December in the City of Miami." As the President recalled, last December in Mexico City, Vice President Gore confirmed the intention to hold the summit, immediately after the approval of the North American Free Trade Agreement (NAFTA). Also, President Clinton briefly mentioned the proposed summit, last January, in the last State of the Union Address mainly dedicated to domestic issues.

In the formal announcement, President Clinton described some of the issues that will be included in the summit's agenda. He said, "we want to consider two broad themes: first, how to strengthen our democracies, defend them collectively and improve our governance; second, how to promote economic growth while advancing a strategy of sustainable development that protects the environment and alleviates poverty." These two broad topics are not exhaustive, President Clinton added that "to help to define our agenda, we will also encourage business, labor and nongovernmental organizations all across the hemisphere to exchange ideas and propose initiatives that can enrich the summit's deliberations."

There is ample evidence that a "process of intensive consultation," has already started in several fronts. For instance, the President announced that Vice President Gore will travel, this week, to Argentina, Bolivia and Brazil. Also, two major presentations with more details about the summit were recently made by the two highest ranking officials of the Clinton Administration who deal with inter-American affairs. These presentations were made by Richard Feinberg, Special Assistant to the President for Inter-American Affairs and by Alexander Watson, Assistant Secretary of State for Inter-American Affairs.

Both statements complement the President's announcement and should be seen as authoritative, since the authors are co-chairpersons of the interagency task force responsible for the coordination of the summit's preparatory activities. Feinberg spoke at the meeting of the Latin American Studies Association (LASA), in Atlanta, on March 10. Watson spoke at the Institute of the Americas' "1994 Hemispheric Policy Forum," in La Jolla, on March 2. Also, both statements complement each other, since Watson presents a comprehensive overview of hemispheric relations, while Feinberg focuses on several details about the summit.

The core of Feinberg's presentation is the notion of "substantive symmetry," described as a "new era in which all countries -- North and South -- face a similar agenda rooted in their common participation in one world economy." Watson also sees a process of "convergence" in the hemisphere, on security without external threats, on democratic pluralism and market economics and on addressing multilaterally transnational issues, such as migrations, drugs, human rights or the environment.

Within this context, for Feinberg the hemispheric agenda contains three major topics. First, the promotion of democracy, including good governance, domestic dialogue, nonpartisan engagement by the United States and the collective defense of democracy. Second, to advance economic growth, through open regionalism and streamlining the state. Finally, to address the social agenda, by shifting resources toward the poor.

For Watson, the Clinton Administration hemispheric policies cover the following topics. First, multilateral and bilateral instruments to support democracy and economic reform. Second, NAFTA has a key role to play in the advancement of economic reform in the hemisphere. Third, subregional economic integration is a sound base for further progress toward hemispheric free trade. Fourth, the challenge of poverty has to be confronted. Finally, effective democratic governance, by improving the functioning of government, its efficiency and honesty.

The announcement of the hemispheric summit puts to rest the concern, sometimes voiced in Latin America, that the Clinton Administration was more interested in other parts of the world, such as the former socialist bloc, the Middle East or the dynamic Asia-Pacific region.

Furthermore, the Clinton Administration is aware of the uniqueness of the event. In President Clinton's terms, the summit will be "the first meeting of hemispheric leaders in over a generation, and it will be the first-ever meeting of democratically elected leaders." Also, as described by Feinberg, this "once-in-a-generation opportunity" will be "the first ever held in the United States."

Concerning the results expected, Feinberg says that the summit "offers a unique opportunity to capitalize on the unprecedented convergence of democratic values and economic thought throughout the hemisphere." Therefore, it "will test whether hemispheric leaders can transform shared values into concrete work plans."

Finally, according to Feinberg, "a productive Summit will catalyze consensus, give impetus to fresh ideas, set in motion a series of ministerials and fortify multilateral mechanisms." Feinberg concludes that "if the Summit of the Americas succeeds, it will inspire hemispheric relations for the rest of this century and beyond."

VII.2. EXTENDING NAFTA: WHO IS NEXT?
(WDW/21/94 13 July 1994)

Two expected events gave ground to the belief that there would soon be an answer to who is next in the line of accession to the North American Free Trade Agreement (NAFTA). One event was the previously announced visit to Washington of the newly elected President Eduardo Frei of Chile. The other was an obligation emanating from the NAFTA implementing legislation. Both events have now passed and except for Chile the question of who else is next remains unanswered.

