INTERNATIONAL ECONOMIC HIGHLIGHTS 1987
# TABLE OF CONTENTS

## PRESENTATION

<table>
<thead>
<tr>
<th>I. TRADE</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. &quot;Just a Little Trade War&quot;</td>
<td>6</td>
</tr>
<tr>
<td>2. Negotiating Trade in Services: Part One</td>
<td>8</td>
</tr>
<tr>
<td>3. With the Trade Bill Approved by the Senate, What Next?</td>
<td>10</td>
</tr>
<tr>
<td>4. Freer Trade Between Canada and the United States</td>
<td>13</td>
</tr>
<tr>
<td>5. Framework Agreement on Trade and Investment Between the United States and Mexico</td>
<td>16</td>
</tr>
<tr>
<td>6. Negotiating Trade in Services: Part Two</td>
<td>19</td>
</tr>
<tr>
<td>7. Intellectual Property Rights</td>
<td>22</td>
</tr>
</tbody>
</table>

## II. COMMODITIES AND AGRICULTURAL PROTECTIONISM

| 1. The Decline of Non-Fuel Commodities | 25 |
| 2. Dealing with Agriculture, Faute de Mieux | 27 |
| 3. Costs and Benefits of Agricultural Protectionism | 30 |

## III. HIGH-TECH INTERDEPENDENCE

| 1. The Chip War | 33 |
| 2. Superconducted into the Twenty-First Century | 35 |
| 3. The "Chip War" Can Become a "Fierce War" | 37 |
| 4. Toshiba Apologizes | 38 |

## IV. THE U.S. ECONOMY

| 1. The Trillion Dollar Dragon | 42 |
| 2. The Economic State of the Union | 43 |
| 3. Chairman Volcker's Departure | 46 |
V. THE U.S. DOLLAR

1. The Dollar's Plunge 48
2. On Reference Ranges 50
3. "The Dollar Is At The Level At Which It Can Be Tested" 52
4. The Gamble on the Dollar 54

VI. ECONOMIC POLICY COORDINATION

1. Prime Minister Nakasone's Visit: "Pretty Short on Specifics" 56
2. No News From Venice...? 58

VII. INDEBTEDNESS, ADJUSTMENT AND GROWTH

1. Chairman Volcker on International Debt 61
2. Developing Countries' Indebtedness: Quantifying the Debate 63
3. The Brazilian Saga 66
4. The Commercial Lenders' Viewpoint 67
5. Citicorp Bites the Bullet 70
6. Growth and Adjustment: The Role of the Fund 72
7. Adjustment and Growth: Mr. Camdessus Joins the Debate 75
8. Financial Deregulation and Third World Indebtedness 78
9. Securitization 81

VIII. INTERDEPENDENCE OF FINANCIAL MARKETS

1. The Globalization of Financial Markets 84
2. Financial Market Structure: Deregulation or Reform? 86

IX. THE STOCK MARKET CRASH

1. Vertiginous Interdependence 89
2. After the Meltdown 91
3. The Magic of the Market 94
4. Looking for Bright Spots 96
X. MULTILATERAL FINANCIAL INSTITUTIONS

1. World Development According to the World Bank 99
2. The World Economy, According to the IMF 102
3. Ritual and Substance 104
4. Highlights from the Bank-Fund Annual Meetings 106
PRESENTATION

This document gathers the weekly dispatches transmitted, during 1987, by ECLAC Washington to ECLAC headquarters in Santiago, Chile. Classified by subject, only for their presentation here, the dispatches are ordered chronologically within each chapter, to illustrate the evolution of the different issues. As it is evident, the chapter headings correspond to some of the items of the agenda of the present international political economy.

As measured by the number transmitted, some issue-areas of this agenda demanded relatively more attention throughout the year. Thus, in the forefront appears the indebtedness of developing countries, followed closely by trade and other dimensions of commercial interdependence. Also, the economy of the United States, the dollar, as well as the coordination of economic policies among industrialized countries, demanded almost equivalent attention.

Illustratively, the crash experienced by the stock market, in October, was the single event that demanded relatively more coverage, as many as four consecutive dispatches. Even so, now it can be safely said that this extraordinary event defied most expectations, because its consequences apparently have not been as profound as originally anticipated. Although the considerable attention and coverage elicited by the stock market crash fully justified itself at the time, because of the ominous precedent these events recalled.

As the regular readers of these dispatches well know, their content depends upon their purpose. For instance, some of the dispatches summarize the daily treatment of a certain subject or event in the five newspapers regularly monitored by ECLAC Washington --The Journal Of Commerce, The New York Times, The Wall Street Journal, The Washington Post, and The Washington Times. Others, summarize a document or a statement issued by a prominent participant in the international economic scene. In every case, the overall purpose is to increase the reader's awareness about some of these issues.

Each dispatch tries to remain within the limit of 750 words, which considerably constrains their scope and depth. Briefness constitutes an obvious indication to the reader that the dispatch represents only an initial and consequently preliminary overview of the subject. Thus, the purpose of the dispatch is accomplished when the reader concludes that the subject demands or not further attention.

Certain reasons justify bringing together these dispatches, even when evidently most, if not all, have lost their freshness.
One of these reasons is to make them available for easy consultation to those interested in the viewpoint of an observer placed at the vantage point offered by Washington, D.C., when the events were taking place. After all, this testimonial value is probably the only merit these dispatches still have, after the passing of time has placed them in context.

Additionally, these dispatches constitute a very persuasive illustration of how perplexing the present can be, as well as of how necessary it is to let some time elapse before jumping into hasty conclusions. Nevertheless, as it can be verified, the temptation to conclude sometimes proved irresistible, although more often than not the drawing of conclusions was deliberately avoided, by leaving ongoing debates without resolution, or by leaving unanswered most of the questions raised by an event or an issue. This explains, the tentative nature of these dispatches, because of the closeness to the events they describe.

Finally, viewing together the titles and the subjects covered in these dispatches gives the impression of a year crowded by an exhilarating succession of events, probably more exciting as a whole than the individual events themselves appeared at the time. This confirms something better described by the prestigious historian Ferdinand Braudel, when he said: "unlike the flow of rivers, whose tempo is fastest at the source and then diminishes, the stream of history begins slowly but accelerates rapidly as it approaches us and our epoch." In another way, this exhilaration contributes to the fascination exerted by the present, to which this document hopefully renders a modest tribute.
I. TRADE

I. 1. "JUST A LITTLE TRADE WAR" (7 January 1987)

Under this heading The Washington Post commented editorially some of the implications of the last trade measures of 1986, adopted by the U.S. Government against what were considered unfair trading practices by the European Community. Thus, in matters of international trade, the first question of 1987 was centered around how to interpret the significance of these retaliatory actions. Immediately, two alternative viewpoints emerged. First, some view these measures as part of the usual arsenal of pressures utilized by trading partners involved in negotiations. The other more pessimistic viewpoint, considers these retaliatory actions as the ominous presage of a year in which the specter of protectionism threatens to become real.

Before looking into some of the reasons which support each one of these interpretations, the events themselves should be briefly described. First, the confrontation originated from the accession of Spain and Portugal to the European Community. Among other consequences, this entailed the potential loss for the United States of around US $400 million in exports of feed grain--corn and sorghum. Import duties imposed on these products amounted to 20%, with the accession--particularly of Spain--they increased to 150%.

Second, under the rules of the General Agreement on Tariffs and Trade (GATT), the European Community should compensate the United States for losses resulting from the admission of new members. Thus, on March 31, 1986, the U.S. Government stated its intention to respond to the agricultural losses suffered as a result of the Community's enlargement, unless it obtained adequate compensation. In May 1986, the United States announced that, in the absence of a settlement by July, U.S. duties would be raised on products of comparable value to those affected by the levies imposed by Spain. On July 2, 1986, the United States and the European Community arrived at an "interim agreement," by which it was decided that the dispute would be resolved no later than December 31, 1986. This interim agreement was designed to permit continued sales of feed grains to Spain, while negotiations were under way.

Third, by mid-December, despite repeated efforts which included Cabinet level negotiations, both sides remained far apart on the crucial question of compensation. On one side, the
United States is seeking annual duty-free entry into Spain for over 4 million tons of corn and sorghum. On the other side, the European Community has offered duty-free entry for 1.6 million tons of these products annually.

