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PRESENTATION

This the tenth year that the weekly dispatches transmitted during a year from ECLAC Washington to ECLAC's headquarters in Santiago, Chile and other subregional offices are gathered in a single document.¹

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

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

1) The congressional and presidential elections in the United States dominated during the year. The outstanding performance of the U.S. economy was not enough to give the control of both the legislative and the executive branches to one major contender. At the time of the election, exhibiting a moderate rate of growth, with low inflation and low unemployment, the U.S. economy entered the 67th. month of sustained expansion, the third longest expansion since the Second World War.

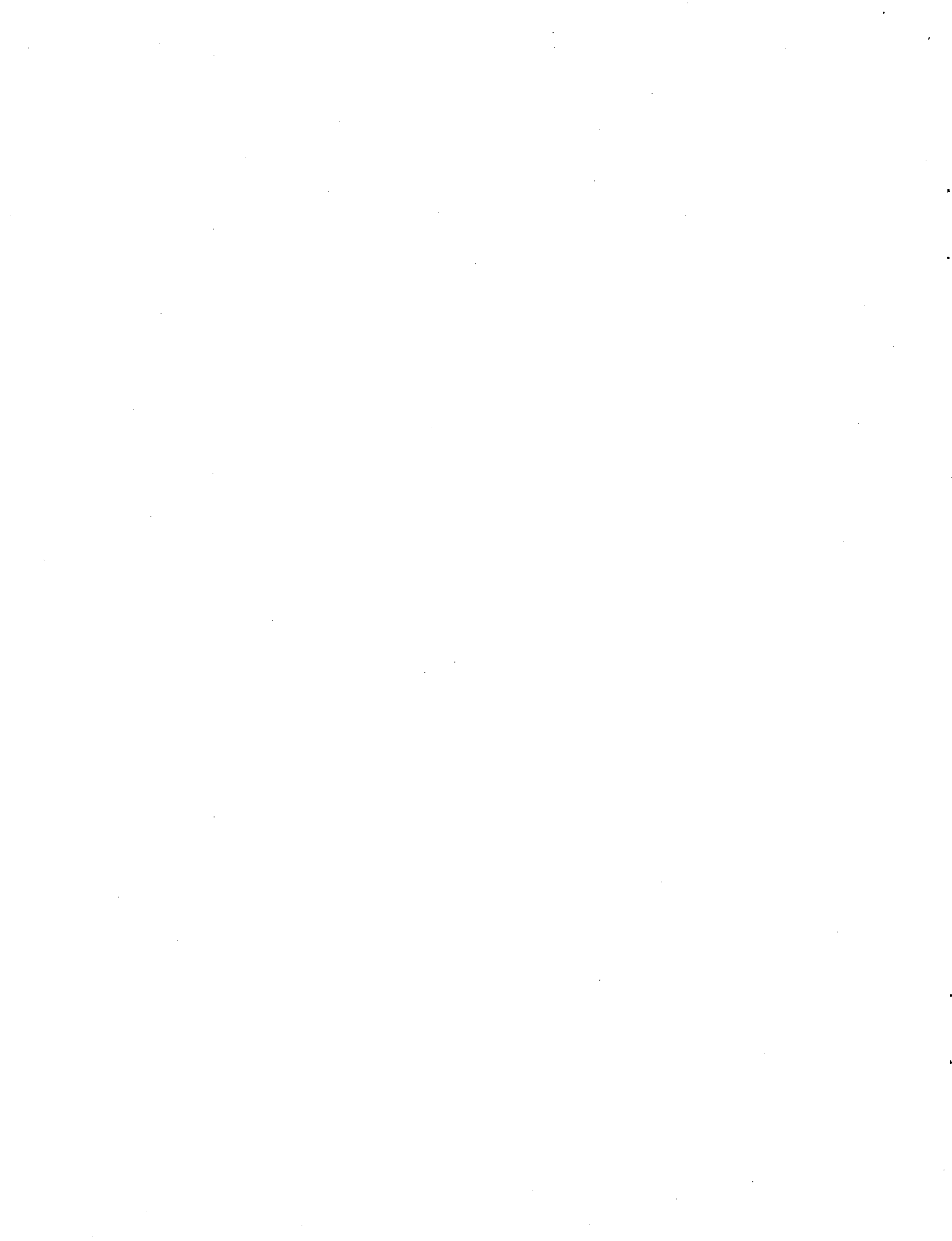
2) The globalization of capital markets manifested itself in the vertiginous evolution of foreign exchange markets, with the Bank for International Settlements (BIS) estimating that, in April 1995, \$1.2 trillion were transacted there every day, up from \$800 billion in 1992. The next biggest was the U.S. securities market, with an average daily turnover, in April 1995, of \$175 billion. According to the IMF, the foreign exchange market is the core of the international financial system, since it is "the largest, the most liquid, the most innovative, and the only 24-hour global financial market in the world."

3) Finally, after the so-called "tequila effect," capital flows to the developing countries, particularly to the so-called emerging markets, returned and exceeded the levels attained before the Mexican financial crisis. Therefore, fears of a collapse in these flows were disproven.

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

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

¹ ECLAC Washington, International Economic Highlights (LC/WAS/L.2) 17 August 1988; (LC/WAS/L.4) March 1989; (LC/WAS/L.8) 15 March 1990; (LC/WAS/L.11) 22 March 1991; (LC/WAS/L.14) 11 March 1992; (LC/WAS/L.17) 11 March 1993; (LC/WAS/L.23) 30 March 1994; (LC/WAS/L.27) 21 February 1995; (LC/WAS/L.33) 8 March 1996.



I. THE WORLD ECONOMY

I. 1. THE IMF'S FIRST WORLD ECONOMIC OUTLOOK (WEO) (WDW/12/96 15 MAY 1996)

The advanced copy of the first WEO was released on April 17, as every year, just before the Spring meetings of the International Monetary Fund (IMF) and the World Bank (WDW/11/96, p.64).

This year's single volume contains the following chapters: I) global economic prospects and policies; II) world economic situation and short-term prospects; III) fiscal challenges facing industrial countries; IV) fiscal policy issues in developing countries; V) fiscal challenges of transition: progress made and problems remaining.

A downturn in the growth of the world economy in 1995, to 3.5 percent, was slightly less, by 0.2 percent, than the projections made in October 1995. This "slight weakening" was a consequence of the more marked slowdown in the industrialized economies of North America and of Western Europe, and also of "lackluster" activity in Japan.

Despite the deterioration experienced by almost all the industrialized countries, the global outcome remained positive, because the slowdown was compensated by the continuation of vigorous growth in many emerging market countries, particularly of East Asia.

Still, the IMF staff remains "cautiously upbeat," because "overall, there do not seem to be grounds to expect a prolonged or generalized slowdown." Such discreet optimism supports the projection that the world economy will grow at an average of 4 percent in 1996 and 1997, a moderate improvement over the 3.5 percent it reached last year.

This positive outlook is grounded on several hopeful trends and developments. Among these, the following figure prominently: the control of inflationary pressures; significantly low real long term interest rates; the alignment of the principal currencies along economic fundamentals; growth in world trade of almost 7 percent in 1996; containment of spill over effects from the Mexican financial crisis; and growth in the transition economies.

There remain, however, some "obstructions" in the path of global economic expansion. Prospects in Europe remain bleak; budgetary imbalances persist in the industrialized economies; fiscal imbalances also persist among the developing countries; and the transition economies are far from having attained stability.

Last year, the most profound downturn was experienced by a group of Western European industrialized countries, characterized as the "inner core" of Europe, or the strong currency countries. By contrast, in the European countries that depreciated their currencies, described as the "outer ring," growth was "better sustained." While in the first group of strong currency countries, "activity stagnated in the second half of 1995, and unemployment began rising."

In the developing countries output increased by 6 percent in 1995, for the fourth consecutive year, mainly because of the robust growth experienced in Asia, the initiation of recoveries in Argentina and Mexico, and the continuation of stabilization and reforms particularly in Africa.

A bright spot in the prospects of some developing countries was the "continuation of large capital inflows, which gathered momentum in the closing months of last year and January of this year. Such flows "recovered strongly in 1995, topping levels seen in earlier years."

Overall, net private capital flows to the developing economies amounted to \$166.4 billion in 1995, up from \$149 billion in 1994. However, the same flows to the developing countries of the Western Hemisphere reached only \$39.6 billion in 1995, less than the \$50.7 billion of 1994. By contrast, capital flows to the developing countries of Asia increased from \$75.1 billion in 1994 to \$98.2 billion in 1995. Notice that in 1995, almost \$140 billion of total private capital flows went to the developing countries of Asia and of the Western Hemisphere.

This surge in capital flows to some developing countries, which started at the end of last year, "led to pressures on exchange rates, large accumulations of foreign exchange reserves, and increases in domestic liquidity."

Almost the same rate as last year's, of 6.4 percent, is projected for all the developing countries in 1996 and 1997, with those developing countries of the Western Hemisphere expected to grow 3.1 percent in 1996.

By contrast, growth in the Asian developing countries is expected to "slow slightly" to 8.2 percent in 1996, from 8.4 percent in 1995.

Finally, the "countries in transition" are expected to grow moderately, at 2.5 percent, in 1996, with output remaining "most robust in countries that began earliest and that have persevered longest with macroeconomic stabilization and structural reforms." As with Poland, where output expanded at 6 percent in 1995 and is projected to grow 5.5 percent in 1996.

This year's first WEO has also a special focus on fiscal policy, since many "macroeconomic and structural policy challenges, which are often interrelated, are in the fiscal area." Thus, three chapters of the WEO are dedicated to analyze the fiscal challenges in the industrial, the developing and the transition economies.

I. 2. FISCAL CHALLENGES IN INDUSTRIAL COUNTRIES (WDW/17/96 19 JUNE 1996)

The dedication of three chapters of this year's first World Economic Outlook (WEO) to fiscal policy challenges (WDW/12/96, p.1) has a good explanation. In the case of the industrial countries, it is because these economies are experiencing an "unprecedented" ballooning of public debt.

As demonstrated by Paul Masson and Michael Mussa from the IMF, it used to be that public sector deficits in the industrialized economies were a response to extraordinary circumstances, such as the two world wars and the Great Depression. Therefore, a return to normalcy meant also a return to balanced budgets.

The exception to this rule has only happened in the last two decades, during which all the industrial countries have exhibited persistent budget deficits in the absence of major emergencies. In the terms of the IMF staff, "the continuous and sustained rise in budget deficits and debt ratios in most industrial countries over the past couple of decades, a period of general peace and prosperity, is especially striking."

Everything started quite recently, in the mid 1970s, with the first oil crisis. Furthermore, these large deficits "widened dramatically after 1980," but not because of lack of revenue. For instance, in all industrial countries "revenues have increased from a simple average of 28 percent of GDP in 1960 to 44 percent in 1994."

The problem originates on the other side of the fiscal equation, since "government expenditures in industrial countries jumped from a simple average of 28 percent of GDP in 1960 to 50 percent in 1994."

Consequently, there has been an explosion in public debt in the industrialized economies. "Between 1980 and 1995, the average gross public debt in these countries swelled from about 40 percent of GDP to about 70 percent."

Several factors are responsible for these extraordinary fiscal imbalances. First, "the growth of public pensions, social spending and other transfers." Second, unemployment benefits almost amounting to normal salaries and lasting for long periods. Third, the slowdown in productivity, which started in the 1970s and took a while to be perceived, has led to a smaller tax base than expected. Fourth, real interest rates remained high, despite the slowdown in productivity growth. Finally, flexible exchange rates and open financial markets gave access to resources that allowed governments to finance larger deficits. Additionally, inflationary financing is foreclosed, because "any option of reducing the real level of government debt by generating unanticipated inflation has largely been removed by supersensitive investors who quickly exact a risk premium."

Also absent this time were some traditional justifications of deficit spending, such as investment in physical infrastructure, to improve the rate of return on private capital, or to improve human capital by spending in education or health care. In the last couple of decades, "virtually all of the growth of government spending has been in the areas of transfers (including public pensions), subsidies and interest payments, not public investment or education." For instance, in the last three decades, "public investment shrank as a share of GDP in most industrial countries."

The problem is that such rates of public indebtedness are not sustainable. In present conditions, according to the WEO, only through primary surpluses--excluding interest payments--can the ratio of public debt to GDP return to the levels that existed before 1980 in most industrialized economies.

For example, if interest rates and nominal GDP growth rates remain constant at present levels, to attain a net debt target of 30 percent of GDP, by 2010 in all the industrial countries, demands average surpluses of at least 3.5 percent. Even larger surpluses would be required to return debt-to-GDP ratios to the levels that prevailed before 1980.

Additionally, the lack of sustainability of present levels of public indebtedness in the industrial countries can also be illustrated by means of "generational accounting." This subtracts "the present value of expected lifetime transfer receipts for each age group . . . from the present value of expected lifetime tax payments."

To complicate matters even more there is aging and the so-called "invisible debt." This last compares explicit and implicit future liabilities, such as promises to pay public pensions and health care benefits to retirees, with likely future tax revenues. The results lead to the need to undertake radical reform of pension systems.

The conclusion is that "budget deficits in almost all industrial countries have in the past two decades become too big, out of bounds by peacetime standards, and in many cases unsustainable." The most negative consequences of these large and persistent budget deficits are that "interest rates are biased upwards, investment is reduced, and the growth of living standards is less than it could be."

Finally, two lessons are drawn from the observation of several cases of fiscal consolidation. First, "a policy of tight fiscal consolidation does not necessarily lead to recession." Second, "more emphasis on spending cuts than on revenue increases appears to help."

I. 3. ECONOMIES IN TRANSITION (WDW/19/96 3 JULY 1996)

It took a while, and a radical transformation in the world economy, for a quotation from Marx and Engels to become the leading quotation of a World Bank report. The words come from The Communist Manifesto and are used to illustrate the profound transformation that is taking place in what were known as the "centrally planned economies."

The report says that today's process of transition is "aptly, if ironically," described by Marx and Engels depiction of the "turbulent spread of capitalism in the nineteenth century." Marx and Engels saw a process where "all fixed, fast-frozen relations, with their train of ancient and venerable prejudices, and opinions, are swept away, all new-formed ones become antiquated before they can ossify. All that is solid melts into air . . . "

The "transition" of these economies "back to a market orientation" is the topic of this year's nineteenth World Development Report, released by the World Bank on June 27. It covers the changes in the economies of Central and Eastern Europe (CEE), the newly independent states (NIS) of the former Soviet Union, and China, Mongolia and Vietnam.

In the terms of President James D. Wolfensohn, the Report is about one third of the world's population. It "drives home the utter necessity of both liberalizing economies through opening trade and market opportunities and stabilizing them through reducing inflation and practicing fiscal discipline--and then of sticking to these policies over time."

Divided in two parts, the first one describes "the challenge of transition" and includes the following chapters: 1) patterns of reform, progress, and outcomes; 2) liberalization, stabilization and growth; 3) property rights and enterprise reform; and 4) people and transition.

The second part describes "the challenge of consolidation" and includes the following chapters: 5) legal institutions and the rule of law; 6) building a financial system; 7) toward better and slimmer government; 8) investing in people and growth; and 9) transition and the world economy.

A definition of the process of transition is attempted in the introduction, while the final chapter draws the main lessons from the experience of these economies in transition.

The process of transformation of a centrally planned economy is more than the adoption of economic reforms, because it entails "systemic change." According to the report, "transition is different. It is not simply the adoption or modification of a few policies or programs but a passage from one mode of economic organization to a thoroughly different one."

Transition is more than "economic engineering." To succeed it must "restructure the institutional basis of the social system and develop civil society," amounting to an "enormous

agenda" that comprises at least three sets of reforms. First, liberalization and stabilization; second, privatization and definition of property rights; and third, reshaping social services and the social safety net to ease the pain of transition.

The description of this profound process of change demands answering several questions.

First, the differences in transition policies and outcomes among countries can be explained by "the interplay between choice and circumstance," or by the application of policies and by the legacy of geography and history, or what is termed the "inherited structure of the economy."

Second, the question "most often asked in the study of transition" is about the effectiveness of rapid or gradual reform. The report says that there is "no single or simple answer" to this question. However, the most impressive performance is that of gradualist China, "the fastest growing economy in the world since market reforms began in 1978." Therefore, the report concludes against gradualism that "for most transition economies, the answer to the key question about the pace of change is now clear: faster and more consistent reform is better."

Third, the report addresses the issue of how can social policies "ease the pain of transformation while propelling the process forward." The answer is that "direct measures to alleviate poverty" are essential, such as safety nets, targeting, and generous access to pensions.

Admitting that there is "no unique blueprint," the rest of the report describes the reforms that are necessary to consolidate the transition. Such as strengthening the rule of law; the development of effective financial systems through financial sector reform; government must restructure itself, to facilitate private sector activity rather than supplant it; and health and education systems must be reformed to increase their effectiveness and flexibility.

All these transformations must happen with the simultaneous integration of these economies into world markets, for "locking in" the reforms and for the benefit of "the rest of the world and the transition economies themselves."

To conclude, the report presents an agenda for the providers of foreign assistance to the process of transition. The challenge is "to provide assistance that facilitates and encourages the move to the market rather than substitutes for it."

I. 4. THE LYON SUMMIT (WDW/20/96 10 JULY 1996)

In an election year, for the President of the United States, a successful G-Seven Summit is an event that happens without major disasters. This was the case of the most recent Lyon Summit, attended by the heads of state or government of the seven major industrialized economies--Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

However, this also gives ground to the usual questions about the relevance of these gatherings. For instance, former French President Valery Giscard d'Estaing commenting on the G7 meeting said that "the fact that it has become a spectacle, weakens its usefulness." Also, former President George Bush said that "there is a certain irrelevance to the G7 meetings."

In the same vein, C. Fred Bergsten, the head of the prestigious Institute for International Economics, in a book titled Global Economic Leadership and the Group of Seven, co-authored with Randall Henning, says the meetings are "becoming increasingly ineffective and are failing to counter low growth."

To the defense of the G7 process came out Deputy Secretary of the Treasury Lawrence Summers, in remarks made on the eve of the Lyons Summit to the Emerging Markets Traders Association, in New York, on June 24.

Deputy Secretary Summers described G7 accomplishments in two issue areas. First, on macroeconomic policy and exchange market cooperation, a "strong focus on economic fundamentals" has led to relative exchange rate stability without inflexibility and to low inflation, increased fiscal discipline and smaller external imbalances. The shining achievement is the "orderly reversal" of exchange rates among the major currencies, agreed on April 1995. Second, to meet the new challenges in global capital markets, such as the Mexican crisis, there is a new consensus "about the macroeconomic policy requirements for financial stability."