Section 108 of the NAFTA implementing legislation states that the Administration has to "determine with which foreign country or countries, if any, the United States should seek to negotiate a free trade area agreement or agreements."

This requirement consists of two steps that had to be given at specifically determined deadlines. The first step directed the U.S. Trade Representative (USTR) to submit, by May 1, 1994, "a report on significant market opening," to the President and to the Committee of Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

Probably as evidence of the discomfort caused by the requirement of naming individual countries, the USTR report covered all regions of the world and ranked every U. S. trading partner by the amount of U.S. exports. In the letter of transmission, the USTR expressly indicated that this ranking of trading partners "should not be interpreted as an indication of which countries might ultimately be selected." This amounted to a postponement, until the next deadline, of the decision on naming the potential candidates for negotiating free trade agreements. The next step consisted in requiring that the President "submit to the appropriate Congressional Committees, no later than July 1, 1994, a report containing recommendations on future trade area negotiations."

In spite of such a clear requirement, the President's report pointedly says that "we are not now in a position to identify specific countries or groups of countries." Furthermore, to avoid restricting the mandate to any specific type of agreement, the report "addresses primarily the issue of bilateral and regional arrangements including, but not limited to, free trade areas."

Meanwhile, just before the July 1 deadline, President Eduardo Frei of Chile made an official visit to Washington. This led to some speculation about a possible linkage between President Frei's visit and the designation of potential candidates for free trade area negotiations.

Such speculation was dispelled promptly by one paragraph contained in the single page statement, issued by the White House Office of the Press Secretary, describing the results of President Frei's visit.

The statement says that "President Clinton reaffirmed to President Frei his firm commitment to negotiate a free trade agreement next with Chile now that the North American Free Trade Area (NAFTA) and the Uruguay Round negotiations have been completed." Also, "the Administration is working with Congress to obtain fast track authority as the first step toward formal U.S.-Chilean negotiations" (WDW/19/94). Finally, "the two presidents asked the United States Trade Representative and the Chilean Minister of Finance to provide them a joint recommendation on the best avenue for a Free Trade Agreement -- whether bilateral or NAFTA accession."

Consequently, at this point, Chile is the only country designated as a potential candidate for negotiating a free trade agreement with the United States. Additionally, if the negotiation will result in a bilateral agreement or in accession to the NAFTA will be based on the "joint recommendation" of the USTR and the Chilean Minister of Finance.

This last point was clarified by President Clinton, on June 28, during the "photo opportunity" with President Frei, at the Oval Office. Asked if the Clinton Administration would "favor Chile entering through NAFTA or through a free trade agreement, which is bilateral?" President Clinton answered: "I don't really have an opinion on that at this time. I want to discuss it with the President, and I want our advisers to be able to discuss it and just determine the best way."

Clarifying also the order of priorities, President Clinton added, "the most important thing for me now is to get the Congress to approve the fast track negotiations with Chile so that we can accelerate this economic partnership whichever way we decide to go." To conclude, President Clinton said it was "very important . . . to know that the Congress will support that, because I have said all along that I thought we ought to move next with this free trade agreement to Chile . . . that could be a model for all of South America."

The President's report to the Congress on future free trade area negotiations notes that given the ongoing consultations on the December Summit of the Americas, "other than Chile, the Administration is not now prepared to name specific countries as candidates for future free trade area agreements." Consequently, "passage of the Uruguay Round implementing legislation is our immediate top trade legislation priority with the Congress. It is our intention that this legislation contain renewed trade agreement authority and fast track procedures."

VIII. MULTILATERAL FINANCIAL INSTITUTIONS

VIII.1. FIFTY YEARS AFTER BRETTON WOODS
(WDW/23/94 27 July 1994)

Fifty years ago, on July 22, ended the meeting of the victorious allied powers that created the Bretton Woods institutions. So-called, after the village in New Hampshire where the "founding fathers" sat in conference for three weeks at the Mount Washington Hotel.