Fourth, because this last proposal was considered "grossly inadequate," the U.S. Cabinet level negotiator, Ambassador Clayton Yeutter, rejected the request made by the Europeans that the deadline of December 31, 1986, established in the "interim agreement," be extended until the end of January 1987.

Fifth, instead, the United States decided to impose, as of January 31, 1987, import duties of 200% on the following products: Blue Mold, Edam, Gouda and soft-ripened cheeses; endives, carrots and olives; as well as white wine, cognac and gin. With these measures, US $250 million in imports from France and US $100 million in imports from Great Britain would be affected, as well as Danish sales of canned ham, Dutch cheese exports, Italian white wine shipments and imports of olives from Greece.

There is little doubt that this evolution of events gives ground both to the pessimistic perspective and to the one that views these measures as mere negotiating ploys.

In support of the more benign interpretation appear several considerations. First, the U.S. Government decision to start imposing the new duties on January 1, 1987, in effect, grants the extension of the deadline requested by the Europeans, adding only a new element of pressure to the negotiations. Second, with the inauguration of the 100th. U.S. Congress, these measures can be interpreted as the resort of an embattled Administration, which has decided to "circle its wagons," to blunt the edge of an aggressive Democratically controlled Congress, which appears determined to approve a trade bill in 1987. As the new Speaker of the House, Representative Jim Wright Jr. (D-Texas) declared, the trade deficit is "the most important economic problem facing the nation." Third, commenting on the statement by Ambassador Yeutter that he "would not give odds" on whether the new tariffs would go into effect, Leonard Silk in The New York Times said, "obviously, no poker player ever announces that he is bluffing."

Furthermore, the figure of US $400 million annually is puny in contrast with the US $10 billion of monthly trade between both partners. Finally, to anticipate the argument that these measures were part of a global protectionist strategy, the U.S. Government, simultaneously, announced that it was granting to Brazil a six-month extension, before taking action against it for imposing barriers on imports of U.S. computer equipment and software. All these reasons led to the belief that we are in the presence of the normal fireworks which accompany any difficult trade negotiation.
Nonetheless, on the other hand, there were also grounds to perceive these actions as ominous indicators of the beginning of a protectionist wave. For one thing, the intentions of the Democratically controlled Congress should be taken very seriously. Second, the last figures released by the Commerce Department on the U.S. trade deficit were not helpful at all. By the end of the year, the announcement that, contrary to expectations, the trade deficit in November reached US $19.2 billion, raised justified doubts about a substantially smaller trade deficit in 1987. Furthermore, other measures previously adopted by the U.S. Government give ground to infer the existence of a more consistent protectionist trend. For instance, only days before, imports of machine tools had been restricted. Also, in December, the United States announced its intention of holding separate talks with France, West Germany and Great Britain on account of the allegedly excessive subsidization of sales of the new version of the Airbus, the jointly built European civilian aircraft that seems to be successfully competing against American aircraft. And so on, other worrisome events could be listed to support the contention that the latest trade measures of 1986 constitute a firm indication that protectionism, with all its dire consequences, may become the dominant trait of 1987.

I. 2. NEGOTIATING TRADE IN SERVICES: PART ONE (11 March 1987)

On January 28, 1987, a consensus was attained on the procedures which will be observed throughout the progress of the Uruguay Round. The setting seems to be in place for the adoption of decisions on the different items constitutive of the Round's agenda. Among the latter, trade in services probably represents the most forward looking of these issues. In effect, it seems to be the area in which the Contracting Parties of the General Agreement on Tariffs and Trade (GATT) are confronting some of the questions which, besides those raised by the globalization of capital markets, form part of the new international political economy.

Thus trade in goods will be dealt by focusing on items as traditional as tariff and non-tariff barriers, safeguards or subsidies, as well as countervailing measures. Also, other issues more recently suggested, such as intellectual property or trade-related investment, still form part of GATT's traditional mandate, as the setting within which the commerce of goods is internationally managed.
By stark contrast, the institution seems to be threading new ground on the subject of trade in services. In this field, for the first time, an attempt will be made to accomplish an ambitious objective, consistent in negotiating the adoption of a "multilateral framework of principles and rules."

This relatively ambitious objective, in such a novel issue area of the international economic agenda, was agreed upon after the clearing of several significant "procedural" hurdles. As it is usual in international negotiations, matters of form serve to disguise profound economic and political differences among the participants. For instance, one of the main questions raised by the consensus achieved in Punta del Este, in September 1986, referred to the structure deemed more adequate for the negotiation of trade in services. Once it was agreed that GATT furnished the appropriate framework, two distinct negotiating groups were established, the Group of Negotiations on Goods (GNG) and the Group of Negotiations on Services (GNS), both under the Trade Negotiations Committee, which oversees the overall conduct of the Uruguay Round.

In other words, the issue of negotiating trade in services has been placed under the aegis of the GATT. This constitutes obviously a considerable expansion of the original mandate of an institution whose legitimacy, until very recently, was being challenged because it rested on the assumption of formal equality among trade negotiating partners. Thus, the first question which may be asked is if this evident task expansion, even by means of the establishment of two separate negotiating groups, reveals a shift away from the recognition of international asymmetry.

The programme for the "initial phase of negotiations"—modest as these terms might sound—consists of the "non-exhaustive" enumeration of "a number of elements," which bring forth many of the qualitative differences exhibited by negotiations in services, in contrast with the more traditional activities related to negotiating trade in goods, where there exists more experience. Suffice it here to mention for illustrative purposes some of the main issues which will have to be confronted during this initial phase, programmed to last throughout 1987. First and foremost, among the "elements" of agenda, appear what are termed "definitional and statistical issues." The discussions on this item will not be an abstract, conceptual exercise, since the purpose is to identify "broad concepts on which principles and rules" can be based upon. In this case, the question of how are services defined acquires a relevant dimension, loaded with profound implications. Also, even if there emerges a conceptual consensus, the question will have to be confronted of how accurately present trade statistics measure the transactions in the items so-identified.
Furthermore, once these conceptual and qualitative matters have been clarified, the next element of the agenda refers to what will be the "coverage" of the multilateral framework for trade in services, whose design constitutes the expected outcome of the negotiations. This clarification of "coverage" leads to the question of what is the relationship between the provision of a service and international factor mobility, or of capital and labor. From this linkage, between trade in services and factor mobility, emanates one of the most crucial questions these negotiations are raising for developing countries, namely, how service transactions relate to the matter of labor mobility. Basically, in its own terms, this is only another manner of asking the question of how to determine comparative advantages among negotiating partners, an essential requirement for the arrival at agreements on "multilateral frameworks of principles and rules" capable of generating mutual benefits.

Finally, a third group of "elements" in the agenda of the initial phase refers to "existing disciplines and arrangements," as well as to the "measures and practices" which contribute or limit the "expansion of trade in services," with the purpose of promoting "transparency and progressive liberalization." In this case, the assumption seems to be the same which underlies liberalization and barrier demolition of trade in goods, but applied to trade in services. From this perspective, the position of the United States and of other industrialized countries seems to be that there exists a giant trade-off between concessions offered on trade in goods in exchange for concessions granted on trade in services.

I. 3. WITH THE TRADE BILL APPROVED BY THE SENATE, WHAT NEXT? (29 July 1987)

After almost four weeks of grueling debate, the Senate approved its version of the trade bill, having rejected or withdrawn more than 250 amendments which were presented during the debates in nine Senate Committees. The end-result consists of a 1,000 page bill to be confronted with the version approved in April by the House of Representatives, in a conference to iron out the differences. From this House-Senate conference will emanate the final version to be sent to the White House, sometime during the coming fall.

President Reagan's reaction did not make itself wait, "when all is said and done, he said, it will be up to the Democratic
leadership as to whether or not Congress sends me a bill that I must veto or puts together something we can accept."

The results of the vote in the Senate can be somewhat misleading, because the bill was approved by a decisive 71 to 27, with 19 Republican Senators --out of 46-- joining 52 Democrats in favor and only 27 Republicans against. This gives the bill more votes than the two thirds required to override a Presidential veto. Nonetheless, President Reagan declared that "so far the signs point straight to veto." The reason for such certainty lies in the fact that 16 of the 19 Republican Senators, who voted in favor, declared that theirs have to be considered "yes, but" ballots. They believe in the need to strengthen trade legislation, but their final decision will depend on whatever comes out of the House-Senate conference. Also, some of these Republican Senators have argued that a "yes, but" vote gives them access to the conference as players and not as by-standers. Finally, as it is only natural, others voted in favor because they obtained the inclusion in the bill of special provisions aimed at helping their constituents. Thus, among the rank of the "yes, but" voters appears Senator Robert Kasten (R-Wisconsin), answering to the troubled machine and foundry industries of his home state, as well as to the dairy farmers' resistance against the inroads made by foreign competitors.