The main elements of this consensus are that, in a world of capital mobility, "sound policies matter." Also, "exchange rate flexibility is a good thing" and finally, "capital controls cannot substitute for good policies."

Institutionally, the consensus is reflected in an improved method of early warning and stronger surveillance by the International Monetary Fund (IMF). Additionally, an increased role for the market to facilitate the resolution of crises, but accompanied by an expansion of the financial safety net.

The economic communiqué issued at the end of the Lyon Summit reveals that an even wider agenda was covered.

The preamble deals with the challenges and opportunities of globalization and it contains the following sections: I) strengthening economic and monetary cooperation; II) promoting strong and mutually beneficial growth of trade and investment; III) enhancing employment policies; IV) a new global partnership for development; V) the effectiveness of multilateral institutions; VI) multilateral support for development; and VII) successful integration of the economies in transition.

Several highlights can be drawn out from this lengthy and substantial communiqué. For instance, the communiqué decisively broadens the agenda of the next Ministerial Conference of the World Trade Organization (WTO), scheduled for next December in Singapore.

Besides the integration of environmental protection into the multilateral trading system, the Singapore Ministerial will address other issues, such as investment, competition policy, new industrial tariff initiatives, labor standards, market access, standards and norms, government procurement and intellectual property.

One of the most controversial issues in the area of investment and trade was caused by the adoption in the United States of the Helms-Burton Act, which threatens with sanctions some corporations that do business in Cuba.

The outcome was reflected in the following, very indirect, wording of the communiqué: "We reaffirm our commitment to working to strengthen the confidence in and credibility of the multilateral trading system by avoiding taking trade and investment measures that would be in contradiction with WTO and OECD codes."

However, President Chirac was more direct when he said, "I don't think economic retaliation is most effective. Taking an entire population hostage is not elegant."

Some progress was registered on the indebtedness of the poorest countries. The communiqué says "we look forward to a concrete solution being agreed by next Autumn."

Finally, on the institutional aspects concerning the functioning of the United Nations, the communiqué attempts to micro-manage some changes. For instance, it mandates the placement of the existing three Secretariat departments responsible for development "under the authority of a single Under Secretary General," who will also serve as Executive Secretary of the Economic and Social Council.

These are only some of the highlights that appear in the economic communiqué. Also, in the wake of the bombing against a U.S. Army installation in Saudi Arabia, the Summit approved a 40-point plan to combat crime and terrorism.

Briefly, those who believe that the results of the Lyon Summit were irrelevant should look again.

I. 5. INTERNATIONAL MONETARY COOPERATION (WDW/21/96 17 JULY 1996)

In today's world, of flexible exchange rates and vertiginous capital movements, it is legitimate to inquire what are the main traits of the present international monetary system.

Recently, Lawrence Summers, Deputy Secretary of the Treasury of the United States, tried to answer this question, in remarks made to the Emerging Markets Traders Association, on the eve of the Lyon Summit (WDW/20/96, p.7).

Deputy Secretary Summers recalls that the roots of the process of consultation among the industrialized economies, known as the Group of Seven, can be found in the field of international monetary cooperation.

Sometimes this is forgotten, because the G-7's attention has frequently turned toward relatively more urgent matters, such as multilateral trade liberalization, the debt crisis of the developing countries, the evolution of the transition economies and, more recently, the reconstruction of Bosnia.

However, since the consultations among the governments of the most industrialized economies have a "core monetary mandate," the question is how this consultation process has responded to the "major challenges facing the international monetary system."

To be sure, there remain doubts about the existence of such a system today, particularly among those who suffer from "nostalgia for a return to some lost era of stability."

Today's system confronts the following two main challenges, emanating from, first, macroeconomic policy and exchange market cooperation and second, from the functioning of global capital markets.

Today's cooperative process focuses more on "economic policies and the underlying economic fundamentals," rather than on "explicit, formalized exchange rate arrangements."

The basis of this is the "fundamental reality that the only path to enduring exchange market stability is through the pursuit of sound economic policies." Hindsight reveals that "all the major sustained exchange rate misalignments of the floating rate period . . . have been the consequence of some adverse policy mix or fundamental shift in one of the major countries."

Additionally, exchange market intervention has been used more selectively. The reason is that "intervention is less effective when it is widely telegraphed and anticipated, when it is perceived as a substitute for action on the fundamentals, and when employed in the face of strong market pressure in the other direction."

Finally, the process has become more effective, but less formal, by producing fewer communiqués. This has reduced the "distraction of artificial, but consuming, debates about communiqué language." Also contributing to effectiveness is a deliberate effort at "avoiding the overly strident locomotive debates of the past."

Still, there are those who persist in preaching "the false promise of greater coordination." They "argue that the next frontier for the G-7 is to move to a more formalized system of exchange rate arrangements for the major currencies."

Deputy Secretary Summers frontally contradicts this, saying "I do not believe that a more formalized process of exchange rate management would be desirable, or feasible in the present economic environment."

Some "maintain that by simply wishing exchange rates into a band we can keep them there with adroit smoke and mirrors at no real cost." For Deputy Secretary Summers "this was a debatable proposition twenty years ago. In today's capital markets it's not remotely credible."

Others "maintain that we should be prepared to devote economic policy to the achievement of a specific exchange rate objective." However, "even if this were desirable it would be difficult given that the speed with which exchange rates move and the time in which legislatures take to act essentially render fiscal policy unavailable for this purpose."

For the large economies, which are not dependent from international trade, "directing monetary policy at an exchange rate objective would entail real costs, costs in the form of misguided macroeconomic policies, and costs in the loss of flexibility to respond to unanticipated shocks."

Still others see both a "formalized exchange rate and policy commitments" as a "source of external discipline." However, counters Under Secretary Summers, "at no time during the post war period has there been a greater acceptance of the fundamental importance of sound monetary policy and fiscal discipline as there is now."

Be it as it may, the record is invoked to support the Churchillian argument in defense of democracy, that the present system of flexible exchange rates is "far from perfect but better than the known alternatives."

For instance, "by some measures, volatility among the major currencies has fallen by one third to one half." Also, "trade, direct investment and capital flows have continued to expand rapidly despite the fact that we now exist in a flexible exchange rate system among the major currencies."

For these reasons, Under Secretary Summers concludes, the record supports the assertion that "the current system is the best system for the American economy and the best system for the world economy."

I. 6. NEW CHALLENGES IN GLOBAL CAPITAL MARKETS (WDW/22/96 24 JULY 1996)

In his remarks on the eve of the Lyon Summit (WDW/21/96, p.20), Deputy Secretary of the Treasury Lawrence Summers also described some new challenges emanating from today's global capital markets.

In Deputy Secretary Summers' own terms, the "most dramatic" of these challenges "arise from the rapid growth and rapid integration of the emerging markets into the world economy and the international financial system."

First, emerging market economies are growing faster than the G-Seven economies, at rates of 6.5 and 2.5 percent, respectively. According to the Managing Director of the International Monetary Fund (IMF) Michel Camdessus, these economies have achieved "autonomous growth, separate from that of the industrial countries." To the point that if current rates of growth persist for the next ten years, "in 2004, the output of the developing countries will outstrip that of the industrial countries."

Second, Deputy Secretary Summers recalls that "net private capital flows to developing countries have risen dramatically over the last 10 years from about \$25 billion in 1986 to over \$165 billion in 1995."

Finally, according to Deputy Secretary Summers, the composition of these capital flows to emerging markets has "changed fundamentally." From the early 1980s, "when syndicated bank loans were the predominant form of private finance to developing countries," to 1995, when "foreign direct investment accounted for over one-half of private flows and funds raised in security markets comprised one-third."

In this context happened what the IMF's Managing Director characterized as the "first crisis of the 21st century." According to Michel Camdessus, "the 21st century began in late December 1994, when the markets demonstrated, by the intensity of their reaction to a Mexican devaluation that failed because of the lack of credible policies to accompany it, just what globalization means."

Among other consequences, Deputy Secretary Summers said that the Mexican experience revealed the existence of a "new consensus about the macroeconomic policy requirements for financial stability and the appropriate macroeconomic policy response to the 'too much of a good thing' problem of managing capital inflows." The following are the key elements of this consensus.

First, "in a world of capital mobility" it makes a big difference to have in place the "right policies." These comprise "sound monetary and fiscal policies aimed at achieving sustainable growth with low inflation, strong fiscal positions, strong and sustainable current account

positions, high levels of domestic savings, open trade policies, and structural reforms that reduce the risks" caused by capital inflows.

Second, for Deputy Secretary Summers, "exchange rate flexibility is a good thing." In his terms, "it's a good idea to give the exchange rate regime the flexibility to adjust, whether it is to absorb part of the effects of a large and sustained capital inflow or to accommodate some shift in economic fundamentals, domestically or externally."

The IMF's Managing Director disagrees. Admitting that he is in the minority, Michel Camdessus regrets that the exchange rate stability "put in place by the Plaza and Louvre Accords have been, if not abandoned, at least allowed to slumber by the G-7." However, Deputy Secretary Summers counters, "experience has shown that exchange rates, once fixed, are difficult to unfix, and very few countries have orchestrated a smooth and successful exit."

One exception is admitted, fixed exchange rates may be used as "nominal anchors" by countries "trying to restore price stability after a period of hyperinflation." Still, Deputy Secretary Summers comes out clearly against those who "maintain that by simply wishing exchange rates into a band we can keep them there with adroit smoke and mirrors at no real cost."

Finally, "capital controls cannot substitute for good policies," despite the appeal of so-called "silver bullets," such as "speed bumps" to slow down inflows, taxes, or other measures "to transform short-term presumably volatile money into long-term secure investment." Experience "still suggests that the economic distortions and macroeconomic costs induced by controls are more costly than the potential benefits." With one "reasonable exception," when a weak banking system may justify setting up capital controls on flows into banks.

The prevailing consensus has led to institutional reforms to respond to these new challenges. New warning and prevention mechanisms have been adopted at the IMF, in the form of "strong standards of public disclosure of economic and financial data and a new focus on strengthening supervisory standards in the financial systems of emerging markets."

Additionally, sovereign liquidity crises should not necessarily require the mobilization of official finance. For instance, the Group of Ten has said that they are "unlikely to be willing to provide substantial amounts of official financial assistance to deal with all sovereign liquidity crises." Also, Treasury Secretary Rubin has declared that the United States "cannot be the lender of last resort to the world economy."

Just in case, the existing financial safety net has been expanded, doubling the \$25 billion available through the General Agreements to Borrow (GAB), by including 24 new countries.

I. 7. THE IMF'S SECOND WORLD ECONOMIC OUTLOOK (WEO)
(WDW/29/96 16 OCTOBER 1996)

This year's second WEO was released by the staff of the International Monetary Fund (IMF), as usual, almost a week before the inauguration of the annual meetings of the World Bank and the Fund (WDW/28/96, p.66).

According to the IMF staff, "global economic and financial conditions remain generally encouraging." The present "global economic expansion is expected to continue at a satisfactory pace in 1996-97 and over the medium term,"

By contrast with "a disappointing performance recently in continental western Europe," among the emerging market countries in Asia, "the strength of economic activity is particularly impressive."

The industrialized countries have all been successful in the containment of inflation, but "growth and labor market performance have remained uneven." In much of continental Europe, "in response to the faltering of growth in the second half of 1995 and in view of the approaching deadline for Economic and Monetary Union (EMU), the policy mix has shifted toward tighter budgetary policies and easier monetary conditions."

The same unevenness is found in the performance of the developing countries. There, "despite the growing number of success stories, many countries continue to struggle with macroeconomic imbalances and structural impediments that keep their living standards well below what they are capable of achieving."

Finally, in the transition economies, although "considerable improvements in inflation performance, there is still a need to continue the reform process and to achieve and safeguard greater macroeconomic stability."

In these uneven conditions, the rate of expansion of world output is projected at 3.8 percent and 4.1 percent, for 1996 and 1997, respectively. These projections are "little changed" from those presented in May of this year in the first WEO (WDW/12/96, p.1). This means, in other words, that there were not enough surprises since May to justify a revision of the original projections.

The United States remains exceptional, given the sharp slowdown experienced in 1995 by almost all the other industrialized countries. In the United States the achievement consists of "a high level of employment and maintaining growth at close to its potential rate with low inflation." This is "partly attributed to an exceptionally dynamic and flexible labor market that has accommodated a growing labor force and facilitated macroeconomic management."

By contrast, Japan's economic recovery only gained momentum in the second half of 1995. This was accomplished after the successful application of policies "to counteract the deflationary forces stemming from falling asset prices and difficulties in the banking sector and to correct the excessive appreciation of the yen in the early part of 1995."

In Germany, the slowdown of 1995 widened "the large unification-related structural budget deficit that emerged in 1990-91," pushing the actual fiscal deficit to 4 percent of GDP in 1996.

For the developing countries the projection in 1996 and 1997 is for growth to remain close to 6 percent, the same as in 1995. The expectation is that growth will resume in Argentina and Mexico, that it will strengthen in Africa, while "the expansion moderates in a number of Asian emerging market countries."

In the developing countries of the Western Hemisphere, based on the recovery of Argentina and Mexico, growth is projected at 3 percent in 1996 and 4 percent in 1997. Among this group of countries, Chile is characterized as "the most successful economy," where concerns about overheating "continue to warrant some degree of monetary restraint." Brazil is praised for "reigning in inflation," which in August 1996 reached "only 8 1/2 percent . . . the lowest 12-month rate since 1973." Still, "fiscal consolidation and structural reforms, especially trade liberalization, are essential."

The Mexican economy is recovering, with growth expected to "become firmly established in the period ahead." Also, Argentina's growth is resuming, while it is "currently enjoying the lowest inflation rate in more than fifty years." Finally, Venezuela's economic program is "designed to restore confidence, reduce inflation, and set the stage for a resumption of growth in 1997."

The advanced copy of the WEO was released in two volumes on September 25, 1996. The first part contains the "main report" and it includes the following chapters: I) global economic prospects and policies; II) world economic situation and short-term prospects; III) policy challenges facing industrial countries in the late 1990s; IV) financial market challenges and economic performance in developing countries; V) long-term growth potential in transition countries; VI) the rise and fall of inflation--lessons from the postwar experience.

The second part contains "supplementary analysis," including the following annexes: I) the difficult art of forecasting; II) the world oil market: recent developments and outlook; III) the world current account discrepancy; IV) capital inflows to developing and transition countries--identifying the causes and formulating appropriate policy responses.

The WEO's final version will be released by the end of October, including the complete statistical appendix, which already appears in the advanced copy released "solely for the convenience of the media."

I. 8. THE LARGEST MARKET IN THE WORLD (WDW/35/96 27 NOVEMBER 1996)

Those interested in globalization and in finding manifestations of this phenomenon should look at the center of the world financial system. There lies what a recent study by the International Monetary Fund (IMF) characterizes as "the largest, the most liquid, the most innovative, and the only 24-hour global financial market in the world."

There, according to the last evaluation by the Bank for International Settlements (BIS) of April 1995, \$1.2 trillion were transacted every day, up from \$800 billion in 1992. In a single week, operations in this market amounted to the GDP of the United States, or to the total amount of world trade for a whole year.

At the core of the international financial system and through the global network of interbank payments, operates the foreign exchange market. In this mega-market, around 150,000 transactions take place every day, mostly denominated in dollar, yen, or deutsche mark, with several of these individual transactions exceeding \$500 million.

To appreciate the imposing magnitude of the global foreign exchange market, the IMF recalls that "the next biggest financial market is thought to be the market for U.S. government securities," where average daily turnover, in April 1995, amounted to \$175 billion a day.

The IMF also estimates that the "average daily turnover in the world's ten largest stock markets together amounted to about \$42 billion in 1995, still only 3 percent of the volume recorded by the foreign exchange markets."

In any working day, transactions in this "only truly global, 24-hour market," start in the Far East, where Tokyo is the dominant player, while Singapore and Hong Kong are growing fast. From there, foreign exchange transactions pass by Bahrain in the Middle East on their way to Europe, where London dominates, with intense activity also in Zurich and Frankfurt. This 24-hour cycle concludes in New York, the second most active foreign exchange market, after London. Thus, when both New York and London are open, the peak hours of foreign exchange trading take place. By contrast, activity decreases between the end of the day in New York and the opening of Far Eastern markets.

The IMF considers a "striking feature" of these markets that most of the transactions are between domestic and foreign banks, estimating that "between one half and three quarters of the turnover is cross border."

A typical dealer participates in a daily average of between 3,000 and 4,000 operations, with some prices moving vertiginously, at a pace of 20 times per minute in the main currencies. Thus, the dollar-deutsche mark exchange rate can change "up to 18,000 times in a single day." Also, during the most active moments, a typical dealer can execute one transaction every two to four minutes.

With 83 percent of all transactions, in April 1995, the dollar remained the dominant currency, while the deutsche mark accounted for 37 percent and the yen for 24 percent. Geographically, London remained the most active market, increasing from 27 percent in 1992 to 30 percent in 1995. New York was second with 16 percent, both in 1995 and 1992, with Tokyo still in third place, but decreasing from 11 percent in 1992 to 10 percent in 1995. Singapore remained in fourth place with 7 percent in 1992 and 1995, while Hong Kong in 1995 displaced Switzerland from the fifth place.

However, the foreign exchange market is highly centralized, since about two-thirds of the transactions are between a few bank dealers. Only 16 percent of all transactions are carried out by nonfinancial customers and 20 percent correspond to other financial institutions. Other indicators of increased concentration are that the top twenty banks active in New York's foreign exchange market, in 1995, accounted for 70 percent of the market, up from 60 percent in 1992. In London, the top twenty foreign exchange dealers are all banks and they accounted in 1995 for almost 68 percent of trading.

Briefly, the IMF describes the following three as the "most striking structural features" of the foreign exchange market: "1) trading volume is enormous, 2) the share of interbank trading is very high, and 3) the transparency of order flow is very low."

The "enormous" amounts transacted, exceeding by far the amounts of trade in goods and services, is explained because each time goods and services are transferred across borders may involve several currency transactions.

However, among these "structural features" of the foreign exchange market can be found some of the main risks and sources of concern. First, the possibility exists that insolvency of one major player may disrupt the market by causing a chain reaction of settlement failures. Second, due to the concentration of the market among a few major international banks, a disruption can affect the stability of the global banking system. Finally, in case of a disruption, the central banks may be called upon to exercise their role of lenders of last resort, because most of the mayor players are money center banks that enjoy access to the liquidity provided by central banks.