As depicted by some observers, the meeting saw a clash and a compromise between the U.S. delegate Harry Dexter White and the intellectual inspiration of John Maynard Keynes. White pushed for fixed exchange rates in an open trading system, Keynes argued for exchange rate flexibility, trade controls and preferential agreements.

Moving toward the future with their heads turned to the past, both delegations compromised around the objective of avoiding a repetition of the Great Depression. The agreement was later known as a system of "stable but adjustable" exchange rates pegged to the dollar, which was ultimately also pegged to gold.

At its conclusion, the Bretton Woods conference decided the creation of the Bank and the Fund, to oversee the functioning of the "system" and to finance the reconstruction of Europe. Christopher Fildes reminded in the Daily Telegraph that John Maynard Keynes described the conference as "a monstrous monkey-house" that confused the identity of its creatures. The Fund was closer to a central bank, while the Bank was more a fund for reconstruction and development.

Be it as it may, these twin institutions were immediately overtaken by events. Stanford University Professor Ronald McKinnon pointed, in the first article of a Financial Times series on the fiftieth anniversary of Bretton Woods, that until 1971 the world lived under a "Marshall-Dodge fixed dollar standard." This "system" was inaugurated by the Marshall plan for the reconstruction of Europe and by the Dodge plan for the reconstruction of Japan, with the dollar as the anchor of "stable but adjustable" exchange rates.

True, under this "system" the world economy experienced, during the "first two post-war decades," what The Economist characterized with "no exaggeration . . . as a golden age of trade and growth, a time without parallel in the economic history of the world." Although the credit for this outstanding achievement cannot be fully attributed to the Bretton Woods institutions, at least they did not stand against it.

By contrast, it can be argued that what these institutions have exhibited is an outstanding capacity for adaptation to changing circumstances.

For instance, once it was obvious that the reconstruction of war ravaged areas would not be a lasting task, their attention turned toward the developing countries. The first World Bank loan to a developing country was granted to Chile in 1947.

Also, events such as the devaluation of the U.S. dollar in 1971, the two oil shocks of the seventies and the debt crisis of the eighties, moved these institutions into actively promoting financial rescue operations among developing economies, even with some degree of overlapping among their functions.

Today, the Bretton Woods institutions are actively engaged in supporting the transition of the formerly centrally planned economies into market economies. At fifty, these institutions have attained universal membership of 178 countries and have been adept, again, at finding a new reason for their existence. Despite what some observers see as their "spreading a little around the waist" and their exhibiting the "signs of mid-life crisis."

Therefore, the fiftieth anniversary of the Bretton Woods conference has generated an impressive flurry of comments, even criticisms and some proposals for profound if not radical reform. Among the criticisms, one of the most publicized has come out from a coalition of more than fifty nongovernmental organizations that call themselves "the Fifty Years is Enough Coalition." The members of this coalition are organizations such as Oxfam America, Friends of the Earth and Greenpeace USA. Their criticisms have been mainly addressed to the World Bank, for doing "more harm than good."

At the other end of the spectrum appears the prestigious "Bretton Woods Commission," that describes itself as "a private independent group of senior individuals with experience in international finance, development and economics and related areas of public policy." Almost nostalgically, the Bretton Woods Commission report, chaired by the former head of the US Federal Reserve Board Paul Volcker, concludes that what is required is a return to a less volatile monetary system based on "flexible exchange rate bands."

These proposals and criticisms have had their effect, because the final communique of the Naples Summit (WDW/22/94) declares that next years' summit in Halifax, Nova Scotia, will aim at revitalizing the World Bank and the IMF and even the G-Seven itself. The aim is to respond to the question of how "the global economy of the 21st century will provide sustainable development with good prosperity and well-being of the peoples of our nations and the world?"

VIII.2. THE IMF'S ANNUAL REPORT
(WDW/25/94 14 September 1994)

This year's advanced copy of the IMF's Annual Report was released by the Executive Board at the end of July, on the eve of the fiftieth anniversary of the Bretton Woods conference and well ahead of the annual meetings of the Board of Governors, to be held in Madrid at the end of September.

The first part of the Report contains a description of the evolution of "the global economy," during the financial year ending on April 1994. This first part describes the main developments in the world economy and the Board's consideration of the world economic outlook (WDW/14/94); international capital markets; and non-oil commodity prices.