The comparison between the bill approved by the House of Representatives with the Senate's version reveals some positive signs which, admittedly, have given ground to a certain degree of optimism. In the terms of Secretary of the Treasury James Baker III, the Administration considers it has "been much more successful with respect to the Senate trade bill." This can be understood because there appear some contrasting differences between both.

For instance, on the subject of unfair trade practices, the Gephardt Amendment contained in the House bill requires that the President retaliate against countries obtaining "excessively high" trade surpluses, unless they fail to reduce them by ten percent a year. The Senate bill, by contrast, focuses upon the unfair trade practices themselves. It requires from the President to file complaints against countries that maintain consistent patterns of import barriers, to negotiate the abolition of these barriers by 1991, and to impose trade sanctions only if those barriers are not lifted.

Another difference has to do with import relief. The House bill takes away from the President the authority to grant it to domestic industries hurt by a surge of fairly traded imports. The Senate bill requires, from domestic industries seeking relief, to submit a plan to adjust to international competition and grants to the President as much discretion as does the current law.
Other differences have to do with the existence of wider definitions of subsidies and dumping in the House bill, while the Senate bill does not introduce major changes to the current law. By contrast, in the Senate bill appear certain dispositions that have been severely criticized, because legislators appear either oblivious of the risks of protectionism, or "they are counting on the President to save them from themselves with a veto." For instance, there is no provision in the House bill for plant closing, but the Senate bill requires in general that there be 60 days of advanced notification to workers in cases of plant closing or layoffs. Also, the Senate bill contains a provision banning imports of Toshiba products during a period of two to five years, while the House bill does not contain such provision. Finally, there exist some coincidences, for instance, on telecommunications and on the President's negotiating authority.

Numerous propositions appear in the Senate bill to protect specific interests, some of which have been also severely criticized, to the point that it has been baptized the "Christmas Tree" trade bill, on the grounds that it contains "an outrageous amount of bad and mischievous baggage," in the form of "lobby-pleasers and special interest handouts." Most of these "special provisions," or "veto baits" as the Administration calls them, are unrelated to trade and refer to issues such as the repeal of the wind-fall profits tax on oil; to a new quota on lamb imports; to the provision of $365 million in refunds of import duties for a small number of sugar refiners; to a temporary repeal of Rumania's most favored nation status; or to the authorization of $7 billion for agricultural export promotion, retraining and trade adjustment assistance.

Despite these provisions, it is still believed that the House-Senate Conference will produce a bill that can be signed by the President, as evidenced by the assertion made by Mr. Clayton Yeutter, the United States Trade Representative, that the President was not turning trade into a partisan issue, nor following a veto strategy. Of course, this will not be known until the coming fall. In the meantime, the Congress will go into recess and with it will also recede, at least temporarily and from the surface, some of the prevailing apprehensions. Thus, August worriers can relax, until it can be seen how things look in the fall.
I. 4. FREER TRADE BETWEEN CANADA AND THE UNITED STATES
(14 October 1987)

The ink has not dried sufficiently to allow for an accurate evaluation of all the consequences of the recent agreement for the establishment of a free trade area, initialled on October 3 after sixteen months of negotiations, by the representatives of Canada and the United States. Even so, what is at stake not only is of staggering magnitude but some of the characteristics of the agreement, almost immediately, were hailed as a model for future trade negotiations.

First of all, the magnitude of what is at stake can be better appreciated when it is considered that between the United States and Canada already exists the world's largest bilateral trading relationship. Through what President Reagan, in welcoming the agreement, called "the world's longest undefended border," during 1986, passed both ways $124 billion in products and services. Of this amount, $54 billion were U.S. exports to Canada, or 24 percent of total U.S. exports and 70 percent of total Canadian imports. In exchange, U.S. imports from Canada amounted to $70 billion, or about 78 percent of Canada's total exports and 18 percent of total U.S. imports.

Just for the sake of contrasts, these figures should be compared with the exports to the world as a whole of all the other countries of the Western Hemisphere, which in 1985, amounted to almost $100 billion. Furthermore, the inherent dynamism of this intense economic interdependence can be better illustrated by observing that, between 1980 and 1986, U.S. exports to Canada increased by $14.7 billion, while exports to the rest of the world declined by $13.5 billion. Also, during the same period, U.S. imports from Canada rose by $27 billion, compared to an import increase from the world as a whole of $99 billion.

The product composition of this trade relationship reveals basically the dominance of high technology and complex manufactures. For instance, in 1986, 36 percent of U.S. imports from Canada were motor vehicles, while nearly 40 percent of U.S. exports to Canada were automobiles and parts, to the point that two-way automotive trade exceeds $45 billion per year. Other major traded products were office machinery, electronic components, telecommunications equipment, aircraft, professional and scientific instruments, crude petroleum and products, paper, coal and lignite, as well as aluminum and natural gas.
Moreover, while bilateral agricultural trade amounts to only $3.5 billion, or 3 percent of total two-way trade, U.S. exports of services to Canada have generated persistent surpluses, largely offsetting the U.S. merchandise trade deficit, which persists since 1976. For instance, the U.S. exhibited in 1985 a merchandise trade deficit with Canada of $15 billion, a services surplus of $9.3 billion and a current account deficit of $5.7 billion.

Finally, U.S. direct investments in Canada amount to $46 billion, with U.S. investors in control of about 18 percent of all Canadian non-financial industries, ranging from a high of 64 percent in the transport equipment industry to 2 percent in agriculture. For its part, Canadian direct investment in the United States totals $17 billion, which places it fourth in rank as a major investor, after the United Kingdom, the Netherlands and Japan.

Given the magnitude and intensity of the levels of interdependence already existent among these economies, the signature of the agreement for the establishment of a free trade area among them widens and deepens their relationship, in the words of the Canadian Ambassador to the United States, into "unique" and "uncharted territory". Because, besides the traditional dispositions to deal with already interdependent sectors, such as agriculture, automobiles, alcoholic beverages, or energy, the agreement contains some innovative dispositions for the management of interdependence, as well as on trade in services, intellectual property, finance and investment, culture, personnel movements, government procurement, and the settlement of disputes. Some of these last innovative ingredients have already given ground to the assertion that the agreement constitutes "an example of enlightened commercial relations."

Although, admittedly, it is still too early to perform a comprehensive evaluation of the agreement's significance or, much less, to pass definite judgments about where and among whom to look for the winners and the losers. Meanwhile, before jumping to any sort of conclusions, at this point, the most that can be safely done is to focus on some of the most innovative aspects of the agreement.

For instance, the section dealing with trade in services, according to the Office of the United States Trade Representative (USTR), constitutes "the very first international understanding of a comprehensive nature over the services industries under which each side will provide treatment to each other's citizens that is no less favorable than that granted to its own citizens with respect to all new measures affecting services." These dispositions refer specifically to enhanced telecommunications and computer services, tourism, architects and transportation.
Second, on the settlement of disputes, the agreement innovates by the creation of a mechanism by which differences not resolved by direct consultations will be automatically referred to arbitration panels, composed of neutral, independent experts, whose "declaratory opinions" cannot be appealed. Although if the problem persists, in spite of the panel's opinion, the aggrieved party will be allowed to retaliate. These dispositions have raised some questions because, as Representative Jim Leach (R-Iowa) declared, they are "in a constitutional sense, a bit unseemly."

Third, on investment, the agreement's objective is described as the creation of an "open investment climate." Thus, parameters are defined under which Canada will continue to review U.S. investment. Specifically, review procedures applied to indirect acquisitions of Canadian firms are abolished, and those applied to direct acquisitions are reduced. Even so, there are exceptions, as in the case of culture. For instance, "the Parties expressly agree that cultural industries are excluded from the investment chapter."