According to the IMF, "it is not uncommon for a major international bank to have unsecured overnight foreign exchange settlement exposures that exceed its capital." Also, "a bank's total foreign exchange settlement exposure can, and at times does, exceed its capital." No wonder, the risk of disruption in the global foreign exchange market "has become and important concern" to the Group of Ten central banks and to market participants.

II. THE U.S. ECONOMY

II. 1. OMINOUS OPTIMISM FOR 1996

(WDW/1/96 24 January 1996)

To believe James K. Glassman, from the Washington Post, it is ominous that almost all economic forecasters agree about the rate of growth of the U.S. economy for 1996, at around 2 percent. Such unanimity led the New York Times to describe 1996 as "the year of the big yawn."

For instance, more than 90 percent of the 64 economists that participate in the Wall Street Journal's semiannual survey agree that, in 1996, the U.S. economy will enter its sixth consecutive year of expansion. The consensus forecast predicts an annual rate of growth of the gross domestic product (GDP) of 1.8 percent in the first semester and 2 percent in the second semester.

Furthermore, there is wide consensus that the U.S. economy will not fall into a recession this year and that the "soft landing" accomplished by the Federal Reserve will persist. Therefore, the pattern of moderate growth with low unemployment and low inflation is projected to last throughout the year.

Differences appear when the forecasters are asked to predict the start of the next recession. For instance, one fifth of those surveyed by the Wall Street Journal see a recession by the end of 1996, coinciding with the November elections. By contrast, the number of those surveyed who foresee a recession starting in 1997 increases to one third.

Anyhow, the present expansion has already exceeded the average duration of postwar expansions. According to Michelle Laughlin of Sanwa Securities in New York, quoted in the Wall Street Journal, December marked the 57th month of this economic expansion, exceeding the 50-month average duration of post war expansions.

However, not everybody agrees with the optimists. A small group of dissenting pessimists, all of them also quoted in the Wall Street Journal, sees a recession in the very near future.

For instance, Maureen Allyn, chief economist at Scudder, Stevens and Clark, predicts GDP growth of 1 percent for the first half and a contraction of 0.7 percent in the second half. Ms. Allyn sees falling corporate profits, a "dramatic deceleration" in capital spending and consumers too deep in debt, leading to a "consumer-led recession."

Another pessimistic scenario is presented by Elliott Platt, director of economic research at Donaldson, Lufkin & Jenrette of New York. Mr. Platt holds that the soft landing foreseen by many will not last, because the economy has not been submitted to sufficient fiscal and monetary stimulus.

The only two postwar soft landings described by Mr. Platt, when growth slowed without the economy falling into a recession, were preceded by decisive fiscal and monetary stimulus. The first was during the Vietnam War, in 1967, and the second was the expansion in U.S. exports helped by the sharp devaluation of the dollar of 1986.

According to Mr. Platt, presently, there is not enough domestic fiscal and monetary stimulus and almost all the rest of the world is experiencing a slowdown, particularly Latin America, Western Europe and Japan. Therefore, Mr. Platt forecasts 1.5 percent GDP growth in the first half of 1996 and 0.8 percent in the second half.

Finally, Susan Sterne of Economic Analysis Associates of Stamford, Connecticut, forecasts that the big slowdown in growth will take place in the first half of this year. According to Ms. Sterne, consumer demand has been falling for more than a year and there is buildup of inventories. Therefore, Ms. Sterne holds that a "minirecession" is already taking place.

Be it as it may, the main difficulties with these forecasts derive from the fact that 1996 is an election year. First, Stuart Hoffman of PNC Bank of Pittsburgh, quoted in the Wall Street Journal, points out that recessions have happened only twice, in 1960 and 1980, during the 12 postwar presidential election years. Contrastingly, six of the nine postwar recessions have taken place the year after presidential elections.

Turning around the analysis, the question is if the election will be influenced by the behavior of the economy. For instance, a statistical model by Yale University Professor Ray Fair, described by Peter Passell in the New York Times, finds that each percentage point of inflation reduces the votes for the incumbent by 0.83 of a percentage point, as each percentage point of growth increases the incumbent's vote by 0.65 percent. Finally, every quarter of more than 4 percent growth gives one percentage point to the incumbent party.

This model has been very accurate, by less than 2 percent, for explaining past elections, going as far back as 1916. The only exception was the last election of 1992, when Professor Fair's model missed the outcome by 3.4 percent. Unfortunately, this year's election, still remains too close to be accurately called.

Another model is by Alberto Alesina of Harvard and John Londregan and Howard Rosenthal of Princeton. This model predicts that an increase of 1 percentage point in the rate of growth gives an advantage of 1.45 per cent to the vote for the incumbent.

Therefore, warning that these models may have to be taken with a "generous dollop of salt," Peter Passell draws the reductionist conclusion that the results of this year's election may still be in the hands of the Federal Reserve.

II. 2. THE STATE OF THE UNION (WDW/2/96 31 JANUARY 1996)

President Clinton's masterful delivery, last week, of the State of the Union speech, unavoidably became an act of the political campaign, which had already started by the end of last year with the budgetary debate. R.W. Apple in the New York Times saw the President "talking like a front-runner," while David Broder in the Washington Post saw both the President's speech and Senator Dole's response as "the first debate of the 1996 campaign."

In that context, the President was also seen as trying to present a synthesis between seemingly irreconcilable issues. For instance, his most quoted remark proclaimed that the "era of big government is over." However, it was qualified by the assertion that "we can't go back to the era of fending for yourself."

Admitting that "more Americans are living better," the President immediately recognized that "too many of our fellow citizens are working harder just to keep up." Also, for the President "self-reliance and teamwork are not opposing virtues; we must have both." Recognizing that the country is moving "into the era of balanced budgets and smaller government," the President also asserted that "there are some areas that the federal government should not leave and should address and address strongly."

Some of these areas were presented as constituting challenges, on families; on economic security; on world leadership; on education; on crime and drugs; on the environment and on government.

Moreover, these two positions, which the President is seen as attempting to reconcile, coexist openly within the administration. On one side appear those who emphasize "pocketbook issues," such as wage stagnation and more spending on education and training. Therefore, the President challenged the Congress to raise the minimum wage. But in the same vein, the President challenged employers to "share the benefits of the good years as well as the burdens of the bad ones." On the other side appear those who are pressing for emphasizing "values-based issues," such as protecting children and the environment. Therefore, the President challenged parents, businesses, the media, the schools, the communities and the government "to help children make it." Additionally, businesses and communities were also challenged "to take more initiatives in protecting the environment."

According to Alison Mitchell, from the New York Times, with this synthesis, the President is trying to reach out to at least two constituencies. First, presenting a message that cuts across classes, by addressing some of the insecurities that exist basically among the middle class, such as fears of crime and of declining schools. Second, the other message addresses some of the insecurities that prevail among the salaried majority, such as job insecurity, stagnating wages and widening income gaps.

Steven Pearlstein, in the Washington Post, saw the President pursuing these two objectives, by appearing both as "rosy optimist and dissatisfied critic." In these terms, Pearlstein remarked that the President refused to accept the "false choice" between self-reliance and collective action.

Both perspectives are also well represented within the President's inner circle of advisors. For instance, Mr. James Carville, the President's political strategist in the 1992 campaign, is for emphasizing "pocketbook issues." Paraphrasing the slogan of the 1992 campaign Mr. Carville says that this time the "No. 1 is the paycheck, stupid." By contrast, Dick Morris, the President's current political strategist, prefers "values-based issues," such as protecting children, changing the welfare system, education, Medicare and the environment.

Within the cabinet, Secretary of Labor Robert Reich is in favor of emphasizing economic issues such as cutting corporate tax breaks, raising the minimum wage and increasing spending for education and training. By contrast, Secretary of the Treasury Robert Rubin is concerned about presenting these issues along class lines, in a way that antagonizes the business community.

White House press secretary Michael D. McCurry described the expected outcome of this intense debate as leading to "the effective fusion" of these two positions, that coexist within the administration, "into one bigger idea."

Last week's speech was evidence of the way such a synthesis will be presented by the President to the electorate during the campaign. As described in the Wall Street Journal, the campaign is already centered around what an editorial characterized as the "historic challenge now facing virtually all the world's people in the post-Cold War era." This "great challenge for elected leaders," according to the Journal, is "to help their people climb off the safety nets erected for a dangerous world and prepare now to compete in the economy of the 21st century."

By contrast, in less solemn and perhaps more skeptical terms Keith M. Rockwell said, in the Journal of Commerce, that Tuesday night President Clinton displayed "an uncanny ability to exploit a dichotomy in the American electorate, which wants ever-smaller government and ever-more federal programs."

II. 3. WHEN WILL THE RECESSION COME? (WDW/4/96 14 FEBRUARY 1996)

Practitioners of naval artillery know that the first shot goes across the bow. The same cannot be said of practitioners of economic policy. They cannot afford the freedom of engaging in such trial and error techniques, but they inadvertently overshoot anyway.

Beyond the fact that 1996 is an election year, the debate about economic policy perspectives in the United States is now centered on the question of when the next recession will come (WDW/1/96, p.17). Unfortunately, the art of economic forecasting cannot yet predict with certainty the exact date of arrival of business cycle whims. Such certainty only exists Post Festum, or after the fact.

To be sure, there is no discussion about the coming of the next recession. At issue is when it will start and some even say that it has already started. Others predict the coming recession based on the extraordinary length of the present expansion, which is moving already into its 60th. month, well beyond the 50-month average of all postwar expansions.

Almost everybody agrees with Stephen Roach of Morgan Stanley, quoted in the New York Times, saying that "expansions do not die a natural death. In the end they are murdered by the Fed." Therefore, the name of the game is "Fed-watching." As if economics had the capacity of turning on or off, at will, the ups and downs of the business cycle.

Those who see the recession starting by the beginning of next year, see the Fed relaxing, erasing the interest rate increases approved in 1994. They do not see many signals that will lead the Fed, soon, to pull out the gun again and start shooting.

For instance, the Journal of Commerce's "crystal ball for 1996," said "the U.S. economy is structurally sound, with no recession in sight. Productivity is increasing, unemployment is low, American companies are increasingly competitive and the budget deficit is coming down. Still, consumer spending, the economy's main engine is weak. Look for moderate economic growth of 2.2 percent in the new year."

However, some dangerous optimists in financial markets are already rejoicing for the death of inflation. Somebody even predicted that, at a rate of 20 points per working day, the Dow would reach 10,000 by the year 2,000. They have pushed the Dow Jones industrial average beyond the 5,600 mark, embarrassing those that have been crying wolf during the Dow's sustained surge of 14 months and 1,800 points.

The last issue of the bimonthly Prospects of the Swiss Bank Corporation (SBC) warns that instead of looking only at consumer price inflation as a whole, in the United States, more attention should be paid to core inflation.

While the first fell between, April and October, from 3.1 percent to 2.8 percent, due to a decline in gasoline prices, "core inflation," excluding food and energy, bottomed by the end of 1994, indicating a resurgence in prices.

Still others, as Robert Barbera from Capital Investments International quoted in the New York Times, see the economy already "slightly in deflation." Barbera holds that the Consumer Price Index (CPI) in the United States is overstated. Quoting Leonard Nakamura from the Federal Reserve Bank of Philadelphia, Barbera sees the CPI overstated by as much as 2.5 to 3 percent. Consequently, "at present you essentially have more than a hundred percent of the measured inflation as measurement error."

No wonder, Peter Passell from the New York Times described how big corporations in the United States have lost "faith in computer-model economic forecasting." These corporations have dismantled their in-house forecasting capabilities and are relying more on managing risk through hedging and other techniques. They still purchase forecasts from outside companies, such as DRI/McGraw Hill, or what was known as Wharton Econometrics, now WEFA.

Therefore, more than a matter of lack of resources, the forecasting techniques based on computer simulations of the economy have lost the appeal that they enjoyed in the sixties. Humbly, Stephen McNees, former vice-president of the Federal Reserve Bank of Boston, recognized in the New York Times that these models "aren't good at timing issues--say which quarter the recession will begin." Yale Professor Ray Fair, described as "one of the few academics who still focuses on the field," admits that the art of economic forecasting has "stalled."

Politicians, apparently are aware of the limitations of forecasting techniques. They show more concern about who will be blamed, rather than about predicting the exact time when the recession will happen. They are probably also informed that, as declared by Stuart Hoffman of PNC Bank of Pittsburgh, quoted in the Wall Street Journal, recessions have happened only twice, in 1960 and 1980, during the twelve postwar presidential elections.

Finally, politicians are also aware that six of the nine postwar recessions have happened during the year following presidential elections. Thus, inflation is not dead, the exact dates of recessions cannot be accurately predicted and the business cycle is still around, unforeseeable.

II. 4. THE ECONOMIC STATE OF THE UNION (WDW/5/96 21 FEBRUARY 1996)

Last week, President Clinton sent to the Congress the last Economic Report of his present mandate. In the letter of transmission, the President characterizes the U.S. economy as "healthy and strong" and as "the healthiest of any major economy."

Looking ahead, President Clinton describes a strategy aimed at deficit reduction and investment in people, "to ensure that all Americans can become winners in economic change." This is necessary because, over the past two decades, "middle class earnings have stagnated," and "poorest families saw their incomes fall."

To address this challenge the President proposes an "economic agenda . . . to promote growth and to bring the fruits of that growth within reach of all Americans." The main components of this strategy are:

- 1) balancing the budget in seven years respecting "fundamental values," without cutting "Medicare, Medicaid, education, or the environment and without raising taxes on working families";
- 2) preparing workers through education and training;
- 3) increasing economic security, through health insurance reforms, more extensive pension coverage, increasing the minimum wage and cutting taxes for hard-pressed working families;
- 4) creating high wage jobs through technology and exports;
- 5) a government that is smaller, works better, and costs less, since "the era of big, centralized, one-size-fits-all government is over."

This year's annual report of the Council of Economic Advisers (CEA), which appears after the President's message of transmission, celebrates the CEA's fiftieth anniversary. It expands on each of the strategy's elements and contains the following chapters: 1) economic policy for the 21st century; 2) macroeconomic policy and performance; 3) making fiscal policy choices within and across generations; 4) devolution; 5) economic efficiency and regulatory reform; 6) promoting competition in traditionally regulated industries; 7) investing in education and training; 8) the United States in the world economy.

The Report describes the reduction in the Federal budget deficit, as "a major part" of the macroeconomic policy implemented in the past year. However, deficit reduction is not "an end in itself," it is "a means to achieving higher living standards," by preserving and enhancing investments in people, businesses and the environment.

1995 is characterized as a year of "moderate growth and reduced pace of job creation." This is presented as evidence that the U.S. economy has "moved from recovery following the 1990-91 recession to sustained growth." Otherwise, since the economy was operating at near full

capacity by the end of 1994, "higher growth in the short term probably could not have been accommodated without a rise in inflation."

The moderation in growth that followed, during the first half of 1995, is explained as an effect of the increases in interest rates approved by the Federal Reserve, during the previous year, reinforced by the economic crisis in Mexico. First quarter growth in 1995 was estimated at an annual rate of 0.6 percent. However, the "magnitude of the moderation . . . seems clear in retrospect but was harder to read at the time." Meanwhile, inflation "remained remarkably low and stable," at "less than 3 percent per year for the past 4 years, for the first time since the 1960s."

This "impressive record" is cited as evidence that "a regime change has taken place, by which households and businesses have come to expect low inflation for the foreseeable future." The "best news" of 1995 was that "inflation remained low and stable despite an unemployment rate that in the past was associated with rising inflation."

The current economic expansion, in February, reached 59 months, becoming the third longest and exceeding the average of 50 months for postwar expansions. Furthermore, the Report sees no signs that the present expansion is coming to an end.

The absence of signals of a downturn ahead, such as rising inflation, rising interest rates, financial imbalances, banking sector troubles, or an inventory overhang, lead to a positive short term forecast.

Therefore, the present economic expansion is projected to persist in 1996. Real GDP is projected to grow this year at 2.2 percent and the core rate of inflation, excluding food and energy prices, is expected to remain unchanged at 2.8 percent.

Finally, the seven-year forecast projects an increase in real GDP of 2.3 percent, starting in 1997, while unemployment is projected to remain at 5.7 percent and inflation to fall to 2.8 percent, and remain there throughout the forecast period.

There are risks in the forecast. One of them comes from the assumption that "monetary policy will be calibrated to offset the ongoing effects of fiscal contraction." Additionally, a downturn in foreign economic growth may also hurt the forecast.

In the short run, "the economy may hit a pothole in the first quarter of 1996," due to bad weather in the East and to the effects of government shutdowns. Even so, "the economy is expected to rebound and the growth rate over the four quarters of 1996 is likely to be unaffected."

II. 5. THE SLOW GROWTH "MYSTERY" (WDW/23/96 31 JULY 1996)

To prepare his annual report, Charles M. Vest, President of the Massachusetts Institute of Technology (MIT), asked faculty members to enumerate unanswered questions in each of their fields of specialization.

President Vest believes it is more fruitful and relevant, for "practical concerns," to exploit the "enthusiasm for mysteries" and the "readiness to explore the truly unknown." As described in the Washington Post, President Vest's annual report presented an impressive list of unknowns in several disciplines.

For instance, on the functioning of the mind, we do not know how we learn and remember, or how we think and communicate, neither do we understand the relationship between language and thought.

On the weather, we do not know what climate changes can be predicted, or where and when a serious earthquake will happen.

On the universe, we do not know its age and composition, neither where is it heading.

On energy, we do not know how to use solar energy efficiently, neither how to avoid wasting most of the fuels we burn.

On health, of course, we do not know the gene mutations that cause cancer or that allow tumors to develop.

On information, we do not know how the availability of electronically stored and transmitted information can or will be used and understood.

Finally, on economics, we do not know why economies grow and what explains differences in economic performance.

As evidence of this last ignorance, a recent G7 Daily Briefing, on the performance of the three most industrialized economies, illustrates today's slow growth "mystery."

In Germany, "the problem is that there is no readily apparent catalyst for renewed growth: Domestic consumption remains dormant, fiscal policy will stay painfully contractionary, the DM has lost some of its second quarter competitiveness and domestic investment lacks significant punch." In Japan, there is "a recovery that is moderate at best and still vulnerable to numerous growth-retarding obstacles." Finally, in the United States, "the economy appears to be cooling substantially," at a moderate growth pace.