The second part, titled "the Fund in 1993/94," contains a description of Fund's activities, including its surveillance role; the financial support granted to members; technical assistance activities; and financial operations.

Several appendices to the Report provide additional information, such as statistical data on international reserves and on the Fund's financial operations; the principal policy decisions adopted during the year; press communiques, administrative and capital budgets, and financial statements.

The Fund's surveillance activities were carried out against the background of a world economy experiencing "a modest recovery." The second part of this year's Report, under the surveillance heading, contains more summaries of "Article IV consultations with member countries." The number of summaries has been expanded, to "cover selected developing countries and economies in transition, as well as industrial countries." The Report contains surveys of the three largest Latin American economies, Argentina, Brazil and Mexico.

Additionally, for the first time, these summaries include a description of "significant economic developments during the period leading up to each consultation, a table of selected data available at the time of the Board discussion, and a review of the discussion of the Board."

Also for the first time, the Report contains a description of some implications of IMF supported "reform measures on vulnerable groups and how social safety nets can be integrated into reform programs."

With the admission of Micronesia, in June 1993, the Fund "moved even closer to a universality of membership." On 6 July 1994, the admission of Eritrea brought total membership to 179 countries, with applications pending for two more countries.

This expansion in membership and the payments of quota increases by 170 governments, under the Ninth General Review, pushed the total amount of Fund quotas, at the end of the financial year, to SDR 144.9 billion. Thus, in 1993/94, the Fund's "liquidity position strengthened to SDR 54.3 billion, compared with SDR 52.2 a year earlier."

During the 1993/94 financial year, "drawings (purchases) from the IMF's general resources" totaled SDR 5.2 billion, about the same level of the previous two financial years. "Repayments (repurchases) amounted to SDR 4.3 billion in 1993/94, compared with SDR 4.1 billion in 1992/93." The largest drawings were made by Russia (SDR 2.2 billion); Argentina and South Africa (SDR 0.6 billion each); Poland (SDR 0.4 billion); and India (SDR 0.2 billion).

For the second year, the level of outstanding overdue obligations, during 1993/94, experienced a small decline to SDR 2.9 billion. As of April 1994, 9 countries were in arrears, compared to 12 countries the previous year. Five of these countries were ineligible to use the IMF's general resources--Liberia, Somalia, Sudan, Zaire and Zambia. For the first time, in August 1993, Sudan's voting and related rights were suspended, as were those of Zaire on June 1994. These two cases are the first two applications of the provisions of the Third Amendment of the Articles of Agreement, which entered into effect in November 1992.

In June 1994, the Board of Directors approved "the first major change in the structure of the IMF's senior management since 1949, when the position of Deputy Managing Director was established." As proposed by the Managing Director, the number of Deputy Managing Directors increased to three. Mr. Stanley Fischer was appointed First Deputy Managing Director and the other two appointed were Mr. Alassane D. Ouattara and Prabhakar R. Narvekar. Each Deputy Managing Director has authority "to chair Board meetings and maintain contacts with officials of member governments and Executive Directors, the media and other institutions."

For the performance of these activities, the Fund has experienced "the largest staff increase" in its history. Since 1991/92 "the Fund's budgeted staff resources have increased by 507 staff years, a substantial majority having been devoted to work with the countries of Eastern Europe and the states of the former Soviet Union." By the end of 1993/94 the Fund's regular staff reached 2610 staff years from 114 countries, compared to 2100 the previous year from the same number of countries.

The Fund's administrative budget for 1993/94 increased to $476.8 million, from $389 million in 1992/93. The capital budget amounted to $124.8 million, including "$111 million for the construction of an addition to the headquarters building."

VIII.3. THE WORLD BANK'S ANNUAL REPORT
(WDW/27/94 28 September 1994)

Covering the fiscal year (FY) that goes from 1 July 1993 to 30 June 1994, the World Bank's Annual Report includes the following sections: 1) Executive Board's activities; 2) a global perspective of the economic scene; 3) major programs; 4) operations; 5) regional perspectives, with a segment dedicated to Latin America and the Caribbean; 6) services and activities by other members of the World Bank Group, including those of the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the International Centre for Settlement of Investment Disputes (ICSID); and 7) the Bank's finances.