Fourth, these "cultural industries" are defined in a separate annex and they are in effect exempt from the provisions of the agreement. Among these "cultural industries" are found the publication, distribution, sale or exhibition of books, magazines, periodicals, or newspapers in print or machine readable form; films or video recordings, as well as audio or video music recordings; music in print or machine readable form; and finally, radiocommunications, whose transmissions are intended for direct reception by the general public, including all radio, television and cable television broadcasting and all satellite programming and broadcast network services.

The inclusion of these cultural aspects in an agreement establishing a free trade area, probably, constitutes one of its most innovative aspects. In fact, the United States recognizes "the importance to Canada of maintaining its cultural identity," while trying to assure, at the same time, that "Canadian cultural policies do not constitute a discriminatory and unnecessary barrier to U.S. trade." Apparently, on the basis of this recognition a quid pro quo was found, by which Canada agreed that those "cultural measures it takes will not impair the benefits the U.S. would otherwise expect from the provisions of the agreement."

Finally, even in the traditional areas of interdependence the agreement exhibits other innovative traits. For instance, on the automotive industry it includes "a new North American (U.S. and Canada) rule of origin based on direct cost of manufacturing," in order "to stimulate increased use of U.S. and Canadian automotive parts and materials." Also, it is
specifically determined that the benefits derived from free trade in automobiles can be enjoyed "by current participants only (mainly Chrysler, Ford and General Motors)." The purpose of this disposition is to specifically "ensure that no new firm may receive" benefits, "such as duty free access to parts or vehicles from third countries." These dispositions will make it very difficult for foreign manufacturers to access the North American markets under free trade conditions.

Additionally, on energy, the agreement tries "to assure the freest possible bilateral trade" including nondiscriminatory access for the United States to Canadian energy supplies and secure market access for Canadian energy exports to the United States. In this area, an immediate concession was granted by the United States by allowing the export of up to 50,000 barrels per day of Alaskan North Slope crude oil, provided that it moves in U.S.-flagged vessels.

To conclude, it should be reminded that this is the second agreement of this kind recently concluded by the United States with a trading partner, since the first one was signed with Israel almost two years ago. Also, immediately after the announcement of the agreement with Canada, it was revealed that as a result of secret negotiations, which lasted several months, the United States and Mexico, within the next thirty days, would sign a free trade agreement among themselves. Of course, a trend has already been detected, summarized editorially in The New York Times as "today Canada; tomorrow the world."

I. 5. FRAMEWORK AGREEMENT ON TRADE AND INVESTMENT BETWEEN THE UNITED STATES AND MEXICO (18 November 1987)

Two years after the United States signed an agreement with Israel to establish a free trade area, and only weeks after the United States and Canada concluded an agreement also for the creation of a free trade area in the next ten years, the United States and Mexico signed an agreement setting up a "framework of principles and procedures for consultations regarding trade and investment relations."

Before jumping to the conclusion that these events are constitutive of a trend, several special circumstances have to be taken into consideration. For instance, in the words of the U.S. Trade Representative, Mr. Clayton Yeutter, the Israel-American Free Trade Area "is but the latest in a long series of examples of how American and Israeli destinies are intertwined." Also, in President Reagan's terms, "the people of the United States and Canada have had a long and harmonious friendship that is the envy
of the world." Now, they "share membership in the world's largest
free trade area," which formalizes the fact that between them
there already takes place the world's largest bilateral trading
relationship. For its part, Mexico constitutes the fourth largest
trading partner of the United States, after Canada, Japan, and
West Germany, with a total of $30 billion two-way trade turnover
in 1986. Also, despite the severe impact of the present economic
situation, Mexico remains the third largest export market for the
United States and it still holds the fifth place as supplier of
U.S. imports. Consequently, all these bilateral trading
agreements can be interpreted as designed to bring forth a more
thorough formalization of the already intense linkages of
strategic and commercial interdependence existent among allies
and neighbors.

Nonetheless, Ambassador Yeutter has admitted that only after
the GATT ministerial meeting, held in Geneva in 1982, failed to
launch a new round of multilateral trade negotiations, the United
States "decided to pursue bilateral agreements, including free
trade areas," as a component of a "new strategy" conceived "as a
way to break down trade barriers."

For Ambassador Yeutter, free trade areas (FTAs) "strengthen
the multilateral trading system" and their promotion by the
United States is part of this "bilateral strategy," aimed at
complementing "multilateral efforts in two important ways." The
first one is derived from "the very fact that the U.S. is willing
to negotiate FTAs," because this has "renewed the interest of the
rest of the world in the multilateral system." In this sense,
other countries are advised that "if they want to continue to
have access to the world's largest market, they had better get
serious about improving the GATT."

The other way in which FTAs are said to complement
multilateralism derives from the expectation that these bilateral
negotiations "should serve as important precedents for progress
in the Uruguay Round." This is said to be so, because "as
currently constituted," the GATT is considered incomplete since
it "does not address the realities of modern trade." By contrast,
FTAs are expected not only "to eliminate all duties and virtually
all non-tariff measures, but also address services, intellectual
property rights and investment issues."

But so much for the rationalization of this avowedly
"bilateral strategy" to enhance multilateralism. As indicated by
its title, the recent agreement between Mexico and the United
States does not aim at the establishment of a free trade area, it
only creates "a framework of principles and procedures," to carry
out "consultations regarding trade and investment relations." In
the words of Mr. Guy Erb, a U.S. businessman who chairs the
U.S.-Mexico policy committee of the Overseas Development Council
(ODC), the recent agreement "is not nearly so ambitious as the
agreement between the United States and Canada, but it is still highly significant," for several reasons.

First of all, in Mr. Erb's opinion, the agreement's significance can be better appreciated when it is recalled that the last bilateral commercial treaty between Mexico and the United States was allowed to expire in 1949 and ever since there has not existed a broad trade agreement between the two countries.

Second, the negotiations themselves seem to have evolved rather slowly. After the decision was adopted to undertake them, on April 23, 1985, Mexico's earthquake in September of the same year, as well as its accession to GATT, on August 1986, contributed to slow down the negotiations. In the end, these last really started only in January 1987, to culminate ten months later, on November 6, 1987.

Third, the contents reveal the high sensitivity of the different issues included in the agreement, a factor which also must have contributed to the negotiations' protractedness. For instance, the agreement contains three parts: first, a statement of principles; second, the establishment of a consultative mechanism; and third, a promise to exchange data. Finally, a "side letter," initialled simultaneously, contains the decision to undertake, within ninety days of the agreement's signature, multilateral consultations on several sensitive issues.

The consultative mechanism and the promise to exchange data are the simplest and the less controverted parts of the agreement. On the mechanism, consultations within thirty days are agreed on any trade or investment issue, by request from either side. On the exchange of data, both parties agree to improve the collection and transmission of statistical information and promise to participate in a GATT sponsored study on tariffs.

By contrast, several controverted issues appear in the preamble --which apparently took the longest to negotiate because it contains the statement of principles-- as well as in the side letter.

First of all, the "statement of principles" begins by declaring the mutual disposition to enhance friendship and cooperation and recognizes the need for dialogue and frequent consultations on trade and investment. It asserts, as well, the desirability of resolving all contentious issues as soon as possible.

Second, there follows a set of statements which, from their ordering, can be inferred to be the result of mutual concessions. For example, while Mexico's "present status as a developing country" is recognized, this is immediately followed by an
admission of the importance of "promoting a more open and predictable environment for international trade and investment." Also, the need to eliminate non-tariff barriers, to facilitate access to markets, is followed by the recognition that "export earnings are important to the ability to fulfill foreign debt obligations." Furthermore, the mention of the benefits from increased trade, as well as the detrimental effects of protectionism, is accompanied by a confirmation of the increased importance of services and of the "complementary role" played by direct foreign investment in growth, employment, trade, technology transfer and economic development. Then, after recognizing the importance of protecting intellectual property rights, there appears an allusion to the special role played by commerce in the development of border regions. Finally, this list of principles concludes with an expression of support for the progress made by the "current process of trade liberalization of the Mexican economy."

On the other hand, the issues which will have to be addressed during the next ninety days, as they appear in the so-called "side-letter," give a good idea of their highly controverted nature. For example, textiles, steel, electronics, agricultural products, investment, technology transfer and intellectual property, as well as the exchange of information about the service sector, constitute the agenda of what lies ahead in the coming negotiations between Mexico and the United States. Thus, the "framework agreement" just sets the scenario, the substantive discussions will follow.