According to Harvard Professor Robert Lawrence, "when it comes to prospects for growth, America is actually doing about as well as (or as poorly) as Europe and Japan." The ongoing debate about the causes of the slowdown is lively. Some blame technological change and international competition, while others blame producers of services, for not applying technologies that raise productivity.

However, Professor Lawrence notes, "no one has yet come up with a complete explanation for why it has happened and a full prescription for what should be done about it." Therefore, since "no one has yet solved the productivity slowdown mystery," concludes Professor Lawrence, this is "something like the economists' version of cancer."

The concern about slow growth has also come to the southern part of the Western Hemisphere. University of California Los Angeles (UCLA) Professor Sebastian Edwards has produced a paper titled The Disturbing Underperformance of the Latin American Economies.

The paper was presented to the last Interamerican Dialogue's Plenary meeting, on 17 May 1996. It is Professor Edwards' valedictorian from his position as Chief Economist for Latin America at the World Bank, before returning to his tenured position at UCLA's Graduate School of Management.

In Latin America and the Caribbean, according to Professor Edwards, the problem is that "after almost a decade of reform effort the region has relatively little to show in terms of improved economic performance and social conditions. Poverty has not been reduced; growth has been modest, at best; in many countries real wages are below their 1980 level; and employment creation has become sluggish."

From this lethargic behavior, Professor Edwards draws two conclusions. First, "an increasing number of people are becoming disillusioned and are beginning to look at alternative policy alternatives." Second, "the only way to avoid a return to populism is to generate, sooner rather than later, a significant revival of growth."

The difficulty is that experts and policy makers do not know how to respond to the challenge. Also, fast growing economies, such as those of East Asia and even Chile in this Hemisphere, only compound the difficulty. After all, economics does not yet have an answer to the question of why some grow fast while others slumber.

What is to be done? Professor Lawrence's response is "we do not know how to cure cancer, but we do know many things that improve the odds of survival." The same with economics, "we do not know the cure for the slow growth in living standards but can be pretty sure that improved education, better technology, more public and private investment, and increased trade are likely to help."

II. 6. PLANTED IN THE CENTER (WDW/33/96 13 NOVEMBER 1996)

The voters last week decided to express their preference for the center, splitting their ballots to reelect President Clinton and preserving the Republican majority in Congress.

Both parties can claim major victories. The President is the first Democrat since FDR, only the third in this century, to win a second term. For the first time since 1930, the Republicans retained control of both the House and the Senate for more than two successive years.

The economy helped again President Clinton, confirming Seymour Lipset's assertion that it still is the most accurate predictor of electoral behavior. For instance, an analysis of GDP growth rates in postwar election years reveals that an average rate of 4.6 percent prevailed when the incumbent was reelected, while an average of 2.98 percent prevailed when the incumbent was defeated. An annualized rate of 3.4 percent for the first half of 1996 was enough to reelect the President, still below the average and quite under the average 6 percent rate that has prevailed in five of the last eight election years.

In these times of fiscal stringency, however, it was exceptional that the rate of growth in this election year was not supported by an expansionary fiscal policy. Every election year since 1960 has seen the ratio of the structural (cyclically adjusted) federal budget balance to GDP become more negative. The fiscal performance of 1996 departs from this pattern, because robust growth is happening despite a modest tightening of fiscal policy. The Congressional Budget Office (CBO) revealed that in 1996 the cyclically adjusted deficit decreased to 2 percent of GDP, from 2.8 percent in 1994.

Even so, Republicans retained control of Congress, despite losing approximately 10 seats in the House and winning two seats in the Senate. Exit polls revealed that half of the voters approved the present Republican Congress, with half also hoping for a divided government, if the President was elected to a second term. Therefore, Republicans will maintain control of the House by a margin of 225 to 208 and they increased their control of the Senate by two with 55 Senators.

The results were immediately interpreted as strengthening the moderates and conciliatory statements were promptly issued by the leadership of both parties. Far from indicating a "realignment," the election revealed the Democrats in control of the Northeast, the Upper Midwest and the Far West, while the Republicans control the South and the Midwest.

What emerged was characterized by an observer as an almost unprecedented equilibrium between both parties, reflecting a political system in transition toward an indeterminate future, in which the center will prevail until there are clearer definitions. Briefly, the election indicated preference by the voters for moderation and bipartisanship.

Therefore, the President moved swiftly, the next day, to reorganize his White House staff and cabinet, which ignited rumors that at least one position in the cabinet would go to a Republican. Within the Republican camp the situation remained less clear, with the Senate Majority Leader Trent Lott (R-Miss) emerging as a leader. Still, the Republicans were seen as coming out of the election divided in the following five factions: traditional conservatives, moderates, America firsters, moralists and supply-siders.

No wonder, Senator Lott declared that they were willing to let President Clinton come up with his agenda. He said, "the president is sort of entitled to the first at bat. We're not going to rush out there and start trying to pass X number of bills in the first 100 days."

The prevailing equilibrium does not allow the President too much margin in setting the agenda. Domestically, the trend toward fiscal conservatism will continue, with significant constraints on federal spending growth likely to continue in the medium and longer term. In this context, there will be increased pressure for the reform of mandatory spending programs, such as Medicare and Social Security. As a result, the federal budget deficit will continue declining and generating favorable reactions in the markets, as those seen in the aftermath of the election.

The opportunity for the President to reveal the agenda for the next four years will come with the presentation of the budget for fiscal year 98 and the State of the Union next year. The President has said that he is seeking to "create a vital center."

Meanwhile, the transition will consist of the replacement of almost all the President's cabinet. Except Treasury Secretary Robert Rubin, who stays as a symbol of continuity for the markets, the search for replacements has already started. Therefore, the battles over principles and over ideas will rapidly become battles over persons.

In foreign policy, except emergencies such as those in Zaire and Rwanda, the agenda will be decisively influenced by funding decisions. Therefore, one of the first issues to emerge in the foreign policy arena will be the funding of the State Department and of multilateral institutions. Another issue that will demand attention early in the President's second term is the application of the Helms Burton Law. Finally, trade relations with China will rapidly demand immediate attention, as will also whether the President will demand and obtain "fast-track" authorization to negotiate new trade agreements. Stay tuned.

III. THE DEVELOPING ECONOMIES

III. 1. PROSPECTS FOR THE DEVELOPING ECONOMIES (WDW/13/96 22 MAY 1996)

This year's Global Economic Prospects and the Developing Economies 1996 was released by the International Economics Department of the World Bank, on May 7. According to Michael Bruno, the Bank's Senior Vice President for Development Economics and Chief Economist, "the participation of developing countries in the accelerated pace of integration over the past decade has been marked by large disparities."

Global economic integration means "the widening and intensifying of international linkages in trade and finance." As measured by the ratio of world trade to GDP, global integration increased three times faster, during 1985-94, than in the preceding decade. Also, in the same period, foreign direct investment (FDI) doubled as a share of global GDP.

Based on the performance of these indicators in 93 developing countries, the REPORT concludes that these countries are part of the trend toward global economic integration. The ratio of trade to GDP for the developing countries has increased at the same pace as that of the industrialized economies, and their share in all FDI increased to almost two fifths.

However, the Report also describes wide disparities among the 93 developing countries observed. For instance, the ratio of trade over GDP decreased for 44 countries, while it only increased moderately for 17 countries. Thus, three quarters of the "remarkable increase" in the trade/GDP ratio "over the last decade was accounted for by just ten countries." Additionally, the relative participation of developing countries in the world's total FDI increased to 38 percent, but "two-thirds of these flows went to just eight developing countries."

The analysis is based on a "speed of integration index," drawn from changes, between the early 1980s and early 1990s, in the following four indicators: the ratio of real trade to GDP; the ratio of foreign direct investment to GDP; credit ratings for each country from the magazine Institutional Investor; and the share of manufactures in exports.

These indicators allow for classifying the 93 countries into the following four categories: fast, moderate, weak and slow integrators.

By region, among the fast integrators in East Asia appear almost all the fast growing exporters, such as Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand. In Latin America and the Caribbean only five countries make it to the category of fast integrator: Argentina, Chile, Costa Rica, Jamaica and Mexico. In the Middle East only Morocco is

classified as a fast integrator, while only Ghana and Mauritius are so classified in Sub-Saharan Africa. Finally, in Europe the Czech Republic, Hungary, Poland and Turkey are fast integrators.

Three main conclusions are drawn from this classification. First, countries classified as fast integrators also exhibit the highest rates of output growth. Second, the speed of integration is also influenced by the adoption of policy reforms aimed at growth and stability, such as macroeconomic stability, realistic exchange rates, and open trade and investment regimes. Third, the availability and maintenance of adequate economic infrastructure is also required, particularly telecommunications and transport.

To avoid the impression that it is enough for the developing economies to do the "right things," the Report recognizes the existence of "serious external obstacles" to their integration into the world economy. To illustrate some of these obstacles the Report focuses on antidumping practices, agricultural protection, and the Multifiber Agreement (MFA).

Most of the countries classified as "slow integrators" are dependent on exports of primary commodities, or those where primary commodities account for more than half of their total exports. However, the Report tries to dispel the fatalistic conclusion that slow integration may be correlated to exports of primary commodities.

The cases of Chile, Indonesia, Malaysia and Thailand, are highlighted as "fast integrators" that are also successful exporters of commodities. These successful performers exhibited the following characteristics: 1) high productivity in existing commodities, with high per capita growth in capital stocks and income; 2) spectacular diversification into nontraditional commodities, such as fruits, vegetables, or shrimp; 3) fostering productivity, through strengthening the private sector, attracting foreign capital and technology, enhancing research and development, and promoting financial flexibility.

To conclude, the Report presents a set of positive long-term projections for the next decade, based on the existence of a "broadly favorable" international environment, characterized by: 1) modest but steady rates of growth in the industrial countries; 2) lower inflation and world real interest rates; 3) significant growth in private capital flows, due to moderate world real interest rates, continued liberalization among the recipients, and portfolio diversification by investors; 4) strong growth in trade volumes, averaging over 6 percent a year; 5) gradual decline of the boom in non-oil commodity prices.

Based on these favorable assumptions, overall growth in the developing economies is projected to accelerate to 5.4 percent over the next decade. For Latin America and the Caribbean growth is projected at 2.6 percent in 1996-97 and to accelerate to 3.8 percent between 1996-2005.

III. 2. FISCAL POLICY ISSUES IN DEVELOPING COUNTRIES (WDW/18/96 26 JUNE 1996)

This is the title of the second of three chapters dedicated in the last World Economic Outlook (WEO) to fiscal policy challenges (WDW/12/96, p.1).

By contrast with the industrialized countries (WDW/17/96, p.3), the good news is that the developing countries enjoy some advantages in the nature of the fiscal challenges they confront.

First, they can avoid some of the mistakes that have led to the ballooning of public debt in the industrialized countries. In the terms of the WEO, the developing countries should avoid the costly explosion in pension entitlements which "have contributed to increasingly unsustainable fiscal burdens" in the industrialized countries.

The other advantage is that in the developing countries there is still ample room for improvement on the revenue side of the fiscal equation. For instance, the rise in public deficits and debt ratios in most industrialized countries has not taken place because of a lack of revenue. Public revenues have increased in the industrialized countries from 28 percent of GDP in 1960 to 44 percent in 1994. In the developing countries, by contrast, central government revenue represented 18 percent of GDP between 1990-95. Therefore, it is on the side of revenues where are found some of the main fiscal policy challenges.

Finally, a "marked improvement" has taken place in the fiscal balances of many developing countries, which has led the central government deficit-to-GDP ratio, for all developing countries, to decline from 5.5 percent in 1983-89, to 3 percent in 1990-95.

To be sure, these averages mask significant variations among countries. For instance, "the strongest improvement in fiscal balances has been among the developing countries of the Western Hemisphere," where fiscal deficits have fallen "from almost 4 1/2 percent of GDP in the mid-1980s to under 1/2 of 1 percent of GDP in 1990-95."

This is not the case in Africa, where the average fiscal deficit has declined, but remained at 4 percent of GDP in 1995. Still, the role model are the Asian developing countries, particularly the strong growth performers, where fiscal deficits on average declined to 2.3 percent of GDP.

However, there is no room for complacency. According to the WEO, in the 1970s and 1980s, "upward trends in public spending were associated with government attempts to accelerate the process of development and industrialization through state involvement in economic activities." In many cases, fiscal imbalances were "the underlying cause of macroeconomic instability," as in Argentina, Brazil and Mexico in the 1980s.

By contrast with the 1970s and the 1980s, the WEO finds that "there is now widespread consensus on the need for fiscal discipline, on the associated benefits in terms of monetary and financial stability, and economic growth and development, and on the need for constraints to be placed on the size and role of the public sector."

The constraints can be found in the enforcement of at least three basic instruments of "fiscal consolidation." First, the reduction of public employment; second, tax increases and third, the privatization of state-owned enterprises.

One main difficulty is that some of these measures can have adverse consequences, in the short run, on the real incomes of domestic consumers. This is the case of the removal of subsidies, the relaxation of price controls, and currency devaluations. Specifically, the WEO recognizes that "the adverse effects of adjustment and reform on the poor and vulnerable need to be addressed through well-targeted and cost-effective social safety nets."

Other major difficulties are essentially political, such as those generated by attempts to reduce public sector employment.

Tax increases can also be complicated by the tax structure, particularly for those governments that still rely on taxes on international trade. Between 1975-90, trade taxes in all the developing countries accounted for almost 30 percent of total fiscal revenue, while they represented only 3 percent in the industrialized countries.

Furthermore, difficulties in increasing tax revenues are among the main factors that explain the propensity of governments in developing countries to "pursue fiscal objectives partly through quasi-fiscal means."

Finally, the reduction of employment in public enterprises is an essential condition for their privatization.

Still, the WEO draws conclusions from a comparison between the performance of developing countries in the 1980s and the size of their fiscal deficits. This comparison reveals that those with "small fiscal deficits (or surpluses) had markedly higher growth rates than countries that had moderate or large deficits."

Even admitting that large fiscal deficits may be the result of slow growth and of "external difficulties," the conclusion is that "the experience of many developing countries suggests that weak fiscal discipline, indicated by persistent fiscal deficits, does reduce growth over the long term."

For instance, "countries that had large deficits in the 1980s experienced real GDP growth of only about 3 percent in the 1990-95 period compared with growth of almost 7 percent in small deficit countries.

III. 3. THE DISPARATE DEVELOPMENT "MYSTERY" (WDW/24/96 11 SEPTEMBER 1996)

As in medicine it is still unknown what causes cancer, in economics many "mysteries" remain unsolved. For instance, there is no accepted explanation for slow growth, neither for why some economies grow faster than others.

Why there are disparate rates of growth was among the main topics of a conference sponsored by the Inter-American Development Bank (IDB), held last week at the Bank's headquarters.

This conference is evidence that the IDB has not only surpassed the World Bank in lending operations in Latin America and the Caribbean. The IDB is also assuming the role of agenda setter in the field of development in the Hemisphere. The presence at last week's conference on "development thinking and practice" of virtually everybody that counts, as a development thinker and practitioner, illustrates the new role the IDB is playing as leading the debate about the substantive aspects of economic development.

Among the most salient issues that served as background to the conference figured prominently the question of how Latin American countries, after years of painful and costly adjustment, still have to achieve rates of growth that show they are overcoming poverty.

By contrast, on the conference agenda appeared also the question of how the East Asian economies, in two or three generations, have accomplished spectacular rates of growth that have allowed them to reduce poverty significantly. Briefly, the question is what is it that the East Asians are doing right and what is wrong with Latin American and Caribbean economic performance.

To be sure, with such an agenda and background, the conference witnessed some fascinating clashes of different viewpoints, some manifestations of complacency and of triumphalism, and even some cries of nostalgia for simpler and easier times.

A conference highlight was a luncheon address by Deputy Secretary of the United States Treasury Lawrence Summers, who came to remind the participants in the conference that, after all is said and done, there are "no shortcuts to development."

At the outset, Deputy Secretary Summers admitted that as there has been "unprecedented progress," in the last quarter century, there has also been "enormous diversity of experience" and "striking dissimilarities." For instance, he contrasted the impressive average rate of growth in Asia of 7 percent last year, with the dismal average of growth of 1-2 percent per year for Africa, "in good years." He also described how "income distribution in East Asia is much more equitable than in Latin America." The example he used was Indonesia's richest fifth getting five

times more income than the poorest fifth, while in Brazil and Guatemala these same ratios were 32 and 30, respectively.

Speaking to those who think there is an alternative way, Deputy Secretary Summers was emphatic in warning that "there are no shortcuts," because of the following five unavoidable points. First, "avoid inflation--macrostabilization is a first step." Second, avoid price and exchange controls, "let markets set prices for goods, services and currencies." Three, protection breeds inefficiencies, therefore open trade regimes and allow economic integration. Fourth, state-owned enterprises perform poorly, thus "privatize state-owned companies." Finally, regulation may strangle the economy, consequently, "reduce the size of government by eliminating excessive regulation."

Consensus on these five propositions is not given. Using the example of Russia, Deputy Secretary Summers illustrates the "shortcut" option describing attempts to adopt "reflationary policies," or trying "to get government back into the business of allocating resources."

The "Russian shortcut" contrasts with Deputy Secretary Summers alternative of "austerity with adjustment." The purpose is not to impose austerity alone, it is necessary to adjust, "to ameliorate the pains of austerity, at least for the poor."

For instance, in Latin America expenditures have to be adjusted, particularly those that privilege the already affluent, or that overinvest in new facilities, while underinvesting in maintenance. It is also essential to "adjust revenues," by broadening tax bases and improving collection. Finally, the adjustment of both revenues and outlays will contribute to raising national savings and to generate resources, "to cushion the impact of austerity on the poor."

Furthermore, Deputy Secretary Summers holds that stabilization is not enough, the reform process has to be pushed to the next stage, through the development of financial markets and the reform of legal systems. This also shows that governments must play an "important role." Mainly by "investing in people," in education and in health care. Finally, "for reform to succeed in the long-run, everyone must share in its benefits." This requires political consensus built in open political systems.

For Deputy Secretary Summers the bottom line is that development is more than "low inflation rates or vibrant stock markets, although these are important. The ultimate objective of development is improved living standards for all people."

However, the mystery of why some accomplish this objective, while others lag behind, remains unsolved. "We don't know all the answers. Far from it, " Deputy Secretary Summers concluded, "but we have learned a lot."

III. 4. TWO ATTITUDES ON DEVELOPMENT (WDW/25/96 18 SEPTEMBER 1996)

Several years before the end of the Cold War, before the world economy became one, Albert Hirschman said that "development economics," as a separate discipline was in decline. In Hirschman's terms, as in physics, "there is only one economics."