With the admission of the Republic of Macedonia, by the end of the fiscal year, the number of Bank members reached 177. Action was pending on membership for Bosnia-Herzegovina, Eritrea and the Federal Republic of Yugoslavia.

Total new lending commitments by the World Bank Group in FY 94 amounted to $20.8 billion, down by $2.8 billion from the previous year. From this total, almost all the decrease was accounted by Bank lending, from $16.9 billion to $14.2 billion in FY 94. International Development Association (IDA) commitments in FY 94 amounted to $6.5 billion, only marginally below FY 93's $6.7 billion. Overall, gross disbursements also decreased in FY 94, from $12.9 billion from the Bank and $4.9 billion from IDA, to $10.4 and $5.5 billion, respectively.

Lending in FY 94 remained below the indicative lending goals set in the budget, at between $17 and $19.5 billion. This shortfall was almost fully accounted for by the decrease in adjustment lending from more than $4 billion in FY 93, to $2.4 billion in FY 94.

Fast disbursement adjustment lending in FY 94 declined to 12 percent of total lending, from 17 percent in FY 93. According to the Bank, "to a certain extent, the decline in adjustment lending has been purposeful, especially in Latin America, where the transition from adjustment to lending operations is well under way." Also, there has been a decrease in the balance of payments justification of adjustment lending, given "the explosive increase, to $177 billion net, during 1993 of capital flows to developing countries."

The sector that accounted for the largest number of commitments in FY 94 was agriculture, with 18.8 percent, while human resources followed, with 15.8 percent. The largest borrowers of Bank funds in FY 94 were China ($2.1 billion for eight projects), followed by Mexico ($1.53 billion for five projects) and Russia ($1.52 billion for six projects). The three largest borrowers of IDA credits were also China ($925 million for six projects), India ($835 million for six projects) and Bangladesh ($597 million for three projects).

The segment dedicated to Latin America and the Caribbean describes the region in 1993 showing "large disparities in growth rates across countries, a definite downward trend in inflation in most countries, continued capital inflows, significant expansion of regional trade, and a growing perception that investment in social and economic infrastructure must be increased."

However, the less bright spot is that "despite relatively high per capita income levels in most countries, poverty and income distribution continue to be major problems." According to the Bank, "about 32 percent of the region's population lives in poverty, and the lower 20 percent on the income scale receives only 4 percent of total gross domestic product (GDP)." Also, "the level of poverty is particularly acute among indigenous groups. Poverty in these groups is in excess of 70 percent in Peru and Bolivia and more than 80 percent in Mexico and Guatemala--rates significantly higher than those of the nonindigenous populations."

The Bank describes "the region's challenges" as "to reduce poverty and increase the well-being of its people through environmentally sustainable development." Consequently, in Latin America and the Caribbean, the Bank will continue "the planned transition in lending from adjustment to long-term issues--human resources development, environmentally sustainable development, and private sector development."

For this purpose, the Bank's proposed program for Latin America and the Caribbean in FY 1994-96 "shows a decline in lending for adjustment and debt reduction from 24 percent to 3 percent, an increase in lending for human resources/poverty reduction from 23 percent to 33 percent, and an increase in environment and forestry commitments from 7 percent to 13 percent." This "focus on human resources and poverty issues," concludes the Bank, "reflects the region's historically highly stratified social structure and skewed distribution of income."

To carry out its activities, the Bank's administrative budget amounted to $1.38 billion in FY 94 and $1.42 billion approved for FY 95. At the end of FY 94, the Bank employed 6,338 regular and fixed-term staff, of whom 4,145 were higher-level staff from 123 nations, 59 percent from industrialized countries and 41 percent from developing countries. Women employed as higher-level staff increased by the end of FY 94 from 28.4 percent to 30.0 percent. The staff increased, in FY 94, by 2.3 percent, with 257 new

higher-level staff recruited, of whom 32.7 percent from developing countries and 39.3 percent were women.

VIII.4. THE IMF-WORLD BANK MEETINGS IN MADRID
(WDW/30/94 19 October 1994)

This year's annual meetings of the International Monetary Fund (IMF) and the World Bank were held in Madrid's Palacio Municipal de Congresos at the Campo de las Naciones, from September 29 to October 6.