I. 6. NEGOTIATING TRADE IN SERVICES: PART TWO (25 November 1987)

Not much additional evidence is needed to conclude that the agenda of a new international political economy is gradually groping towards the surface. Several subjects have already gained a position in this agenda, where there prominently appear, besides the globalization of capital markets, issues such as trade in services, as well as the protection of intellectual property rights. Of course, all these issues are surrounded by controversy, in large degree because the United States has led the discussion, suggesting that they become part of ongoing international negotiations.

Recently, on October 28 and on November 4, the United States delegation tabled, in Geneva within GATT's Uruguay Round, two concrete proposals to deal with the protection of intellectual property rights and with trade in services. Needless to say, both proposals constitute a breakthrough in the negotiations, since until now the concrete intentions of the United States on these matters remained unknown.
The most innovative of the two proposals is the one referred to trade in services. As it can be recalled, at the beginning of the year, a consensus was attained in Geneva on negotiating procedures, which included the subject of services. By contrast, the last proposal presented by the United States on this pathbreaking issue, in effect, sets the substantive agenda of the negotiations.

The consensus attained in Geneva on negotiating procedures, on January 1987, led to the recognition of several "agenda elements", which were to be discussed during the negotiations' "initial phase." Among these elements there appeared, first, definitional and statistical matters; second, the coverage of the multilateral framework on services; and third, the identification of those measures and practices which facilitate or hinder trade in services.

On November 4, 1987, the U.S. delegation submitted the proposal for the negotiation of a "framework agreement" on trade in services, despite the recognition that "participants in the GNS (Group on Negotiations on Services) should continue to deepen their analysis of all the elements of the 1987 work plan." In the terms of the U.S. Trade Representative, the presentation of this proposal derives from the adoption by the United States of a two-step approach, starting with the early negotiation and implementation of a "framework agreement," to be followed by the negotiation of "specific sector agreements ... to which countries could subscribe individually." Thus, during the present stage, the immediate objective is the attainment of a framework agreement, whose constitutive elements are described with a certain degree of precision in the U.S. proposal.

This framework agreement is expected to contain two sorts of elements: first, general considerations and second, specific concepts. Among the general considerations are found: 1) as a general aim, the progressive liberalization of a wide range of services, in as many countries as possible; 2) a recognition of the sovereign right of every country to regulate its services industries, with the framework ensuring against the adoption of restrictive or distortive measures of trade in services; 3) for the framework to be beneficial to every country, regardless of its stage of development, progressive and time-phased liberalization of world services markets should be pursued, in order to provide for a more competitive environment which enables consumers to utilize services bearing the most advanced technology at the lowest prices; 4) the framework should also contain rules for cross border movements of services, as well as for the establishment of foreign branches and subsidiaries to produce or deliver services in the host country; and 5) the framework should serve as a point of reference for the
negotiation within the GNS of subsequent individual sector agreements.

Among the specific concepts that the framework agreement on services should contain, according to the proposal presented by the U.S. delegation, are found: 1) transparency, meaning that measures affecting service industries should be developed and maintained in a clear and predictable manner, to make information on such measures readily accessible and known to all interested parties on an equal basis. 2) Non-discrimination, understood as the unconditional extension of the benefits of the agreement to all signatories, although flexibility is allowed for the unilateral imposition of exceptions or for the adoption of safeguards in relation to the agreement's coverage, if the number and the extent of these exceptions remains limited. 3) National treatment, by which foreign service providers should be treated identically as domestic service producers, including specifically access to distribution networks, local firms and personnel, customers, licenses and rights of use of brand names. 4) Local establishment, where there is no reasonable basis for requiring it, service providers should be able to supply them across borders. 5) Discipline on state sanctioned monopolies, be they private or government owned, entails the provision of their services to foreign-based users on a non-discriminatory basis with respect to quality, price and quantity. 6) Subsidies, be they domestic or for export, are to be submitted to analogous rules as those existent within GATT for trade in goods. 7) Non-discriminatory accreditation procedures, aimed at discouraging licensing measures unrelated to professional competence and ability to perform, because these discriminate against foreign providers of licensed services. 8) Finally, consultations and dispute settlement procedures can be similar in concept to those already existent within GATT.

If, during the present phase of the negotiations, a framework agreement containing such general considerations and specific concepts can be negotiated and implemented, concludes the proposal presented by the U.S. delegation, this "could then be the point of departure for the negotiation of sectoral agreements during the later stages of the Uruguay Round."
I. 7. INTELLECTUAL PROPERTY RIGHTS (IPRs)  (2 December 1987)

In stark contrast with trade in services, the protection of IPRs does not seem to have yet gained admission into the agenda of the new international political economy. After all, copyrights are internationally regulated by the Berne Convention for the Protection of Literary and Artistic Works, which dates from 1971 and to which the United States decided to access only in 1986. Also, patents and trademarks are regulated by the Paris Convention for the Protection of Industrial Property. Finally, there already exist several intergovernmental institutions to deal with some of the international dimensions of both of these matters. For instance, under the United Nations Educational, Scientific and Cultural Organization (UNESCO) operates the Universal Copyright Convention, in which the United States is still present—despite its withdrawal from UNESCO in 1984—by participating actively in the meetings with the other 78 members of the Intergovernmental Copyright Committee. Also, to promote the mutual recognition, as well as the harmonization of national legislation, headquartered in Geneva, there is the World Intellectual Property Organization (WIPO). Thus, it cannot be said that the protection of IPRs has been absent from international interdependence.

What seems to have happened in this international issue-area is that the existing mechanisms and norms appear overtaken and surpassed by the accelerated pace of technological evolution. Consequently, at stake is the modification of a status quo, apparently judged by some as no longer adequate to present technological circumstances. Only until very recently, for example, the violation of copyrights had to do with the unauthorized reproduction of books, films and music, while the violation of patents consisted of copying brand-name consumer goods. How rapidly circumstances have changed, making obsolete some of the existent instruments and approaches, is better seen because patent violation today consists of the copying of highly sophisticated agrochemicals, pharmaceuticals, or even of extremely complex parts for aircraft. Or because modern violation of copyrights consists in the unauthorized reproduction of computer software and the much more complex duplication of chips lay-out design and topography.

Obviously, the terms in which these matters are discussed have also experienced considerable change, particularly when it comes to the acceptance of existent approaches, norms and instruments. For instance, until not long ago, IPRs were considered non-tariff barriers (NTBs) that, by definition, remained outside the bounds of the GATT. Furthermore, certain complacency seemed to prevail with the status quo, which only
gradually experienced very slight change, as a result of the unilateral acceptance of a degree of harmonization of national legislation. This relative complacency with the status quo found confirmation in the fact that the whole issue of IPRs was perceived in terms of a basic confrontation between supposedly privileged nations, endowed with technological capabilities, and those lacking such comparative advantages.

Even so, simultaneously, rapid and substantial changes were taking place in perceptions and actions. Without awaiting for the conclusion of the debate about the differences between the technologically endowed and the technologically disabled, the United States in the Trade and Tariff Act of 1984 began to transcend the terms of this confrontation. First, the benefits granted under the Generalized System of Preferences (GSP) were linked to the record exhibited by the potential beneficiary in the protection of IPRs. The same kind of requirement appeared, as requisite to obtain the condition of potential beneficiary, in the relatively more geographically restricted preferences granted under the Caribbean Basin Initiative (CBI). Finally, all these activities culminated with the section on IPRs contained in the Punta del Este Ministerial Declaration, launching the Uruguay Round. In effect, the section represents a rather definite clarification, in the sense that henceforward the subject falls within GATT's jurisdiction. The declaration states that "the negotiations (on IPRs) shall aim to clarify GATT provisions and elaborate as appropriate new rules and disciplines." Moreover, the overall purpose of the negotiations on this issue is defined as the design and approval of "a multilateral framework of principles, rules and disciplines dealing with international trade in counterfeit goods." To conclude, as if to placate those in favor of the status quo or those in favor of less activist approaches, these aims are said to be "without prejudice to other complementary initiatives that may be taken in the World Intellectual Property Organization and elsewhere."