The attempt to create a separate discipline to deal with the peculiarities of the developing economies failed, according to Hirschman, because it could not resist the onslaught from both neo-classic and neo-marxist economics.

At the conference sponsored by the Inter-American Development Bank (IDB) on development thinking (WDW/24/96, p.33), Harvard Professor Amartya Sen presented a paper on "Development Thinking at the Beginning of the 21st Century." According to Professor Sen, there is no such decline and there are at least two distinct approaches to development theory.

To begin with, Professor Sen rejects the dichotomy between the state and the market, for several reasons. He refuses to accept "the rather common generalization that the development experiences show the folly of state activism and the unconditional merits of the pure market economy."

For example, Western Europe "successfully guaranteed broad social security," while Japan and East Asia "had much government leadership in transforming their economies as well as society." The same can be said about how "public education and health care have been pivotal in bringing about social and economic change."

Also, "pragmatic policy has drawn both on the market and on the state" and governments can be "over-active and too interventionist," as when they want to control production, trade and competitiveness. Contrastingly, states have sometimes been "under-active" in education, health, gender equity and land reform.

Professor Sen concludes, "it is not particularly helpful to try to see the lessons in terms of a 'confrontation' between the market and the state." Therefore, "to comprehend what the market can do so well need not involve ignoring what the state can -and does- achieve, nor entail seeing the market mechanism as a free-standing success irrespective of state policy."

Instead, Professor Sen proposes the following two approaches to development. The first approach, called BLAST, is that there is no development without sacrifice, paraphrasing Churchill, without "blood, sweat and tears." By contrast, the other approach, called GALA, "sees development as essentially a 'friendly' process, with a focus on helping each other and oneself."

However, to avoid falling into another neat dichotomy, Professor Sen holds that it is a "distinction between two major attitudes to development, each of which can occur in a pure or in a mixed form." Additionally, he admits that he is "more impressed with GALA, because the accomplishments of BLAST have been heavily oversold."

Sacrifices as requirements for development have taken many forms, such as "low welfare, high inequality, intrusive authoritarianism." One example of this approach is based on the "overwhelming need for accumulation," understood as "the formation of physical capital," at the expense of "human resources."

Some shortcomings of this approach, baptized as "accumulation blast," have to do with the "comparative neglect of the well-being and quality of life in the present." For instance, how can present deprivations be valued, or what is the role of "human capital."

Therefore, "a GALA view of development provides a more natural way of seeing the interdependence between the enhancement of human welfare and of the expansion of productive capacity and developmental potential."

By contrast, Professor Sen concludes, in the BLAST alternative, "paying much attention to distributional concerns and to equity would seem, in this perspective, to be a mistake at early stages of development." Trickle down should be enough, because "deliberate attempts to hasten the sharing would only mess up the formation of the forceful stream from which the trickles would have to find their way down."

Another "hardness" in the BLAST approach argues that calls for democracy and human rights cannot be afforded at the early stages of development. In other terms, the question is if there is a "conflict between civil and political rights on the one hand and economic development on the other."

Professor Sen sees no conflict between "economic success," as among the East Asian countries, and social policies. "There is nothing whatsoever to indicate that any of these social policies is inconsistent with greater democracy, or could be sustained only through the authoritarianism that happened to be present in South Korea or Singapore or China."

The same can be said about the relationship between famines and the absence of political and civil rights, a topic that has occupied Professor Sen's attention in the past. "No substantial famine," he concludes, "has ever occurred in any country with a democratic form of government and a relatively free press."

Finally, Professor Sen concludes "the rejection of the 'hard state' that denies the importance of human rights (including the political rights to open public discussion) is, thus, complementary to the rejection of other forms of hardness that view development as a terribly "fierce process." To substantiate his argument he quotes Adam Smith on the advantages of public action: "for a very small expence the publick can facilitate, can encourage, and can even

impose upon almost the whole body of the people, the necessity of acquiring those most essential parts of education.

III. 5. THE EAST ASIAN "MIRACLE" REVISITED (WDW/26/96 25 September 1996)

At the conference on "development thinking and practice," held at the Interamerican Development Bank (IDB), much attention was paid to the East Asian development experience (WDW/24-25/96, p.33, 35). Among other reasons, because the Japanese Government financed part of the costs of the meeting.

Again, the question was asked what is it that the East Asian countries have done right, by contrast with what the Latin American countries have done wrong. Briefly, the question was if there are any lessons that can be drawn from the East Asian experiences that are relevant for Latin America and the Caribbean.

Beyond the financial support, the Japanese interest in the conference manifested itself in the presentation of the inaugural address by the highest ranking technocrat from the Japanese Ministry of Finance, Mr. Eisaku Sakakibara presently Director-General of the International Finance Bureau.

Additionally, several prominent Asian academics participated in the conference. Among them were some well-known Japanese experts on Latin America, such as Professors Akio Hosono, from the University of Tsukuba and Mitsuhiro Kagami from the Institute of Developing Economies (IDE), both former staff members of ECLAC.

Mr. Sakakibara's inaugural address set the tone of the meeting by asking if globalization implies that there is a "universal model or uniform set of rules," as envisaged in the so-called "Washington consensus," characterized as "free markets and sound money."

For Mr. Sakakibara, with the process of "globalization," simultaneously, there is a process of "localization," or "an identification with local values." Therefore, "the rather monolithic view held by many governments in the developed world and international organizations that there is only one universal model to which all countries in the world should adhere is quite problematic."

According to Mr. Sakakibara, today, there are at least three kinds of capitalism. Following the classification of Western capitalism into two categories, the Anglo-Saxon and the Rhine-Alpen suggested by a French banker, he proposes the addition of a third category, "a Japanese or, potentially, an East Asian category."

In a similar vein, Professor Ajit Singh from the University of Cambridge presented a paper titled Catching Up With the West: A Perspective on Asian Development. The purpose of Professor Singh's paper is to review the East Asian experience, "to draw analytical and policy implications."

First, Professor Singh considers "no exaggeration to say that post-World War II economic expansion in a number of Asian countries are the most successful examples of industrialization and fast growth over a sustained period in the entire history of mankind." Reviewing the East Asian experience in the eighties, he finds "impressive increases in the average standards of living of the population, reductions in poverty, increasing real wages and rising employment." The stark contrast with Latin America is appalling.

However, of more interest are the policy issues that Professor Singh draws from his reading of Asian experience. He points out that there is a "continuing controversy" about these policy issues, "in which the main protagonists are the World Bank with some orthodox economists on one side and a number of academic economists, not all of whom are heterodox, on the other."

The central differences between both sides, according to Professor Singh, are on the following issues: i) the effectiveness of industrial policy; ii) how open were the East Asian economies; iii) the nature of competition in domestic markets; iv) the role of savings and investment; v) why the Asian economies did not have a debt crisis; vi) the relationship between technology policy, industrial policy and international competitiveness; vii) the relationship between macroeconomic stability and industrial policy.

Professor Singh does not try to answer all these significant questions, he only focuses on "just one of the main issues, that of savings and investment." Considering the case of Japan and Korea, the analysis is based "on the dynamics of the accumulation process (mediated through high profits) the associated technical change and the growth of productivity rather than on static resource allocation and getting prices right or wrong."

Some astonishing lessons for Latin America are drawn from this description. First, "the East Asian countries have not followed the 'market friendly' approach" that the World Bank tried to discover in its analysis of the "miracle." Government intervention in that part of the world was practiced through "vigorous and purposeful industrial policies."

Second, presently, the East Asian countries have been "reluctant liberalizers." Because, "contrary to the Bretton Woods institutions," these countries "have not sought close integration with the world economy.

Third, the Latin American countries have "enthusiastically reduced tariffs and trade barriers as well as capital controls." Therefore, "the central issue is: will the liberalisation experiment succeed in terms of evoking and adequate supply response?"

Unfortunately, recent rates of growth in Latin America show that such a response has yet to come. Therefore, Professor Singh asks, "if adequate supply response continues to be elusive, at what point will the architects of the Washington consensus be willing to admit that the experiment has failed?"

IV. TRADE

IV. 1. THE ISOLATIONIST IMPULSE (WDW/6/96 28 February 1996)

Those that dismiss the recent results of the New Hampshire primary, as ephemeral campaign rhetoric, should think again. The victory scored by presidential hopeful Patrick J. Buchanan has caused shivers within the Republican Party, in corporate boardrooms, and among those who took for granted the solidity of the bipartisan consensus on free trade.

Even those who hold that the Buchanan victory is the result of his running against four moderate conservatives admit, without hesitation, that more is involved.

First, Mr. Buchanan is credited with reflecting the dissatisfaction of less-skilled and less-schooled workers, from the lower and middle class, whose compensation has been declining.

The last economic report of the President's Council of Economic Advisers (WDW/5/96) revealed that, from 1948 to 1973, overall real compensation increased 3 percent a year. By contrast, in the last twenty years since 1973, the annual rate of increase has been 0.7 percent. However, a breakdown of this last figure reveals that average real wages of male high school dropouts and male high school graduates fell 20 and 27 percent, respectively, during the same period.

No wonder, exit polls are showing that most Buchanan supporters have incomes of less than \$100,000. Additionally, about two-thirds say that the most important issue influencing their decision was abortion, while more than half say it was foreign trade or immigration.

A woman, who disagreed with Mr. Buchanan's proposal to outlaw abortion, declared in the New York Times that she supported him because "her husband was working two jobs and that she was working six days a week cleaning houses."

Ms. Carol Deane, in Nashua, New Hampshire, said her "parents were able to buy a brand new house on my father's salary, and he worked at a job that didn't even require a high school degree." Thus, Ms. Deane concluded, "something's gone wrong."

Furthermore, Ms. Deane declared that she supported Mr. Buchanan because "the so-called elites," described as "international businessmen, career politicians, bankers," did not "understand what working people were going through."

Second, with the call for protectionism, Mr. Buchanan is drawing on basic national ideology and pushing the Republican Party back to its traditionally protectionist posture.

A recent paper by Seymour Lipset and Jeffrey Hayes, on The Social Roots of U.S. Protectionism, points out that in the United States the first 150 years after independence, with the support of the Republican Party, were of "largely uninterrupted protectionism." Free trade and internationalism have prevailed, since World War II, as part of the anticommunist bipartisan consensus.

However, Lipset and Hayes hold that the "American creed," of anti-statism, individualism, populism and egalitarianism, justifies both "isolationism/unilateralism and internationalism." The "Creed" has "rationalized not one but two seemingly polar opposite perspectives on America's role in the world."

Moreover, "isolationist/unilateral tendencies were never very far beneath the surface because American ideology continues to legitimize them." Particularly the "populist element of the American Creed also contributed to the continuing vitality of inward looking trade politics."

Alfred Eckes, former chairperson of the International Trade Commission (ITC) and author of a tariff history of the United States, claimed in the New York Times that "Mr. Buchanan best exemplifies traditional Republican thinking on trade issues." Thus, Mr. Eckes congratulates Mr. Buchanan for having "reinvigorated the economic nationalist tradition in the Republican Party."

In these terms, Mr. Buchanan's campaign has already inhibited Republican support for free trade. For instance, Senator Dole, the front-runner in the race for the Republican presidential nomination, has come out against starting new trade negotiations, for the time being.

This has signaled an interruption of the bipartisan consensus that, since World War II, supported the assumption of leadership by the United States in opening the world trading system.

Some consequences of this breakdown of consensus are already evident, for instance, in the Administration's lack of negotiating authority and in the interruption of previously announced trade negotiations, such as for Chile's accession to the North American Free Trade Agreement (NAFTA).

It remains unanswered if this breakdown of consensus is only a temporary interruption, caused by the intensity of the political campaign. Or if it signals the end of the bipartisan support for free trade and internationalism, which existed during the years of the Cold War.

It may be that as the Great Depression and the World War inaugurated a period of active internationalism and free trade, the end of the Cold War may be opening the door to a period of introspection and protectionism.

Then, the protectionist stance adopted by candidate Pat Buchanan, rooted as it is in profound causes, could be the initial expression of a more radical turn toward isolation.

IV. 2. BARRIERS TO U.S. EXPORTS (WDW/14/96 29 MAY 1996)

The eleventh National Trade Estimate Report on Foreign Trade Barriers was released, as mandated by law, on March 31. Section 311 of the Uruguay Round Trade Agreements Act (1994 Trade Act) requires the U.S. Trade Representative "to submit to the President, the Senate Finance Committee, and appropriate committees of the House of Representatives, an annual report on significant foreign trade barriers."

The annual presentation of this report has set an example, because other trading partners of the United States, such as Canada, the European Union, Japan and Latin America and the Caribbean, also release their own reports describing the barriers confronted by their exports in the U.S. market.

The law requires that the U.S. report should contain "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." Additionally, the report also "provides a valuable tool in enforcing U.S. trade laws." This means that the report's conclusions are used to draw the lists of countries that will be submitted to investigations for alleged discrimination against U.S. exports and violations of intellectual property rights. Such investigations are carried out unilaterally according to the much dreaded 301 and "super 301" legislation.

Trade barriers are defined broadly by the report, as "government laws, regulations, policies, or practices that either protect domestic products from foreign competition or artificially stimulate exports of particular domestic products."

Barriers are classified in the following nine categories: 1) import policies; 2) standards, labeling and certification; 3) government procurement; 4) export subsidies; 5) lack of intellectual property protection; 6) services barriers; 7) investment barriers; 8) anticompetitive practices; and 9) barriers that encompass more than one category, such as bribery and corruption, or that affect a single sector. In this year's list, anticompetitive practices appear for the first time as a separate category.

Included in the report are "the largest export markets for the United States," amounting to 42 nations, with the Newly Independent States (NIS) of the former Soviet Union counted as a unit, Taiwan, Hong Kong, and two regional groupings, the European Union and the Gulf Cooperation Council.

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

As in last year's report, the same thirteen Latin American countries are cited again this year: Argentina, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Peru, and Venezuela.

Measured by the length of their citations Japan appears in the first place with 40 pages, second is the European Union with 24 pages, China is third with 16 pages and Korea follows closely with 15 pages.

Countries appear in the report listed alphabetically. The enumeration of the barriers is preceded by a description of the trade deficit or surplus with each partner, the amount of U.S. imports, exports and investment, and the rank occupied by the country as a market for U.S. exports.

Excluding Mexico, which ranks third, Brazil ranks fourteenth, as the most significant export market for the United States in Latin America.

Other Latin American countries come far behind in this ranking, Venezuela is twenty fourth, followed by Colombia twenty fifth, Argentina twenty sixth, Chile twenty eighth, Dominican Republic thirty second, Peru thirty ninth, Costa Rica fortieth, Guatemala forty second, Honduras fiftieth, El Salvador fifty second, and Nicaragua eighty first.

Not all the citations are negative. For instance, the report recognizes and commends all the Latin American countries for the unilateral reduction of trade barriers that they recently implemented. Also, the report recognizes the efforts at tariff unification and reduction undertaken by subregional integration schemes, such as the Andean Pact, the Central American Common Market, or MERCOSUL.

However, all the Latin American countries are cited for lack of intellectual property protection and for the erection of services or investment barriers.

For instance, in the case of Argentina, the report mentions the patent system for pharmaceuticals as "a contentious bilateral issue," considering insufficient the most recently approved legislation.

In the case of Brazil, recently approved phytosanitary standards, within MERCOSUL, are mentioned as raising difficulties for U.S. exporters, because of their implementation with insufficient advance notification. Also, Brazilian export subsidies appear cited for the first time in this year's report.

Chile's relatively clean record remains almost the same, while in the case of Colombia standards, testing and certification are cited for the first time, as well as television local content quotas.

IV. 3. THE U.S. TRADE POLICY AGENDA FOR 1996 (WDW/15/96 6 JUNE 1996)

It is not an easy task to present a positive trade policy agenda in an election year that has not been exactly hospitable to free trade. But Section 1541 of the Omnibus Trade and Competitiveness Act of 1988 mandates that "the President shall submit to the Congress during each year (but not later than March 1) a report on A) the operation of the trade agreements program . . . and B) the national trade policy agenda for the year in which the report is submitted."

Both requirements are contained in a single volume, issued on deadline by the United States Trade Representative (USTR), under the title 1996 Trade Policy Agenda and 1995 Annual Report of the President of the United States on the Trade Agreements Program.

For the first time, this year's report also includes, as chapter IV and annex I, the annual report on the functioning of the World Trade Organization (WTO), required by the Uruguay Round Agreements Act (1994 Trade Act). Additionally, the report includes, in annex II, a list of the trade agreements reached by the United States, since 1984, "which afford increased market access or reduce barriers and other trade distorting policies and practices by other parties to these agreements."

This is also the last major report on U.S. trade policy presented by Ambassador Michael Kantor, before his appointment as Secretary of Commerce to replace the late Ron Brown.

In the overall "review and outlook," which now sounds as a valedictorian, Ambassador Kantor describes the foundations of the Administration's trade policy agenda, based on the recognition of "four new realities that are shaping our world."

First, the "nation's strength begins at home." Second, "globalization and interdependence of the economies of the world is here to stay." Third, "in the post-Cold War world, trade has taken its place at the foreign policy table, alongside strategic and political concerns." Fourth, "trade is more important than ever to the U.S. economy."

To illustrate this last point, Ambassador Kantor presents some figures. For instance, in 1970, trade represented 13 percent of U.S. Gross Domestic Product (GDP), while in 1995 this figure was estimated to have reached 30 percent. Additionally, exports generated 11 million

jobs, which pay on average 13 to 17 percent more than non-trade jobs.

Ambassador Kantor also recognizes that "the U.S. market has hard limits on its growth," because of a mature economy and low population growth, which constitutes only four percent of world population.

Therefore, "to grow and prosper at home," the emphasis is placed on exports. The United States, Ambassador Kantor concludes, "must open the most lucrative markets in the rest of the world." Quoting President Clinton's speech at American University, of February 1993, "the key" is described as to "continue to welcome foreign products and services into our markets, but insist that our products and services be able to enter theirs on equal terms." The belief is that if the playing field can be leveled, "the American worker will do the rest." Thus, the aim is "to pursue an aggressive agenda to level the playing field for U.S. workers and companies."

The agenda consists of three pillars, characterized as "implementation, enforcement, and expansion of the trade agreements negotiated during the last three years."

Implementation means that "a major priority this year is to ensure that the members of the World Trade Organization are living up to the commitments they made during the Uruguay Round of multilateral trade negotiations." Besides working through the WTO committees, regional initiatives, such as the Free Trade Area of the Americas (FTAA), the Asia Pacific Economic Cooperation Forum (APEC), and the TransAtlantic Market Place, will also be used "to press for implementation of Uruguay Round commitments."