To celebrate the fiftieth anniversary of the Bretton Woods institutions(WDW/23/94), the meetings were preceded by a conference on "Fifty Years After Bretton Woods: The Future of the IMF and the World Bank." However, the birthday celebrations were disrupted by the presence of several nongovernmental organizations, camped outside the meetings.

As reported by The Washington Post, two demonstrators from the environmental organization Greenpeace, during the inaugural speech pronounced by King Juan Carlos of Spain, "showered fake dollar bills" on the participants. The bills were marked with slogans such as "50 years of destruction," reminiscent of the highly publicized catchphrase coined by the "Fifty Years Is Enough" coalition of nongovernmental organizations.

These organizations also held a parallel "Alternative Forum" to the official meetings that issued a declaration saying: "on the threshold of the turn of the century, the distressing history of the Bretton Woods institutions should be merely an unpleasant memory, a lesson not to be forgotten."

Beyond these incidents, the main highlights of the meetings were the mostly upbeat assessments of the state of the world economy and a nondecision.

On the present state of the world economy, the Interim Committee of the Board of Governors of the IMF issued a "Declaration on Cooperation to Strengthen the Global Expansion." The Declaration first asserts that "the immediate prospects for economic growth in the world economy are better than they have been at any time in this decade."

Also positively reviewed is the evolution of the developing economies, of the economies in transition and of the industrial countries. The declaration concludes with the description of three central elements of a common strategy "to strengthen growth and reduce unemployment, while safeguarding the progress toward price stability" in the industrial countries.

The three elements of the strategy are: 1) "structural reforms to eliminate impediments to sustained growth," such as dismantling nontariff barriers, the long-term financial viability of health and public pension systems, and fundamental labor market reforms; 2) "to significantly reduce fiscal deficits beyond the effects of cyclical recovery, and cut debt to GDP ratios, thereby facilitating lower real interest rates"; 3) "to adjust monetary conditions to maintain price stability, as a condition for sustaining medium-term growth, including by timely increases in interest rates with a view to preventing the

emergence of inflationary pressures." Finally, the Interim Committee decided to review the progress in the implementation of the common strategy at its Spring 1995 meeting.

Despite these optimistic assessments, difficulties appeared when dealing with the issue of increasing the access to the Fund resources. On the existing limits to the access to IMF resources, the Interim Committee recommended to the Executive Board of the IMF to increase "the annual access limits from 68 percent to at least 85 percent of quota."

The nondecision had to do with the allocation of 36 billion in Special Drawing Rights (SDRs), originally proposed by the Managing Director of the IMF, with the support of the developing countries and the transition economies.

The Group of Seven, according to the U.S. Treasury Secretary Lloyd Bentsen, supported the allocation of only SDR 16 billion, dedicated to the forty new members that have joined the IMF since the last SDR allocation in 1979-80. Secretary Bentsen declared, in the summary of the G-7 deliberations, "we will not accept a general allocation of SDRs. What the G-7 members want is an allocation that offers the most benefit to the present countries and the economies which are now in transition."

Since the allocation of SDRs is the kind of decision that demands the approval of at least 85 percent of Board members, the majority was not reached either for the "general allocation" of SDR 36 billion, proposed by the Managing Director, or for the SDR 16 billion supported by the G-7.

As described by Managing Director Camdessus, the 36 billion he recommended comprised the SDR 16 billion for a special allocation supported by the G-7 and a general allocation of SDR 20 billion. of which SDR 11 billion would go to the industrial countries that are members of the G-Ten.

The press saw this nondecision as a manifestation of clout by the developing countries. As David Wessel said in the Wall Street Journal, the "developing countries flexed their muscles for perhaps the first time in the 5-year history of the postwar financial institutions."

The Interim Committee Chairperson, Belgium's Minister of Finance Philippe Maystadt, agreed when he said: "there was a demonstration today that, in certain circumstances, all the members cannot be forced just to accept what the G-7 has decided the previous day. I think in a way it is kind of premiere. I have attended this meeting for some years now, and it was a little bit refreshing that all was not settled the previous day.