A further step was given just a month ago, when the U.S. Trade Representative tabled in Geneva, on October 28, 1987, a comprehensive proposal within the Uruguay Round on IPRs negotiations. To begin, Mr. Clayton Yeutter, in the presentation of the U.S. proposal, makes it very clear that "inadequate and ineffective protection for intellectual property seriously distorts trade." Furthermore, in what amounts to an epilogue to the debate on the subject of GATT jurisdiction, Mr. Yeutter recalls that the launching of the Uruguay Round entailed the establishment, within GATT, of a negotiating group dedicated to "the trade-related aspects of intellectual property rights." Although Mr. Yeutter recognizes that "this is a new area of negotiation for GATT," he also warns that "if the GATT is to have credibility as an institution it must evolve with changing economic conditions and confront new trade problems." Of course, existing arrangements, such as the Berne and the Paris
Conventions, are judged insufficient, for two basic reasons. First, they are seen as "never intended to be used as enforcement mechanisms," and second, "they do not have effective dispute settlement provisions." Consequently, GATT's role in this issue-area is defined as "a supplement," to facilitate the protection of intellectual property and to reduce trade distortions.

To conclude, the U.S. proposal can be summarized by focusing on its three basic objectives: 1) the approval of a set of standards and norms, to provide adequate and effective protection of intellectual property; 2) the establishment of international mechanisms for dispute settlement and enforcement procedures; and 3) to require from signatories that they bring their national legislation into conformity with a set of agreed norms, to be contained in a specific annex. Finally, the scope of the agreement is spelled out by listing at least five different forms of IPRs to which the new framework will be applied, if approved: copyrights, patents, trademarks, trade secrets, and chip lay-out designs.
II. COMMODITIES AND AGRICULTURAL PROTECTIONISM

II.1 THE DECLINE OF NON-FUEL COMMODITIES (13 May 1987)

"Flagging demand, rising supplies, falling prices, and generally deteriorating terms of trade," summarize what the World Bank and the International Monetary Fund call "the commodities problem of developing countries." In effect, 1986 has been a particularly bad year for non-fuel commodities, probably one of the worst of the last fifty years. "Indeed," say the Bank and the Fund, "real commodity prices in 1986 were at their lowest level since the depression of the 1930s."

In contrast to the previous decade, when instability was the main trait of commodity prices, in the present decade they have been characterized by a declining trend. Thus, during the 70s, there was a resurgence of the concern of classical economics about a rising trend in the prices of raw materials, because of limited supplies, amidst population growth. By contrast, during the 80s, due to the steep decline in prices, along with productivity growth, increasing use of synthetic materials and pervasive protectionism, there has emerged a renewed emphasis on the hypothesis of declining commodity prices in real terms over the long run.

Judged by the performance of commodity prices during the 80s, it has to be admitted that there exists sufficient ground to justify this concern. For instance, during the first half of the 80s, the dollar prices of primary commodities fell dramatically in absolute terms, as well as relative to the prices of manufactures. Between 1980 and 1986, the average price in dollars for non-oil primary exports from developing countries fell by 26%, and by 37% relative to the prices of developing countries' manufactured imports. In 1986, prices for these commodities fell by 10%, and given the fact that this decline took place with a declining dollar, the drop in real terms was even greater.

Several factors contributed to this poor performance. Among them can be found, first and foremost, the sharply decelerating demand resulting from the slow growth experienced by the world economy, and second, unusually large increases in supply. The pace of economic activity in industrial countries still constitutes the most important determinant of the cyclical movements in aggregate commodity prices. Consequently, the incipient growth in world consumption of these products can be partly attributed to the sluggish performance of the Western European economies, which account for 50% of the world imports of
non-fuel primary commodities, as well as to the same kind of slack performance in Japan, which accounts for 15% of world imports of the same commodities. Admittedly, to this behavior of demand has to be added the fact that supply factors generally reinforce the trends in demand, in such a way that, for instance, investment decisions made earlier contribute to the downward trends provoked by the decreases in demand basically caused by the sluggishness in the pace of economic activity among the main consuming countries.

Some of the negative consequences of these trends can be better appreciated by observing the terms of trade of primary product exporters. For instance, from 1980 to 1986, the cumulative decline in the unit values of exports of developing countries amounted to 25%, in terms of U.S. dollars, and 15% in terms of SDRs. By 1986, the terms of trade of primary product exporters were around 20% lower than at the beginning of the decade, which represents an annual decline of over 3%. Evidently, this severe reduction in purchasing power, accompanied as it was by the reduced availability of external finance, translated itself into a drastic reduction in imports, whose volume fell on average by 1% annually over the same period. The pervasive effects of this can be better appreciated by observing that, in 1980, exports of agricultural and mineral products --other than fuel-- accounted for over 50% of the total exports of as many as 73 countries.

But so much for the bleak past, what about the prospects? As recently as this last week, for instance, fears of inflation generated by the continued weakening of the dollar, as well as by the recent increase in interest rates, pushed the closely watched Commodity Research Bureau (CRB) index --which comprises 26 futures prices-- to 222.59 (1967=100). This represented the highest level of the CRB index since January 28, 1986, up from 221.71 the week before, and 209.07 at the start of 1987. Nonetheless, whatever may be the lasting significance of these fears of inflation, the medium term prospects for non-fuel commodities remain negative, from almost any perspective. First of all, it has to be considered that prices are starting from the very low base set in by 1986, which as it was already mentioned were among the lowest registered during the last 50 years. Second, from 1986 until 1995, projections of increases of 4.5% per year, in the export volumes of non-fuel primary commodities, show that by 1995 the terms of trade of the exporters of these products will still be around 30% below the 1965 level and 10% below the 1980 level. Finally, according to the World Bank and Fund projections, for the next 15 years the prices of non-fuel commodities are expected to recover somewhat relative to the prices of manufactures. For instance, from 1986 to 2000, it is projected that non-fuel commodity prices will rise by 15% in real terms. But considering the fact that 1986 was a record low, in the year 2000, commodity prices will still be 4%
below their 1985 level. "In a broader historical perspective," according to the Bank and the Fund, commodity prices will "still be lower than in any postwar year before 1985, and as much as 25% below their 1980 level." Thus, in conclusion, "no substantial recovery is expected in the next 10-15 years."

If this adverse outlook in the terms of trade of commodity exporters is combined with the perspective of higher interest rates and scarce lending, developing countries seem to be bound to an extremely negative conclusion of the present century.

II.2 DEALING WITH AGRICULTURE, FAUTE DE MIEUX (20 May 1987)

With the usual pledges in favor of improving growth prospects through greater cooperation, of overcoming trade imbalances, as well as of stabilizing exchange rates, after two days of meetings in Paris, last week concluded the annual gathering at Ministerial level of the Council of the Organization for Economic Co-operation and Development (OECD).

It is tempting to dismiss these increasingly frequent, high-sounding, and somewhat esoteric statements, issued at the conclusion of meetings like this one, as mere declarations of good intentions. Because, more often than not, these attempts at reassuring highly skeptical financial markets, by presenting them with an apparent unity of purpose and action, within hours, are contradicted by events fueled not so much by what is stated in the formal communique, but particularly by what remains unmentioned.

In effect, among jittery financial marketeers, it is relatively easy to attest that after several of these communiques, such as the Louvre agreement, or those issued after G-7 meetings, world economic growth keeps declining, the dollar continues to fall, and trade imbalances continue yawning. Furthermore, recently in the United States, fears of inflation have pushed up interest rates, raising the specter of tight monetary policies, which in the present context of prolonged but sluggish expansion can only lead to world recession.

Nonetheless, amidst these evidently skeptical, if not cynical, reactions, the good news is that just the mere fact that the representatives of the leading industrialized economies meet with such frequency is indicative, by itself, of the existence of a disposition to look for common solutions to mutually identified problems. Also, on the positive side, it
should be noted that sometimes decisions are agreed upon to confront some of the pending issues constitutive of the international economic agenda.

In these last terms can be better appreciated the results of the last Ministerial Council of the OECD. The final communiqué of the meeting is divided into four parts: I) improving growth prospects; II) macroeconomic policies; III) structural adjustment policies; and IV) relations with developing countries. Admittedly, concrete results are hard to find throughout the four sections of the communiqué, except in the one dedicated to "structural adjustment policies." In this section, divided by issue areas, is addressed the very important and urgent problem of agricultural protectionism, but not without previously recurring to some relatively high-sounding generalizations. For instance, it is said that "priorities in reforming structural policies will vary in individual countries reflecting differing national situations but also international requirements." From here, it is concluded, that "it is thus essential that concerted action be guided by common principles," because "to ensure the greatest gains from reform, action must be broad, bold, sustained and, to the extent possible, built on international economic co-operation." In effect, some of the decisions announced in almost all the policy areas mentioned in the communiqué mainly consist of ordering progress reports, as in the case of technological change; or in the ratification of agreements already approved by previous meetings, as in matters such as employment, energy, the environment, as well as in the support for the Uruguay Round.