Enforcement means "promises are worth nothing without effective rules, dispute settlement procedures, and remedies." For this purpose, in January 1996, the US Trade Representative created a Monitoring and Enforcement Unit dedicated "exclusively to monitoring implementation of U.S. trade laws and trade agreements, determining compliance by foreign governments with their trade agreement obligations, and pursuing actions necessary to enforce U.S. rights under those laws and agreements." Some "tools" that will be used for enforcement are: dispute settlement mechanisms; sections 301 and Special 301 on intellectual property; Title VII on government procurement; Section 1377 on telecommunications; and the WTO agreements on subsidies and antidumping.

Finally, expansion means "to build on the regional and multilateral agreements already reached, seeking higher levels of obligations." For instance, "a primary challenge in 1996 is to continue building on the NAFTA, the FTAA, APEC, and TransAtlantic Market Place agreements." Additionally, multilateral negotiations will focus on topics left over from the Uruguay Round, such as market access for competitive industries; services; intellectual property protection; investment; standards; the environment; WTO accessions; the Singapore Ministerial; reauthorization of the expired Generalized System of Preferences (GSP); and approval of the Interim Trade Program for the beneficiary countries of the Caribbean Basin Initiative (CBI).

IV. 4. WILL 'FAST-TRACK' COME BACK? (WDW/34/96 20 NOVEMBER 1996)

A key issue in the foreign affairs agenda of the next Administration is the expansion of trade liberalization in the world (WDW/33/96, p.27). To be sure, this is an area where the Clinton Administration can show some credentials of effective bipartisanship, as evidenced by the approval and implementation of the North American Free Trade Agreement (NAFTA) and the Uruguay Round. The same can be said of the Republicans, since both the NAFTA and the World Trade Organization (WTO) were approved by solid Republican majorities.

However, the circumstances in Washington have changed so profoundly that it is risky and perhaps irrelevant to make projections solely based on experience. The key question now is if trade expansion belongs to the proverbial 'center' resulting from the new balance of power that prevails in Washington. Unfortunately, it is still premature to try to draw conclusions, because the signals do not yet point in a clear direction.

To try to draw such conclusions from the campaign is also fruitless, since trade liberalization practically disappeared from the electoral agenda, after the primaries held within the Republican Party. Also, the way trade was debated during the primaries made auspicious its disappearance from the campaign. At least, such respite left the door open for dealing with trade liberalization in a less polarized environment.

The first signals heard, after the election, point in the direction of reopening the debate about granting to the President 'fast-track' authorization to negotiate trade agreements. The immediate purpose is to overcome the standoff, which hindered coming to an agreement between the Administration and the Congress, about including labor and environmental standards in trade negotiations.

It is encouraging to note that the first positive indication about a willingness to compromise on 'fast-track' has come from Representative P. Crane (R-Ill), chairperson of the House Ways and Means Committee. Unidentified sources, quoted in The Washington Times, have said that Representative Crane favors giving the Administration "reasonable flexibility" to decide if labor and environmental standards should be part of trade deals.

The Administration may also be willing to compromise because obtaining 'fast-track' authorization would enhance its presence in previously agreed international engagements.

By the end of this month, the President will participate in the summit of the Asia-Pacific Economic Cooperation forum, in Subic Bay, Philippines, to discuss how to liberalize trade among the members by the year 2020.

Additionally, in December the World Trade Organization (WTO) ministerial will meet in Singapore, to start dealing with some issues left unsolved by the last Uruguay Round.

Finally, next year in May, 34 trade ministers of the Western Hemisphere will meet in Belo Horizonte, Brazil, to decide when and how to launch the negotiations to create a Free Trade Area in the Americas (FTAA).

Therefore, the basic elements for a compromise on future trade negotiations apparently exist, but they justify only moderate optimism. The reasons for moderate optimism are that the constituency in favor of freer trade seems to be shrinking.

According to a national poll commissioned by BankBoston, better known in Latin America as the Bank of Boston, conducted just before the past elections among 1,003 U.S. residents, a majority believes that free trade leads to fewer U.S. jobs. In the presentation of the results, Ira Jackson, Executive Vice President of BankBoston declared that "free trade is a loser for most Americans."

Some of the survey's results further illustrate that only a minority supports free trade. For instance, 54 percent believe free trade agreements "do more to increase foreign imports into the United States, while 29 percent believe they help U.S. exports more."

Also, 57 percent are against the approval of new trade agreements with Latin America and 36 percent are in favor. More impressive, 52 percent admitted that they favor less free trade than a year ago because of what they know about NAFTA and the Uruguay Round, while only 27 percent say their opinions are more favorable.

What these results show is that it is possible that the leaders of both parties will compromise and find a bipartisan solution for the promotion of trade liberalization. But such a compromise seems easy, when compared with the task of changing the perceptions shared by a majority of the public about the consequences of freer trade. Strong bipartisan leadership and cooperation will be required to overcome such misperceptions.

Only 25 percent of those surveyed define themselves as "free traders," in favor of eliminating all trade barriers to all markets. By contrast, 45 percent describe themselves as "fair traders," in favor of pursuing new agreements and of using sanctions to open closed markets. Finally, 23 percent see themselves as "protectionists," in favor of using barriers against foreign imports.

Notice that these opinions were expressed while the economy was experiencing a long period of moderate expansion, with mild inflation and low unemployment. It is not difficult to imagine what will happen at the conclusion of the present expansion.

V. TRADE LIBERALIZATION IN THE WESTERN HEMISPHERE

V. 1. THE CARTAGENA MINISTERIAL (WDW/9/96 20 MARCH 1996)

Major changes have taken place in the degree of support for the goal of building a Hemispheric free trade area, set at the Miami Summit for 2005. In the United States, these changes were generating legitimate doubts about the results that could be expected from the next ministerial meeting, to be held in Cartagena today and tomorrow.

The skepticism was so intense that just the fact that the meeting is taking place is in itself seen as a major accomplishment, particularly for the host government.

Some of the events that were clouding the meeting's prospects had to do mostly with domestic politics in the United States. After all, this is an election year, in which almost any controversial topic immediately becomes subject to the dynamics of the political campaign.

For instance, the approaching political campaign was responsible for the temporary breakdown of consensus on free trade, because each one of the major parties refused to confront openly its most protectionist constituents (WDW/6/96, p.40).

Additionally, in what was seen as more than a "coincidence," most of the key staff members of the Administration, in charge of Hemispheric affairs, decided to leave government. Among the highest ranking, Assistant Secretary of Commerce David Rothkopf joined Kissinger Associates; Assistant Secretary of State for inter-American affairs Alexander Watson will head the environmental organization Nature Conservancy; and the National Security Council member in charge of Latin America Richard Feinberg will become the dean of the school of international relations at the University of California in San Diego.

Finally, the recent refusal by President Clinton to certify that the government of Colombia was doing enough to combat drug trafficking, did not augur well for the Cartagena meeting.

For all these reasons, regardless of the results that will be accomplished, just holding the meeting is judged as an accomplishment. It should be granted that it is indeed remarkable how the participating governments have been able to separate trade issues from other more highly controverted political issues.

For example, in a departing interview granted to Richard Lawrence, the respected trade columnist from the Journal of Commerce, Richard Feinberg holds that "not enough credit has

been given to the quiet but solid achievements of the past year." Among these achievements, Feinberg mentions numerous ministerial meetings with the Secretaries of State, Treasury, Defense, Labor, Transportation, Commerce, and Trade. Also, an "A-team" will represent the United States in Cartagena, led by Secretary Ron Brown and Ambassador Mickey Kantor. In all, these high level contacts are evidence, according to Feinberg, that a Hemispheric free trade community is being built.

Be it as it may, the question is what concrete results can be expected to come out of the Cartagena Ministerial.

First of all, the Ministers will receive the reports of the coordinators of the seven working groups that were created in the Denver Ministerial of June 1995. On the basis of these reports, the United States has said that the Ministers will have to respond to the question of "where do they go from Cartagena."

The U.S. delegation has proposed that the Ministers agree on a date to kick off formal negotiations, sometime in 1997, and that they should also agree then on the "structure/organization" of the negotiations. The Vice-Ministers will be instructed to start exploring these issues.

A decision will also be made in Cartagena to create four additional working groups, that were not included in the last Denver Ministerial declaration. These new working groups will deal with the following topics: government procurement; intellectual property rights; competition policy; and services.

Other remaining issues are still subject to controversy, particularly between Brazil, leading the MERCOSUL delegation as a group, and the United States. An example of such a still controversial topic is the proposal by the United States that the Ministers make recommendations on how to address environmental and labor issues. According to Inside Nafta, this proposal is facing "nearly-unanimous opposition," from the Latin American and Caribbean representatives, who prefer the more neutral language contained in the Denver Declaration.

Another unresolved issue has to do with the U.S. proposal on "areas of immediate action." These were left undiscussed by the Vice-Ministers who met last week in Bogotá to prepare the Cartagena Ministerial. Also pending is the decision of where to hold the next ministerial meeting in 1997 and a proposal by Colombia and Chile, supported by Argentina, that the working group on subsidies start discussing domestic agricultural production subsidies.

Thus, the debate is lively and some results can be expected from the Cartagena Ministerial. As described by Richard Lawrence in the Journal of Commerce, the question is if Cartagena will add "big or little momentum." The answer, according to Lawrence, still depends from the existence of consensus in Washington. "Once that develops, Lawrence concludes, there should be a lot more momentum."

V. 2. WHITHER TRADE LIBERALIZATION IN THE WESTERN HEMISPHERE? (WDW/16/96 12 JUNE 1996)

The results of the Cartagena Ministerial, of last March 21, proved that, despite some adverse circumstances, the impulse toward trade liberalization in the Western Hemisphere retains momentum.

Just the fact that the meeting was successfully held in Cartagena, in the middle of a political campaign in the United States, not quite hospitable to the idea of free trade, was a major accomplishment (WDW/9/96, p.48).

However, more will be necessary to consider attainable the goal set at the December 1994 Miami Summit, of negotiating a free trade agreement for the Hemisphere by 2005. Therefore, at this point, it is a valid question to ask what will be required to attain on deadline such an ambitious goal?

At least three basic conditions must be met to consider attainable the Miami Summit's goal. First, the United States will have to exercise active leadership. Second, Brazil and the United States should look in the same direction. Third, a consensus must be actively built between all the governments and private sectors of the Hemisphere. None of these conditions by itself will be sufficient. All of them have to be simultaneously fulfilled.

The way Chilean accession to the North American Free Trade Agreement (NAFTA) was put on hold, due to the breakdown of consensus on free trade in the United States, teaches a key lesson. Leadership by the United States can only be exercised based on the existence of a solid domestic bipartisan consensus on free trade, equivalent to the consensus that prevailed throughout the Cold War years. Therefore, it is essential that domestic bipartisan consensus on free trade returns to the United States, after the temporary distraction of this year's political campaign.

Second, by the force of numbers, it is also essential that Brazil and the United States improve their bilateral relations, to the point that both can envisage the same outcome for the Hemispheric negotiations.

Together, MERCOSUL and NAFTA account for more than 95 percent of the Hemisphere's Gross Domestic Product (GDP) and for more than 85 percent of intrahemisphere trade. Given the relative weight of these two giants, enormous potential could be unleashed by an improvement in their trading relationship.

To illustrate how repressed is this potential, consider that two-way trade between the United States and Canada, in 1995, was approaching \$300 billion. The corresponding figure for two-way trade between Brazil and the United States, also in 1995, was approaching \$20 billion.

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

Fortunately, several positive signals have been coming out lately from the bilateral contacts between Brazil and the United States. The improvement in relations between Brazil and the United States started with President Fernando Henrique Cardoso's visit to Washington, in April 1995. This led to a review of bilateral trade relations, in November 1995, which started addressing several issues that were generating frictions between Brazil and the United States. Among these, there prominently appeared government procurement, the Generalized System of Preferences (GSP), sanitary and phytosanitary measures, antidumping and countervailing actions, obstacles to investment, and intellectual property rights.

Also, as a result of the November review, there were consultations in Brasilia, between Ambassador Mickey Kantor and Minister Felipe Lampreia, before the Cartagena Ministerial. Finally, a meeting NAFTA-MERCOSUL scheduled for the second half of this year. Thus, a marked improvement in relations between Brazil and the United States is already in progress.

Finally, to accomplish the Miami Summit's goal, a patient and thorough process of consensus building must take place throughout the Hemisphere, among all those constituencies interested in trade. It is a sign of the times that international trade negotiations are no longer circumscribed to tariff reduction exercises, of interest to restricted constituencies. The new trade agenda includes new issues, such as services, intellectual property rights, labor and the environment. The inclusion of all these new issues in the trade agenda has activated new constituencies, which transcend traditional notions of the private sector.

Again, if the three conditions mentioned are met simultaneously, the goal of signing a free trade agreement in the Western Hemisphere by 2005 is attainable. To summarize them briefly, first, the resumption of bipartisan consensus on free trade, after the November elections, in support of U.S. leadership. Second, the continuation of the improvement in bilateral relations between Brazil and the United States, leading to an agreement MERCOSUL-NAFTA. Finally, widespread consultations among the different constituencies interested in both the traditional and the new issues of the international trade agenda.

V. 3. THE FLORIANOPOLIS TRADE VICE-MINISTERIAL (WDW/27/96 2 OCTOBER 1996)

Several questions were raised before the first meeting of Vice-Ministers, held in Florianopolis on 16 and 17 September, to prepare the next Ministerial meeting, to be held in Belo Horizonte in May 1997.

First, it was the first meeting hosted by the Brazilian government, in Brazil. Second, there was curiosity about the stance that would assume the delegation from the United States, given the approaching presidential elections. Finally, it was the first time that the governments would engage in a discussion on what has become known as "how and when" to start the negotiations. The answers to these three questions became the highlights of the Florianopolis meeting.

Many doubts existed about the interest of the Brazilian government in the hemispheric negotiations, Florianopolis proved that such skepticism is unfounded. The display of traditional Brazilian hospitality, and the impeccable efficiency with which Itamaraty dealt with the logistics of the meeting, was enough evidence of Brazilian commitment to the process. However, beyond the formalities and amenities, the substantive discussions and the outcome, which will be described later, also confirm this perception.

The second question about how the electoral process was affecting the participation of the U.S. government was answered just by the composition of the delegation. Almost anybody that counts, at the technical level on trade issues in the U.S. government, was part of the delegation. It included staff members from the Office of the U.S. Trade Representative and from the Departments of Agriculture, Commerce, Labor, State and from the Embassy in Brasilia.

Beyond these symbolic, but still highly significant, signals are the substantive accomplishments of the Vice-Ministerial, particularly those concerning "how and when" the negotiations will be undertaken.

Those answers were not the only issues on the meeting's agenda. Private sector participation and the relationship between the Vice-Ministers and the working groups that are functioning were the other topics. Both issues generated intense discussions that resulted in concrete procedural agreements.

However, the outcome about "how and when" to negotiate was the most substantive and therefore the most revealing of the astonishing dynamics that the process is generating.

The main outcome consisted in presentations by both MERCOSUL and the United States of concrete proposals about how to proceed with the negotiations. The MERCOSUL proposal was the most concrete and foresighted, while the U.S. proposal was cautiously presented as twelve questions the governments have to answer.

Briefly, MERCOSUL proposed that the negotiations should take place in three distinct stages: first, business facilitation; second, nontariff issues; last, tariff negotiations. The twelve questions presented by the U.S. delegation were: level of obligations; approaches; organization; structure and priorities; steering group; secretariat; site; private sector participation; business facilitation; other Summit areas; role of sub-regional groups; and timing.

The presentation by MERCOSUL of the proposal to negotiate by stages was the most surprising, because it was totally unexpected. Also, the presentation of the U.S. proposal as a nonexhaustive set of questions facilitated the discussions. Consequently, MERCOSUL appeared as the most eager, while the United States restrained itself.

Canada reacted, offering to present a written proposal on "how and when" for the next Vice-Ministerial in Recife. Mexico proposed the transformation of the existing working groups into negotiating groups and promised to elaborate in the next meeting. All the participants agreed that these proposals would be discussed in the next Recife Vice-Ministerial.

Several revealing conclusions can be drawn from this fruitful meeting. Some essential conditions required to accomplish the objective set for 2005 are beginning to emerge. MERCOSUL, acting with impressive self discipline through a single spokesperson, has assumed the initiative, while the United States is exercising restrained leadership. This has not yet led, as it should in time, to a MERCOSUL-NAFTA dialogue, because there is reluctance from Canada and Mexico to appear too close to the "principal suppliers."

Meanwhile, this reluctance is allowing a dialogue between MERCOSUL and the United States, which at some point will induce the others to achieve a comprehensive and inclusive consensus.

In these conditions, the next Vice-Ministerial is promising, because the participants agreed to review all these issues in Recife. Furthermore, depending on the results of the Vice-Ministerial in Recife, it is feasible that the next Ministerial meeting, in Belo Horizonte, will signal the kickoff for the negotiations.

To be sure, the whole process will be more credible, if the U. S. provides, by next March, some kind of assurance that fast track authorization will be granted by the new Congress.

V. 4. MERCOSUR UNDER ATTACK
(WDW/32/96 6 NOVEMBER 1996)

Honoring a Washington tradition, an internal World Bank document leaked to both the Wall Street Journal and the Financial Times has generated a major stir.

To avoid any doubt about its intention, the leaked document, by Mr. Alexander Yeats, Principal Economist of the World Bank's International Trade Division, is titled Does Mercosur's Trade Performance Justify Concerns About the Effects of Regional Trade Arrangements? YES! (The exclamation sign is in the title).

With such a title, this is not an academic paper attempting to measure these effects. It is more like a "position paper" in the ongoing debate between the advantages and disadvantages of regionalism versus multilateralism.

This is an old and settled debate. As recognized in the last Economic Report of the U.S. President, regional agreements can be "stepping stones toward global free trade." Still, within the World Bank, there is a group of economists, to which Mr. Yeats belongs, who are very outspoken about their preference for multilateralism.

The paper is well organized and the arguments are presented clearly. Mr. Yeats handles with dexterity the use of indexes to illustrate the allegedly "perverse" effects of regionalism.

Three indexes are used in the paper to measure these effects. First, a "trade intensity index" to illustrate how intra-Mercosur trade has increased many times more than trade with third parties. A second index of "regional orientation" is used to measure if the same tendency prevails in exporting a product within and outside the regional market. Finally, a third index of "revealed comparative advantage" is used to identify those products that Mercosur members can export more competitively to third markets.