VIII.5. MAINSTREAMING GUARANTEES AT THE WORLD BANK (WDW/32/94 2 November 1994)

The recent trend in private financing of infrastructure projects (WDW/31/94) has been recognized at the World Bank. On September 8, the Board of Directors approved the proposal made by President Preston, in a Memorandum dated 11 July 1994, "to make more extensive use of the Bank's guarantee authority."

Despite its recognition in the Banks' Articles of Agreement, President Preston admits that "for a variety of reasons, guarantees have been utilized only sporadically in the context of dedicated programs and have never found a widespread role in Bank operations."

Previous attempts, linked to co-financing operations, led in 1991 to the first application of a Bank guarantee to a private sector infrastructure project, the Hub Power Project in Pakistan, a privately financed 1.2 MW thermal power plant. However, according to President Preston, recent developments "indicate that guarantees should become a much more significant form of Bank support."

Among these developments, first, "the financing needs for development of infrastructure in developing countries are now estimated to be very large and well beyond the capacity of the official sources alone to support." Based on the last World Development Report 1994 (WDW/18/94), the Bank estimated that infrastructure investment in developing countries will exceed $200 billion per year. Second, "Bank borrowers are turning to the private sector to invest in infrastructure projects through a variety of private ownership arrangements".(WDW/31/94). Finally, in contrast to the eighties, "several developing countries have now re-established access to private markets."

All these factors generate "both a need and an opportunity for the Bank to help mobilize capital for long-term developmental investments in these countries." Also, since "market forces alone are likely to generate short-term and portfolio investments . . . the Bank's guarantee can be an effective tool to utilize the Bank's intermediation capability in this situation."

By offering guarantees, the Bank seeks "to help mobilize private sector financing for individual projects through targeted and limited support, and to leverage the Bank's participation." Specifically, these guarantees "can be targeted to mitigate against specific risks--generally risks of political, regulatory and governmental performance -- which in particular projects the private sector may not be in a position to absorb or manage."

Additionally, for several reasons, "the comparative advantage of Bank's guarantees is most apparent in infrastructure investments." First, infrastructure projects "require large amount of funds with extended maturities to match the long pay-back periods normally associated with such projects." Second, in these projects, the government is always involved in several ways, "as the provider of some of the inputs, as the purchaser of outputs, or as regulator." Finally, these projects "generally serve domestic markets and earn revenues in local currency, which creates a foreign exchange exposure for foreign investors."

Two types of guarantees will be offered by the Bank. Partial risk guarantees, for sovereign contractual obligations, including transfer risk and partial credit guarantees, to cover the long-term portion of the financing required by the project.

Government contractual obligations include: "(i) maintenance of an agreed regulatory framework; (ii) delivery of inputs or payment of outputs . . . and (iii) compensation for delays of interruption of project operations caused by governmental actions, or political force majeure." The transfer risks "arise from excessive delays in acquiring foreign exchange caused by the government's action or failure to act."

The partial credit guarantees "can be structured to help transform the available medium-term funding to the longer term," or "to encourage term transformation." This can be done through guarantees for "(i) the longer-dated maturities . . . (ii) to provide incentives for lenders to roll over their medium-term loans at maturity; (iii) liquidity guarantees . . . (iv) rolling guarantees that cover a fixed number of scheduled payments."

Guarantees can generate several benefits. For the investors and for the governments, first, "to leverage Bank support by catalyzing additional private resources"; second, "to channel necessary Bank support to private sector projects, while greatly limiting the government's obligation and risks"; third, to "help establish a track record of implementation and contractual performance crucial to increased investor confidence."

For the Bank, "besides providing an effective tool for supporting private sector projects, guarantees inevitably get the Bank involved more directly and explicitly with private borrowers and lenders, thereby building partnerships with the private sector within individual country assistance strategies."

In exchange, the Bank must obtain a counter-guarantee from the beneficiary government, by means of an "Indemnity Agreement, whereby the Government agrees to indemnify the Bank in respect of any payments made by the Bank under its guarantee."

To conclude, the Board will review the experience with guarantees when "the volume reaches 5% of the outstanding IBRD portfolio of loans and guarantees." This limit will be "achieved within 3-4 years, assuming $1-2 billion of guarantee operations per year."