Consequently, after reviewing these evident manifestations of relative inaction, expressed by means of understatements loaded with long innuendos, behind which of course hide relatively distant national positions, it appears as somewhat surprising and paradoxical that it was in the field of agriculture where some of the most concrete decisions can be found. Not only that, but several important facts are candidly recognized. For instance, it was accepted that the "serious imbalances that prevail in the markets for main agricultural products," are "boosted by policies which have prevented an adequate transmission of market signals to farmers." In the end, it is admitted, these policies have led to the result that "supply substantially exceeds effective demand." Furthermore, in a rare admission, it is openly recognized that "excessive support policies" cause profound consequences, such as first, "increasing distortion of competition in world markets;" second, that they "run counter to the principle of comparative advantage which is at the root of international trade," and finally, that these policies "severely damage the situation of many developing countries."
To confront some of these problems, it was decided that "a concerted reform will be implemented in a balanced manner," spelling out the principles on which it will be based. First, the long-term objective of the reform is described as "to allow market signals to influence by way of progressive and concerted reduction of agricultural support, as well as by other means, the orientation of agricultural production." Second, it is admitted that in the achievement of this long-term goal, "consideration may be given to social and other concerns, such as food security, environment protection or overall employment, which are not purely economic." Third, "the most pressing need" is described as "to avoid further deterioration of present market imbalances," for which it is necessary to improve demand prospects, to prevent increases in supply by means of reductions in guaranteed prices and other production incentives, or by imposing quantitative production restrictions. Fourth, it is recognized that "farm income support should as appropriate, be sought through direct income support, instead of through price guarantees or other measures linked to production or to factors of production." Fifth, the Uruguay Round is said to be "of decisive importance," to provide for the improvements of market access and for the reduction of trade barriers in agriculture, although it is recognized that a need exists for "de-escalation of present tensions." Sixth, for this last purpose, OECD governments promise to "carry out expeditiously their standstill and rollback commitments and, more generally, refrain from actions which would worsen the negotiations climate," agreeing specifically "to avoid initiating actions which would result in stimulating production in surplus agricultural commodities and in isolating the domestic market further from international markets." Also, and probably of more importance, they decided to "act responsibly in disposing of surplus stocks and refrain from confrontational and destabilizing trade practices."

Finally, the Secretary General of OECD was instructed to monitor the implementation of these compromises and was asked to submit a progress report to the Council at Ministerial level in 1988.

Thus, in conclusion, to the disappointment of "instant problem-solvers," after this last Paris meeting, some of the most important issues of the international economic agenda remain unsolved. But, at least, an important step forward was given in the search for concerted methods for confronting the very thorny issue of agricultural protectionism, where the industrialized countries, obviously, do not practice what they preach.
II.3 . COSTS AND BENEFITS OF AGRICULTURAL PROTECTIONISM
(27 May 1987)

Now that the Ministerial Council of the Organization for Economic Co-operation and Development (OECD) has decided to undertake a "broad, bold and sustained" reform of agricultural protection in industrialized countries, to evaluate the viability of such reform, it becomes necessary to analyze the forces which appear behind protectionism.

First of all, as the final communique of the Ministerial Council candidly admits, income support to farmers has become the most important explanation for the existence of agricultural protectionism in industrialized countries. This is different from other objectives, frequently invoked in developing countries to justify such policies, such as food self-sufficiency or security, national independence, or foreign exchange savings. Thus, at stake is the protection of a relatively well defined group, which has exhibited an impressive capacity to preserve such privileged treatment. Second, the preferred instrument to sustain the income of this group has been price support, apparently because its economic costs are disguised and its budgetary costs initially can be relatively small. Third, precisely because of the utilization of price support as an instrument of income support, a perverse logic has been unleashed, which helps to understand the relative urgency of reform. Among the main consequences of any price support mechanism are increases in production and decreases in consumption, at least where substitutes are available. Consequently, the most obvious result of these policies is the emergence of output in excess of national demand, which in effect translates itself into growing surpluses --or so-called "butter mountains"-- as well as into higher and relatively more visible budgetary costs. In the end, these surpluses become the real limits to the amount of budgetary resources which can be dedicated to increased price support. Fourth, these interventions in domestic markets depress world prices, either through import limits, or through the direct subsidization of exports, as well as by the growing threat to price stability posed by the overhang of stocks. Thus, through this perverse logic, the preferred mechanism of supporting prices to protect farmers' income generates its own demise, in the form of the increasing availability of surpluses and by the generation of ever more important budgetary outlays.

No wonder this has led to growing dissatisfaction with these policies, because their direct beneficiaries find them inadequate, while others complain about their increasing costs. Such disenchantment lies behind the search for alternative protectionist instruments, such as direct production controls, by
means of restricting output or area, or behind apparently more altruistic disposal of surpluses by means of food aid or the direct subsidization of exports to third markets.

The second set of questions which should be addressed, to ponder the present viability of reforming agricultural protectionism in industrialized countries, refers to the more complicated matter of locating the costs and benefits of such policies. There are several viewpoints from which this question of measurement can be answered. First of all, there is the perspective of the world economy as a whole. Agricultural protectionism in industrialized countries reduces global productive efficiency, because it represents a shift in production from more efficient to less efficient producers, with the consequence that production is higher in high-cost areas and lower in low-cost areas. Thus, from this perspective, "gainers' gains are smaller than losers' losses."

Nonetheless, despite the manifest soundness of this assertion, admittedly, it is still rather difficult to measure. By contrast, the losses for the industrialized countries themselves seem to be relatively easier to measure. From this viewpoint, on the cost side appear the higher prices paid by consumers, as well as the taxpayers' contributions required to finance protectionist measures. On the benefit side appear the direct payments to producers in the form of higher prices. Accordingly, the World Bank's World Development Report, 1986, estimated the costs of price support mechanisms in terms of "transfer ratios," or the average loss to consumers and taxpayers for each dollar transferred to producers. For instance, in the United States in 1985, a transfer ratio of 1.40 generated costs of $4.5 billion. Also, the domestic costs of the Common Agricultural Policy (CAP) of the European Community, in 1980, were estimated at $15.4 billion, at a transfer ratio of 1.50. Finally, in Japan the domestic costs of agricultural protection, for 1976, were estimated at $4 billion, at a transfer ratio of 2.60, given the relative high domestic price of rice.

A recent study of the World Bank and the International Monetary Fund, concludes that, as a whole, in 1985 dollars, "the annual costs of agricultural protection in these three major industrial areas was estimated to amount to $33 billion, 0.4 percent of their combined GNP." To this conclusion it should be added, for illustrative purposes, that these protectionist policies have led to some very impressive aberrations. For instance, in 1982, the European Community became the world's largest exporter of sugar, while Japan, in 1986, produced 900,000 tons of sugar, or about one third of its domestic consumption, at prices to producers of more than seven times the world price and to consumers at five times the world price. In the United
States, sugar producers as well as producers of chemical and other substitutes benefitted, in 1987, of quotas of 1.3 million short tons.

From the perspective of developing countries, even more substantial losses are caused by policies such as trade restraints to protect not only agriculture but also processing industries, as well as to raise revenues. For instance, it has been estimated that a 50% reduction of the trade restraints on coffee and cocoa and their processed products, in 1975-77, would have raised the export earnings of developing countries, in 1985 dollars, by at least $600 million. Also, in 1975-77, a 50% reduction in the OECD tariff on sugar, as well as the equivalent relaxation of quantitative restrictions, would have yielded an annual increase of $1.5 billion in the export earnings of developing countries. Finally, the overall benefit of a 50% reduction in OECD tariffs on agricultural imports and the equivalent relaxation of quantitative restrictions has been estimated, in 1985 dollars, at $3.5 billion a year of increased export earnings for developing countries.

But so much for the measurable effects of agricultural protectionism, how about some of the intangible costs and benefits? For one thing, obviously, world prices based on some of these aberrations are not reliable signals for policy-making. Also, probably of more importance, this predilection of industrialized countries for correcting domestic market disequilibria by transferring them to international markets, at high budgetary costs, furnishes an example of autarky and high protection and thus of waste of resources, which cannot be criticized when found in other countries. Just as a reminder, budgetary costs of farm policies are now estimated to exceed $25 billion a year, both in the United States and in the European Community, and $10 billion in Japan.