The findings are that the spectacular increases in intra-Mercosur trade are in products that are not exported to third parties with the same intensity, because these are products in which Mercosur members do not enjoy a "natural comparative advantage." The main culprit is found in automotive products, where there have been some recent relapses in increased protection, in Brazil and Argentina, against imports from third parties.

If the paper had stopped at this point it could be a cry of alarm about what it calls a "disquieting" trend. Thus, it could still be seen as making a contribution to the debate, even if the analysis is static and the indexes used do not warrant generalizations about the process as a whole.

The index used to measure "revealed comparative advantage" is only good for "processed goods or manufactures." A footnote admits that "trade in agricultural products is so distorted by

export incentives and trade barriers which are likely to obscure whether a country has a real comparative advantage or disadvantage in these goods." How can the conclusion be drawn then, with a bit of hyperbole, that "the findings of this study appear to constitute the most convincing, and disturbing, evidence produced, thusfar, that regional trade arrangements can be detrimental to both member and nonmember countries."

Also, in a footnote, it is admitted that "the possibility exists that exports to third markets (particularly of agricultural products) may have been greatly constrained by high tariffs and nontariff measures." Therefore, a "high RO (regional orientation) index values could be the result of major trade barriers in third markets and not the more favorable (differential) export opportunities provided member countries by the Mercosur arrangement." How can the conclusion be drawn then that "the changing trade patterns analyzed in this study indicate that Mercosur was not internationally competitive in sectors where intra-trade was growing most rapidly."

Consequently, the Procrustean attempt at stretching partial measurements, to draw general conclusions about the perils of regionalism, weakens the paper's conclusions. However, perhaps more interesting and ironic is that there is evidence that the attempt to influence the debate, by leaking the document, has backfired. Because, as a result, World Bank authorities have come out publicly in defense of MERCOSUR.

The first reaction came from the Bank's Vice President for External Affairs, Mark Malloch Brown, quoted in the Wall Street Journal saying "the bank fully supports Mercosur." Mr. Malloch Brown also said that the views expressed in the study "are iconoclastic within the Bank and are meant to strengthen our policy-making process, but they do not represent official policy."

The Bank's vice-president for Latin America and the Caribbean, Shahid Javed Burki issued a statement, characterized as "unusual" by the Financial Times, also defending MERCOSUR. Mr. Burki said that "trade expansion due to Mercosur has benefitted growth in member countries," adding that the process also "enhances the credibility and continuity of the economic reforms being implemented by its member states."

The ironic result of this incident is it has revealed that the strong opposition to regionalism, which has existed within the World Bank, has lost ground. It is a refreshing consequence to learn that, after dominating the scene, those who oppose regionalism within the Bank are now called iconoclasts.

VI. CAPITAL FLOWS

VI. 1. CAPITAL FLOWS TO DEVELOPING ECONOMIES (WDW/3/96 7 FEBRUARY 1996)

Beyond the macroeconomic impact of last year's Mexican financial crisis, evidence is now available that capital flows to the developing countries, particularly to the so-called emerging markets, came out less affected than anticipated.

As revealed by the latest report on capital flows to emerging economies, released in Washington, D.C. by the Institute of International Finance (IIF), the main effects of the Mexican crisis were mostly felt in the first half of 1995. However, the initially sharp slowdown turned into a surge, during the second half of the year, pushing total flows over the level of 1994 and close to the peak they had reached in 1993.

Therefore, the fears of a collapse in these flows were disproved beyond expectation. According to the IIF, in 1995, net private flows to emerging economies remained at the same \$175 billion level of the previous year, while net total flows surpassed the 1994 level of \$198 billion, reaching \$216 billion.

The main factor that explains the amount reached by total flows in 1995 was the increase of \$20 billion in official financing, mostly due to a sharp increase in lending by the International Monetary Fund (IMF). In 1995, both Mexico and Russia drew record amounts of IMF resources, \$12.8 and \$5.2 billion respectively. Thus, lending by the IMF in 1995 was thrice the level of 1994. This led to a moderation of the pattern, that prevailed in the nineties, of almost total dominance of private, as opposed to official flows to emerging markets.

The main factors identified by the IIF to explain the resilience exhibited last year by capital flows to emerging economies are both internal and external. Domestically, sound economic policies persevered in most borrowing countries. Additionally, favorable external conditions prevailed, mainly due to cuts in short-term interest rates in the major industrialized countries.

As interest rates fell, bond issues by borrowers from emerging markets increased in the second half of 1995. Even Latin American borrowers raised \$18 billion, almost the same amount of 1994. Mexican borrowers returned to the markets sooner than expected, raising almost \$5 billion during the second half of 1995. Argentina returned simultaneously, mainly through sovereign issues, amounting to over \$5 billion, while Brazilian borrowers raised a record \$7 billion in 1995. Additionally, the Republic of Brazil returned to international capital markets,

after an absence of 15 years, with a 2-year, 80 billion Euroyen issue in June 1995.

Consequently, while investors in Latin American stock funds experienced heavy losses, in 1995, emerging market bond funds soared. According to Lipper Analytical Services Inc., quoted by Stan Hinden in the Washington Post, Latin American stock funds, in 1995, lost 20.6 percent. By contrast, last year, all emerging market bond funds gained an average of 20.1 percent. The reason was that because of the Mexican financial crisis yields went up. In some cases, such as Mexican treasury bills or CETES, by as much as 70 percent, while Brady bonds experienced rapid yield increases from 10 to 15 percent. For Isabel Saltzman, manager of the Scudder Emerging Markets Income Fund, "the opportunity was incredible. It was the classic panic market."

Also, in 1995, despite an increase in equity flows to all emerging markets to \$87 billion, new international equity issues fell from \$17 billion in 1994 to \$7 billion in 1995. This was a consequence of the generalized weakening of stock markets in Latin America. For instance, Latin American equity issues, mostly in Brazil, fell from \$6 billion in 1994 to only \$1 billion in 1995. Yet, according to the IMF, foreign investment flows to developing countries were dominated by those going to emerging markets in East Asia (52 percent) and Latin America (almost 30 percent).

Finally, in 1995, there was a substantial increase in bank short-term credits to emerging economies, with net inflows increasing from \$43 billion in 1994, to \$66 billion.

The IIF sees a positive outlook for this year, if world interest rates remain low and improving economic fundamentals prevail in most developing countries. Growth in Latin America is projected to increase to 2 percent in 1996, after an estimated 0.4 percent in 1995. The IIF expects 1.5 percent growth in Mexico's GDP, with "a recovery in output in Argentina," and a slowdown to 3 percent growth in Brazil. Also, the current account deficit in Latin America is projected to decline to about \$21 billion in 1996, from \$27 billion in 1995, because of a smaller deficit in Brazil.

Private capital flows will make up the bulk in 1996, projected to reach 90 percent, from 80 percent in 1995, due to some repayments of the "abnormally high" official flows of 1995. Thus, total capital flows to emerging economies are projected to reach \$190 billion in 1996.

Without major disruptions, the IIF projects for this year that net flows from official creditors will fall sharply to \$11 billion. Latin America is expected to repay to official creditors a net \$4 billion in 1996, by contrast to the \$27 billion in net inflows from the same source in 1995.

VI. 2. REMEMBER THE "TEQUILA EFFECT?"
(WDW/7/96 6 MARCH 1996)

Global figures about the performance of emerging markets in 1995 give the impression that the effects of the Mexican financial crisis were short lived (WDW/3/96, p.56).

To be sure, most of the effects were felt during the first half of the past year and they were concentrated mainly in the emerging markets of the Western Hemisphere. Such figures, for 1995, even reveal an increase in net capital flows. For instance, net private flows in 1995, at \$175 billion, remained almost at the same level of 1994, while net total flows surpassed the \$198 billion of 1994, reaching \$216 billion.

However, a recent study by David Andrews and Shogo Ishii, of the International Monetary Fund (IMF), on The Mexican Financial Crisis: A Test of the Resilience of the Markets for Developing Country Securities (WP/95/132), concludes that "significant changes have taken place in the characteristics of private capital flows to developing countries."

Andrews and Ishii point out that these changes reveal that the so-called "tequila effect" was more than "a temporary disruption." The changes identified consist of "significant shifts" by type of borrowers and by currency denomination. Also, yield spreads remain higher and maturities shorter, compared to those that prevailed before the Mexican financial crisis.

International bonds issued by developing countries experienced a "virtual standstill" at the beginning of 1995 and "increased significantly" during the rest of the year. While these placements were dominated by Asian issuers, Western Hemisphere borrowers returned to the markets, but mainly through sovereign issues.

The first issue of 1995, since the Mexican crisis, in international bond markets from the Western Hemisphere was a 5-year, \$100 million sovereign issue from Colombia, in early February, at a spread of over 180 basis points. This was followed by the rapid return of Mexico, in mid-February, through a 6 1/2 year note from PEMEX, for \$137 million. In April 1995, Argentina placed a \$1 billion sovereign bond issue with those international banks that have operations in the country. In May, Brazil returned with a two-year Euroyen issue equivalent to \$0.9 billion. Also, after 15 years of absence, the Republic of Brazil returned to the markets, in June, with another two-year, \$80 billion Euroyen issue. In all, during 1995, Brazil borrowed a record \$7 billion in international bond markets.

As the year advanced, it became evident that particularly in the Western Hemisphere international bond issues were mostly from sovereign borrowers. Furthermore, in 1995, the share of those bonds issued in currencies other than the U.S. dollar rose "substantially." During the first nine months of 1995, for example, placements of bonds in yen and deutsche marks amounted to 28 and 8 percent, respectively, by contrast with 13 and 3 percent, respectively, in 1994.

Concerning equities, Andrews and Ishii indicate that "the share of developing countries in total international equity placements declined to less than 28 percent during the first nine months of 1995, compared with 37 percent in 1994."

However, Latin American equity markets "declined sharply" in 1995. Thus, between mid-December 1994 and early March 1995, the International Finance Corporation (IFC)'s U.S. dollar index for Latin American stock markets fell by almost half.

Similar deterioration was experienced by bond issues from the emerging markets of the Western Hemisphere, during 1995, with yield spreads increasing sharply and maturities becoming shorter.

For Mexico and Argentina "stripped yield spreads on Brady bonds rose from 350 basis points and 750 basis points, respectively, toward the end of 1994 to around 2,100 basis points in early March 1995." By contrast, the spread of Brazilian Brady bonds rose less, "increasing from an end-1994 level of about 1,000 basis points to a March 1995 peak of more than 1,500 basis points." The spread on other Mexican issues also rose from about 110 basis points in early December 1994 to a peak of over 1,000 basis points in March 1995.

Average maturities were not better. The sustained lengthening of average maturities of new bond issues by developing countries, from 4 years in 1991 to a peak of 7.3 years in the final quarter of 1993, was interrupted even before the Mexican crisis. By the end of 1994, these maturities declined to around 5 years. With the return of Latin American borrowers, in the second quarter of 1995, average maturities declined to 3 3/4 years, with some issues posting maturities of 1 to 3 years.

Finally, during the first half of 1995, there was a marked change in the currency denomination of sovereign issues. The share of issues denominated in yen and deutsche mark increased to 25 percent and 6 percent, respectively. New sovereign issues from developing countries have obtained better terms in deutsche marks and in yen, than those available on dollar-denominated issues of the same maturity. Andrews and Ishii hold that Japanese credit rating agencies have given investment grade ratings to borrowers that had received sub-investment grade ratings from U.S. agencies.

All these "significant changes," support the conclusion by Andrews and Ishii that the "tequila effect" influenced the type of borrower, the currency denomination of new bond issues, and led to higher yield spreads and shorter maturities.

VI. 3. EXTERNAL FINANCE FOR DEVELOPING COUNTRIES (WDW/8/96 13 MARCH 1996)

It is a sign of the times that this is the subtitle of the well-known two volumes of World Debts Tables 1996, released by the World Bank on March 12. The subtitle is more in tune with the times because, by contrast with the eighties, the issue today for the developing economies is one of access to private international capital markets.

The first volume, of analysis and summary tables, recognizes this change in priorities by dedicating the first chapter to private capital flows and the second chapter to official financing and external debt.

Part II of the first volume also contains the following appendixes: 1) debt burden indicators and country classification; 2) external debt trends in 1994; 3) official external debt restructuring: October 1994-December 1995; 4) commercial debt restructuring; 5) debt conversion programs; 6) foreign direct investment in developing countries; 7) portfolio investment in developing countries; 8) privatization in developing countries and external financing; 9) regional summaries. Finally, Part III contains the summary tables.

The second volume contains statistical tables on the external debt and flows for the 136 countries that report public and publicly guaranteed debt under the World Bank's Debtor Reporting System.

In 1995, aggregate net resource flows to developing countries grew by 11.5 percent, to reach a record \$231 billion. Private capital flows dominated, accounting for 72 percent of this total, but slowed down slightly from 74 percent in 1993 and 76 percent in 1994.

Private capital flows slowed mainly due to a drop in portfolio flows, mainly caused by the Mexican financial crisis, from \$84 billion in 1993 to \$56 billion in 1995. This contrasted with foreign direct investment (FDI), which continued increasing and reached \$90 billion in 1995.

According to Michael Bruno, the Bank's Senior Vice President for Development Economics and Chief Economist, "private investment flows proved resilient in the aftermath of the Mexican crisis, especially in those countries with strong economic policies."

The report draws the following important lessons for governments from the Mexican financial crisis. A "first broad lesson," is that "countries should be concerned about their vulnerability to a liquidity crisis, even when capital inflows are largely private sector oriented." Second, "large and potentially unsustainable current account deficits are a cause for concern."

Third, "continued real exchange rate appreciation in excess of productivity gains suggests increased vulnerability." Fourth, "the composition and maturity structure of public debt matter, not just its size." Fifth, "financial liberalization may warrant higher international reserves." Sixth, "the health and resilience of the financial system is crucial to ensure sound use of capital inflows and to avoid vulnerability." Seventh, "governments should monitor warning signals and promptly take macroeconomic measures to prevent a large loss of reserves--tightening monetary policy and adjusting the exchange rate." Finally, "prompt action is also needed in the face of a potential banking crisis."

Private capital flows "remain highly concentrated," since about 80 percent go to twelve mostly middle-income countries, among which Argentina, Brazil and Mexico account for 27 percent.

Even so, the regional composition of these flows has changed, since the Latin American and Caribbean share declined from 38 percent in 1993 to 20 percent in 1995. East Asia absorbed the difference, with its share going from 41 percent to 59 percent.

By contrast, official flows remain stagnant, except that the figures for 1995 reveal a strong rebound to \$64 billion, from \$49 billion in 1994, because of the Mexican rescue package.

In 1995, official development assistance remained at the same level of 1994, with \$33 billion in grants and \$14 billion in concessional loans. However, net nonconcessional official flows jumped from \$1.2 billion in 1994 to \$17.2 billion in 1995, with \$11 billion going to Mexico.

Mainly due to budget austerity, as a percentage of donors' GNP, official development assistance (ODA) was pushed down to the lowest point in twenty years. Net ODA flows fell, in 1995, to 0.29 percent of GNP for the members of the OECD's Development Assistance Committee (DAC), the lowest point since 1973.

An increase of 8 percent in debt stocks, in 1995, pushed up the total amount of debt from developing countries to \$2,068 trillion, an increase of \$147 billion from 1994. However, this was more than offset by a rise in exports, with the debt to exports ratio declining from 163 percent in 1994 to 150 percent in 1995.

Except for Sub-Saharan Africa, which saw an increase of 270 percent, the debt to exports ratio improved for all the other regions. East Asia reduced this ratio from 93 percent in 1994 to 83 percent in 1995, while for Latin America and the Caribbean it went from 258.6 percent to 254.2 percent.

The main conclusion drawn by Nawal Kamel, the Bank's Chief of the International Finance Division, is that capital flows to developing countries, in 1995, "proved resilient."

VI. 4. RESOURCE FLOWS TO LATIN AMERICA AND THE CARIBBEAN (WDW/10/96 27 MARCH 1996)

The main conclusion drawn by the World Bank's Chief Economist Michael Bruno, on resource flows to medium and small sized economies, in 1995, did not quite hold for Latin America and the Caribbean. In Bruno's terms, "private investment flows proved resilient in the aftermath of the Mexican crisis, especially in those countries with strong economic policies."

This year's regional summaries of the Bank's World Debt Tables (WDW/8/96, p.60) reveal that aggregate resource flows from all sources to Latin America and the Caribbean, in 1995, decreased 5 percent to \$48.8 billion, from \$51.1 billion in 1994. Also, aggregate net transfers to Latin America and the Caribbean, in 1995, declined by almost half to \$9.7 billion, from \$19.8 billion in 1994.

The figures for private flows reveal that investors "differentiated carefully among emerging markets." East Asia's share of private capital flows, in 1995, increased 59 percent, while the Latin American and Caribbean share decreased to 20 percent, from 38 percent in 1993.

Net transfers from private sources amounted to 0.34 percent of Latin American and Caribbean GNP, a sharp decline from 3 percent in 1993. By contrast with an average increase of 5 percent for all low and middle income countries, in 1995, private capital flows to Latin America and the Caribbean fell by almost one third to \$33.9 billion.

This fall in private capital flows was caused mainly by a decrease of 52 and 35 percent in portfolio equity flows and private loans, respectively. For instance, in the first quarter of 1995, new Latin American bond issues amounted to only \$360 million, a sharp contrast with \$6.3 billion launched in the first quarter of 1994. Additionally, new lending terms were more strict, with maturities shortened on average to 3.6 years, or less than one third of the 11.7 years obtained by East Asian borrowers. While spreads on Latin American issues were equivalent to twice those paid by East Asian borrowers (WDW/7/96, p.58).

In 1995, direct foreign investment going to Latin America and the Caribbean remained at \$18 billion, almost at the same levels of 1994.

Only flows from official sources increased sharply for Latin America and the Caribbean in 1995, from \$11 billion in 1994 to \$40 billion, with the Mexican rescue package amounting to \$30 billion. Even so, aggregate net transfers to Latin America and the Caribbean, in 1995, declined by half to \$9.7 billion. However, excluding Mexico, such transfers became negative by \$2.1 billion.

Due to the increase in official flows to Mexico, in 1995, the total external debt of Latin American and Caribbean countries increased by 8 percent, after an increase of 6 percent in 1994. Thus, the largest share of the debt of low and middle income countries was held by Latin America and the Caribbean, with Brazil and Mexico holding together 15 percent of such share.

Mexico surpassed Brazil as the largest debtor among low and middle income countries, due to the sharp increase of 16 percent in its outstanding debt, caused by the financial rescue package approved at the beginning of 1995.

Without the Mexican figure, in almost all the other countries of Latin America and the Caribbean the increase in debt was moderate, of 4 percent for Brazil, or even a decrease, as with the case of Chile.

At an average of 254.2 percent for Latin America and the Caribbean the debt to export ratio remained high, in 1995, particularly in comparison to 83.3 percent, in the same year, for East Asia. However, some sharp differences exist among countries. For instance, for Chile the debt to export ratio remains low at 129 percent, while it moves to over 2,500 percent in Nicaragua's case.

Also, in 1995, Latin American and Caribbean countries, with a share of 29 percent, have the dubious honor of holding the largest share of the total debt of low and middle income countries. This was the case although some poorest countries of the region and Ecuador, in 1995, concluded several debt restructuring operations.

For instance, Nicaragua benefitted from a 67 percent debt service reduction, under the Paris Club Naples terms, by eliminating 81 percent of its outstanding commercial debt. Moreover, this broad abatement was achieved through a successful buy-back operation, at 8 cents to the dollar, of \$1.1 billion in debt owed to commercial banks.

These figures show, according to the Bank's Chief Economist for Latin America and the Caribbean Sebastian Edwards, "that Latin American countries have not been cut off from international capital markets, as happened in the aftermath of the Mexican debt crisis of 1982, when the major economies of Latin America had not begun a systematic process of economic and financial reform."

However, Edwards concludes that this "is no time for complacency," because "economic and financial reforms must be deepened and widened to weather future contingencies over which the region's economies have no control."

VII. MULTILATERAL FINANCIAL INSTITUTIONS

VII. 1. THE SPRING MEETINGS OF THE BRETTON WOODS INSTITUTIONS (WDW/11/96 8 MAY 1996)

Three issues dominated this year's spring meetings of the International Monetary Fund (IMF) and the World Bank, held in Washington on April 20-23. First, the reactivation of the industrialized economies; second, how to deal with sovereign liquidity crises; and third, the indebtedness of the poorest developing countries.

As it is well known, the spring meetings bring together representatives from the industrialized countries, who meet in the G-Seven and in the G-Ten, and from the developing countries, who meet in the G-24. All these meetings are held in preparation of those of the Interim and the Development Committees, which oversee the functioning of the World Bank and the IMF, respectively.

On the world economic outlook, the G-Seven recognized that "despite the recent pause in some countries," the fundamentals remain promising. However, as recognized by the Interim Committee, there also remain challenges.

First, despite some progress in reducing budget deficits, "fiscal consolidation remains a key priority in most countries." Second, "the removal of structural impediments to higher rates of non-inflationary growth is also critical." For this purpose, it is essential to remove "labor market rigidities that contribute to unacceptably high unemployment in many industrial countries." Finally, the supervision of financial institutions and markets must be strengthened, "to guard against potential sources of macroeconomic instability and fiscal costs."

As described by the Secretary of the Treasury of the United States Robert Rubin, present circumstances "require that policies continue to be directed at sustaining non-inflationary growth and, where necessary and appropriate, at strengthening recovery."

The G-Ten discussed the issue of how to deal with sovereign liquidity crises, adopting a resolution based on a report of a working party prepared under the auspices of the Deputies. The G-Ten resolution is aimed at "the need to contain moral hazard and the desirability of equitable burden sharing." Thus, debtor countries and their private creditors are warned that they should not "expect to be insulated from any adverse consequences of their decisions by the provision of large-scale official financing in the event of a crises."

Additionally, the G-Ten admonishes that "there should be no presumption that any type of debt to the private sector will be exempt from payments suspensions or restructuring in any future sovereign liquidity crisis."

By contrast, the primary role of the "official community" in the resolution of sovereign liquidity crises "should remain centered on the promotion of strong and effective adjustment by debtor countries in the context of IMF-supported programs."

The indebtedness of the poorest countries was discussed in the Development Committee, leading to the approval of six principles to guide further action. The Ministers also requested the draft of a plan of action aimed at the "principal goal" of ensuring that in these countries "adjustment and reform efforts are not put at risk by continued high debt and debt-service burdens." The plan will be reviewed in the next annual meetings of the Bank and the Fund, to be held in Washington by the end of September.

World Bank President James Wolfensohn has been focusing on the need to address the indebtedness of the poorest countries, since he assumed office about a year ago. The total debt stock of the poorest countries amounts to about \$160 billion, with bilateral debt representing close to two-thirds and multilateral debt representing one fifth. However, almost half of all debt servicing goes to multilateral sources, with IDA holding 25 percent of the multilateral debt of the poorest countries, the World Bank holds 15 percent and the IMF 20 percent. Only two Latin American countries, Bolivia and Nicaragua, appear among the group of twenty poor countries identified as having "unsustainable debt burdens."

Other highlights of the meetings were the approval by the Development Committee of a report by a task force on the functioning of the multilateral development banks. Also, the Interim Committee welcomed the establishment by the IMF of a Special Data Dissemination Standard for countries that already have or that are seeking access to international capital markets.

Finally, by contrast with last year, it was remarkable that this time the Latin American and Caribbean countries were absent from the forefront of the meetings. This may be seen as positive, when it is recalled that last year's meetings were dominated by the fallout from the Mexican financial crisis, that started in December 1994.

This year, among the few events concerning Latin American countries was the announcement, a week before the meetings, that the IMF had approved a stand-by credit for Argentina of \$1,041 million, over the next 21 months, in support of the government's 1996-97 economic and financial program. Also, the executive heads of the IMF, the World Bank and the Inter-American Development Bank (IDB) announced, in a joint press conference held on April 22, their support for the new Venezuelan economic program.

VII. 2. THE IMF-WORLD BANK ANNUAL MEETINGS (WDW/28/96 9 OCTOBER 1996)

The International Monetary Fund's (IMF) reappointed Managing Director, Michel Camdessus, apologized at the closing press conference of this year's annual meetings, "for a very dull meeting. The only news was good news." By contrast with last year's, dominated by the Mexican crisis, this year's meetings, held also in Washington from September 28 to October 3, were not haunted by a crisis.

No melodrama was involved in approving what became the two highlights of the meetings. First, the initiative to help the heavily indebted poorest countries (HIPC's). Second, the approval of the New Arrangements to Borrow (NAB), which will double the resources of the existing General Agreements to Borrow (GAB), to \$55 billion.

Several components make up the initiative to help the HIPC's. At the IMF, the initiative consists first of the continuation of the Enhanced Structural Adjustment Facility (ESAF). At issue here is how to finance the functioning of an "interim ESAF," from the year 2000 to 2004. According to the Managing Director of the IMF, this does not demand "enormous amounts of money," a total of about SDR 2.5 billion.

Due to the present budgetary constraints prevailing in the industrialized countries, the Managing Director initially proposed to use "a very limited part, 5 percent" of the Fund's gold reserves. This proposal generated a split among the industrialized countries, with Germany, Italy and Switzerland against the sale of gold and in favor of using exclusively bilateral contributions.

The solution was to instruct the Fund's Executive Board to attempt financing both the interim ESAF and the HIPC initiative through bilateral contributions. However, if such bilateral contributions are not sufficient, enough votes exist in the Executive Board in favor of proceeding to the "optimization of the management of IMF reserves," or to sell gold "amounting to up to five million ounces."

The second component of the agreement consists of a contribution by the World Bank, drawn from future profits, amounting to up to \$2 billion. Finally, the Paris Club creditors agreed to go beyond the 67 percent limit on debt reduction, set in the Naples G7 Summit, to up to 80 percent, for countries qualifying for relief and on a case by case basis.

The three components were essential given the composition of the HIPC's debt, estimated to amount to \$97 billion, of which 58 percent owed to governments, 22 percent to multilateral financial institutions and only 14 percent to commercial banks. In these conditions, among the 20 HIPC's that will be eligible to obtain such assistance, three are from the Western Hemisphere, Bolivia, Guyana and Nicaragua.

Another highlight of the meetings was the approval of the New Arrangements to Borrow (NAB), doubling the resources available under the General Agreement to Borrow (GAB). This decision is a legacy of the Mexican crisis, which according to the Interim Committee intends to "improve the Fund's ability to meet requests for balance of payments assistance by members in circumstances that could have systemic implications."

This decision generated a negative comment from the powerful Institute of International Finance (IIF), which groups almost 200 commercial banks from all over the world. In the yearly letter addressed to the Chairperson of the Interim Committee by the IIF's Managing Director, Charles Dallara says that "market participants do not consider official bailouts a realistic or desirable alternative" to confront crises in emerging market economies. Furthermore, the IIF opposes the expansion of the "1989 IMF policy of lending in the face of unresolved arrears to private creditors." Because such a policy "could send countries the wrong signal, raise problems of moral hazard and increase the cost of capital for emerging markets."

The IIF recalls that "many techniques of the 1980s may be irrelevant today," due to what it terms "the changing nature of emerging markets finance." For instance, net private capital flows to emerging market economies are projected to reach \$225 billion in 1996, up from \$208 billion in 1995. Therefore, the amounts available in multilateral financial institutions pale by comparison. For instance, only equity flows, amounting to \$110 billion, constitute nearly half of all net private flows projected for 1996.

Other highlights of the meetings were the attainment of consensus on the modalities for achieving greater equity in cumulative SDR allocations. Also, the Interim Committee broadened its Madrid Declaration of October 1994, by approving a "Declaration on Sustainable Global Growth" containing, according to Mr. Camdessus, "eleven new commandments."

One of these "commandments" refers to "promoting good governance," including fighting corruption, which generated a reaction among the developing countries in the G-24. The communiqué approved by the Ministers of the G-24 said that "the Bretton Woods institutions should proceed with extreme caution in the application of conditionalities in the governance area." Emphasizing that "the international financial institutions should augment their technical support for the indigenous efforts of the developing countries aimed at improving efficiency and accountability in state institutions."

VII. 3. THE WORLD BANK ANNUAL REPORT
(WDW/30/96 23 OCTOBER 1996)

After more than a year in office, the President of the World Bank introduction to this year's annual report, for fiscal year (FY) 96, describes a year of transition. According to President Wolfensohn this transition "has been made necessary by the extraordinary change taking place in the global economy." Among these changes, perhaps the most important is the decreasing importance of multilateral lending, for some developing countries. Mainly caused by the tripling of private investment flows to all developing countries, such flows went from \$44 billion in 1990 to \$170 billion by the end of 1995. By contrast, net multilateral lending to developing countries, in the same year, amounted to \$12.5 billion, the smallest component of all net flows of official development finance, which in the same year amounted \$64.2 billion.

However, 75 percent of private capital flows go only to twelve countries, among which those of East Asia receive 60 percent of the total. Therefore, the Bank's primary responsibility is to concentrate in the poorest developing countries, or those that do not have access to international capital markets. This also explains the dedication by President Wolfensohn to obtain the approval of the decision to forgive the official debts of the poorest developing countries, recently approved at the Bank's annual meetings (WDW/28/96).

Beyond the numbers, President Wolfensohn concludes that the "immeasurable improvements" in people's lives is the "gauge" by which the Bank's performance should be measured. Therefore, the Bank's "central objectives" remain poverty reduction and sustainable development.

The year was also of transition for the Bank's operating procedures, aimed at strengthening their effectiveness. The purpose immediately is "to raise the standards of all client services" and "to improve the Bank's longer-term ability to meet client needs more effectively."

To accomplish these objectives, total new lending commitments by the Bank in FY 96 amounted to \$21,520 billion, a decrease of 5 percent from the \$22,521 for the previous year. From this total, by contrast with last year, lending for basic social sectors, including education, water supply and sanitation, urban development, environment, population, health and nutrition, amounted to 33 percent.

Meanwhile, adjustment lending amounted to 21 percent, down from 24 percent in the previous year. The relative participation of lending to other sectors was as follows: energy 14 percent; transportation 13 percent; and agriculture 12 percent.

By regions, the biggest increase in loan commitments was in the Middle East and North Africa region, with 21 projects approved for a total of \$1,595 million. Latin America and the Caribbean experienced the sharpest drop, with a total of 54 new projects approved, amounting to \$4.4 billion. This contrasts with FY 95, when \$6.1 billion for 52 projects were approved. In

Africa, all 53 projects approved, amounting to \$2.7 billion, were from the International Development Association (IDA). In East Asia, 46 projects were approved amounting to \$5.4 billion, while for South Asia 21 projects approved amounted to \$2.9 billion. Finally, lending also increased in Europe and Central Asia, with 61 projects amounting to \$4.3 billion, comparable to the 58 projects amounting to \$4.5 billion of last year.

Only one Latin American country appears this year among the three largest borrowers from the Bank, as follows: China \$2,490 million; Russia \$1,816; and Argentina \$1,509 million. The three largest borrowers from IDA were India \$1,301 million; Vietnam \$502 million; and China \$480 million.

In the section dedicated to Latin America and the Caribbean, the REPORT describes poverty and inequality, as "the Achilles heel" of Latin American development, estimating that "about one fourth of the region's population lives with less than \$1 a day." Other challenges for the region are human resource development and the reform and modernization of the state.

To carry out its activities in FY 96, the board of directors approved an administrative budget of \$1,374.7 million, "a drop of 3.6 percent in real terms (0.5 percent in nominal terms)." With the approval of an administrative budget of \$1,177.1 million for FY 97, this will be the "third consecutive year of a decline in the Bank's net administrative expenditures in real terms."

These budget cuts have led to reductions amounting to 608 staff members leaving the Bank, as part of a program to eliminate redundancies amounting to \$112 million. The separation program includes expenses for job-search assistance, training, outplacement consulting, pension plan contributions, and related tax allowances.

Still, at the end of FY 96, regular and fixed term staff numbered 5,681, down from 6,059 as of 30 June 1995. Also, in FY 96, 188 new staff members were recruited, of whom 33 percent were from developing countries and 31 percent were women.

Finally, a survey conducted by the Bank among staff and borrowers revealed that "borrowers are generally more pleased with the Bank's performance than its staff, who tend to take a more critical view." According to the survey, borrowers and staff "did not always agree on the importance of Bank roles." The staff "considered the Bank's advice on policy issues to be its most important role, in contrast to borrowers who ranked this function sixth."

VII. 4. THE IMF ANNUAL REPORT
(WDW/31/96 30 OCTOBER 1996)

This year's annual report of the International Monetary Fund (IMF), for the fiscal year ending 30 April 1996, describes what is characterized as an "extremely active" year, for several reasons.

First, financial support to member countries "rose to an unprecedentedly high level." Second, because of the Mexican financial crisis, surveillance of member countries' exchange rate policies was "comprehensively reexamined" and "strengthened." Finally, "the heavy demands on the institution's financial resources for the second year in a row, coupled with the potential for continuing large demands in the new globalized economy, led the Board to give increased attention to actions to strengthen the adequacy of IMF's resources."

Total new commitments, in stand-by and extended arrangements, attained the highest level ever, reaching SDR 18.0 billion (\$26 billion), which contrasts with SDR 14.1 billion (\$20 billion) committed during the peak of the debt crisis in FY 82/83, and with last year's SDR 15.5 billion (\$22 billion).

The bulk of these commitments corresponds to a few large operations. First, SDR 6.9 billion (about \$10 billion), granted to Russia, in the largest extended arrangement in IMF's history. Second, SDR 6.8 billion to Mexico, under the stand-by arrangement for SDR 12.1 billion. Finally, SDR 720 million under a new stand-by arrangement for Argentina.

Strengthening surveillance entailed several measures, such as increasing informal meetings by the Executive Board, interim staff visits to countries, focusing Article IV consultations on core topics as exchange rate policies, and improving the quality of national statistics. Within this context, a new Special Data Dissemination Standard was approved.

The record commitments and disbursements of the past two years led to several decisions to strengthen "the adequacy" of Fund's resources. First, the "liquidity ratio," or the ratio between uncommitted usable resources and liquid liabilities, decreased to 89.8 percent at the end of FY 96, from 126.1 percent at the end of the previous fiscal year. Second, the Board granted priority to the study of the Fund's future size and to the eleventh General Review of Quotas. Finally, new governments were invited to participate in augmenting the General Agreements to Borrow (GAB), until now funded by the member countries of the Group of Ten (G-10).

However, the most transcendent internal decision of the year passed almost unnoticed. The early and subdued reelection campaign, if it can be called so, of the incumbent Managing Director led, on May 22, to his appointment to an unprecedented third mandate, starting on January 16, 1997.

Only the most adept Fund-watchers interpreted an interview with Managing Director Camdessus, which appeared on April 2 unusually in the front page of the New York Times, as evidence of a bid for reelection.

To be sure, keen observers can argue that it does not happen frequently that an executive head of a multilateral financial institution makes it to the front page of the Times. However, it was a bit early as a bid for renewal of a mandate that expires on 15 January 1997.

Be it as it may, the interview included some candid admissions and a few fascinating comments on Mr. Camdessus personality. For instance, former U.S. Secretary of the Treasury Lloyd Bentsen described him as "tough," because "sometimes you have to lean on him real hard to get things done." While the former head of the Federal Reserve Board Paul Volcker described him as an "activist" who is "always finding things to do."

The most candid admission allowed a rare glimpse to the Fund's decision making style. It had to do with the approval of the Mexican financial package, the largest loan ever granted in the history of the Fund. What was amazing about this decision is that Mr. Camdessus promised to grant such a loan, to the Clinton Administration, before obtaining the approval of the Board of Directors. According to Mr. Camdessus, he went to the Board not to ask for "permission." The only question he asked from the Executive Directors was "is that my job or not?" and in his own words, "they said yes." This courageous decision ruffled some feathers, particularly among the Executive Directors from Great Britain and Germany, but Mr. Camdessus thus gained the gratitude of the Fund's major stockholder and secured his reelection bid.

To carry out its activities, in FY 95/96, the Fund employed "around 2,200" regular and fixed term staff from 125 countries. This figure includes a reduction of 40 positions, but it is still above the 2,184 staff members from 115 countries employed in the previous fiscal year.

The Fund's administrative budget for the fiscal year ending 30 April 1996 amounted to \$475.1 million and \$125.2 million approved for projects. Actual administrative expenditures in FY 96 amounted to \$470.8 million and capital project disbursements totaled \$34.8 million, including \$19.8 million for "major building projects." For FY 96/97 the Board approved an administrative budget of \$490.5 million, an increase of 3.2 percent over the budget for the previous year, and a project budget of \$20.1 million.