In conclusion, if there are not enough reasons to believe, at least, there are plenty of reasons to wish for the success of the reform of agricultural protectionism, recently agreed by the last OECD Ministerial Council. For instance, the Uruguay Round furnishes an extraordinary opportunity for the European Community and Japan, which together account for almost two thirds of world imports of non-fuel commodities. Obviously, altruism will not be the main engine of reform. Rather, the reasons will be the mounting budgetary costs of increasing surpluses, as well as the fact that agricultural protectionism is becoming a bone of contention among industrialized countries. For both of these reasons, it is necessary that negotiations take place to coordinate concessions. Nonetheless, to believe that these negotiations will succeed, at least, stocks should stop growing and subsidized exports should be curtailed.
III. HIGH-TECH INTERDEPENDENCE

III. 1. THE CHIP WAR (1 April 1987)

The retaliatory actions adopted by the U.S. Government against certain electronic imports from Japan amounting to a modest $300 million, in response to alleged dumping practices by Japanese producers of semi-conductor memory chips, were immediately termed an "opening salvo" or a "shot across their bow."

In a sense, at first sight, it seems justified to consider these retaliatory actions as a warning sign addressed to internal and external audiences. Such actions can be viewed as proof of the coming of an end of the "patience" exhibited by the U.S. Government regarding the persistence of its trade deficit. This was evident because, precisely on the same day that the measures were adopted, it was announced that the Japanese merchandise trade surplus in February rose to $8.14 billion, up from $5.7 billion in January.

On the other hand, the actions adopted were relatively circumscribed, in the sense that they affect only certain products which utilize the semi-conductors whose trade is regulated by a specific agreement to avoid dumping, subscribed between Japan and the United States during the summer of 1986.

Furthermore, sensitivity about these products had manifested itself, two weeks before, when the U.S. Government intervened to stop the acquisition by Fujitsu of the California-based chip producer, Fairchild Industries, alleging security risks.

On the internal side, the Republican Administration could be viewed as being under severe pressure, from a Democratically controlled Congress, to do something about the trade deficit, given the undergoing procedures for the approval of an overtly protectionist trade bill.

All these factors contributed to the impression that the "chip war" was better seen as a repetition of the similar measures adopted against European Community exports of cheeses and wines, which almost detonated a trade war at the beginning of the year. Such circumstances were viewed as evidence that the retaliation against the alleged dumping of Japanese semiconductors merely constituted another ritualistic posture, in the increasingly controverted commercial interdependence between the United States and Japan.

Finally, the central banks of the Group of Six (G-6) apparently had fulfilled their promises, contained in the
recently subscribed Paris agreement, by intervening actively in their respective exchange markets to preserve their currencies within certain undeclared "reference ranges." Thus, over the weekend, the retaliatory actions adopted by the U.S. Government against certain electronic imports from Japan were viewed only as another trade episode.

Nonetheless, on Monday when the foreign exchange markets opened, the Japanese yen crossed the barrier of 150 to the dollar, to land at its lowest post-war level of 146.20. Furthermore, to illustrate the very high and intense levels of interdependence attained in the world economy, the dollar's further decline --despite the Paris agreement-- immediately affected the stock markets of the main industrialized economies.

For instance, during the first 45 minutes of trading on Monday, Wall Street experienced its third worse decline on record, of 57.41 points, surpassed only by the loss of 81.61 points of August 11, 1986 and by the loss of 61.87 points in July 7, 1986. It should be noticed that this sudden decline was expected, despite the fact that the stock market had appeared very resilient to other relatively more alarming circumstances, such as the insider trading scandals, the Iran arms deal, and even the news of the Brazilian payments suspension. None of these circumstances had become unsettling enough and the stock market shrugged them off and kept on surging ahead.

This time it was different. The chain reaction unleashed by the trade sanctions against selected electronic imports from Japan immediately affected the already declining dollar-yen exchange rate, which contributed to the anticipation of higher inflation rates in the United States and consequently of higher interest rates and probably of a recession, which in its turn led to a shift by investors out of stocks. There was also another new ingredient, the fact that the United States stock and Government bond markets have become dependent on an influx of foreign financial resources, particularly of Japanese capital exports. Thus, this time, there existed also the possibility that the Japanese, as well as investors from other surplus countries, might decide not to recycle money back into the United States financial market.

In conclusion, the U.S. seems not to be free to affect unilaterally the dollar's exchange rate, to correct its trade deficit, since Japan has at its disposal the means to retaliate in the form of stopping investments in the U.S. bond, securities and real state markets. These linkages, between the two most powerful industrialized economies, certainly can constitute the basis for the arrival at a frequently suggested agreement on economic policy coordination, as a means of generating more stability in the world economy. Otherwise, the so-called "chip war" has proven that it can end up being not "cheap" at all.
III. 2. SUPERCONDUCTED INTO THE TWENTY FIRST CENTURY
(15 April 1987)

Doomsayers and Cassandras better beware, because science and technology seem to be on the verge of performing another qualitative jump of ingenuity and creativity that will, once again, disprove dire predictions. Recent discoveries in superconductivity are being announced at high speed. Those fortunate enough to understand what is going on hold that we are living through one of those rare but intense periodic outbursts of scientific and technological creativity, which have carried mankind to a new plateau of technological development. As it was better described by Philip W. Anderson, a theoretical physicist from Princeton University and Nobel laureate, "We need some time to breathe with this . . . one way or another, this will change the way we live."

To describe some of the events that have been recently happening, at least three questions must be answered. First of all, what is superconductivity? Second, where and how did it happen? And third, what are some of the applications of these discoveries?

The notion of superconductivity refers to certain materials that are capable of carrying electric current without generating the resistance that ordinarily wastes energy by transforming itself into heat. When superconductivity was discovered in 1911, by a Dutch physicist, it was believed that it could only occur at or near absolute zero temperatures, that is, at the theoretical point at which molecular motion stops. Until very recently, superconductors existed at the lowest imaginable temperatures, near minus 400 Fahrenheit, demanding considerable expense for cooling. Thus, in the past, maintaining such low temperatures confined superconductors to very limited and selective applications.

With the recent discoveries, in the past three months, physicists have pushed up the temperatures at which superconductivity occurs by the utilization of certain complex ceramics that can transmit electricity at higher temperatures --or even at room temperature-- without losing power into the transmitting material.

It all seems to have started, about a year ago, at an IBM laboratory in Zurich, where physicists conducted a successful superconduction experiment at higher temperatures, using a compound of barium, lanthanum, copper and oxygen. This complex ceramic became superconducting at a temperature of 35 degrees centigrade above absolute zero. From then on, started what has
been termed as a stampede of experiments that has led to increases in temperatures with different superconducting materials, in places such as AT&T, Bell Laboratories and the Argonne National Laboratory, the Universities of Houston and of Alabama at Huntsville, as well as in Europe, Japan and China. All this activity led, on March 18, 1987, to the organization of a meeting by the American Physical Society, where some of the most recent experiments in superconductivity were presented. As physicist Bertram Batlogg from Bell Labs remarked, in what immediately became one of the most quoted phrases to come out of the meeting, "I think our lives have changed." Or as an MIT scientist said, "this kind of thing you see once in your lifetime."

Some of the most important applications of these discoveries have still to be found. Presently, intense activities are already taking place to shorten the distance between research and development and from there to technology and production. For instance, it has been estimated that as much as 15% of electricity generated, presently wasted in transmission, will be saved. This will allow for the lengthening of the distances between generating and consumption centers. Also, today, almost one half of generating capacity is wasted, because electricity must be generated when it is needed. Until now, electricity cannot be stored, but this dream might soon become reality, because passing current through a superconductor creates a magnetic field, where current can be stored. As Dr. Ching-Wu Chu from the University of Houston said, "you close the loop and the current should last forever. Then you just open up the loop and you can tap the current out." It has also been projected that computers will become smaller and faster, since the danger of overheating in densely packed circuits, performing operations at high speeds, will disappear. In the field of transportation, the possibility has been suggested that by placing superconducting magnets on the bottom of a train and pulling it along a track of ordinary metal, the train will levitate, rising into the air and floating on the magnetic fields. The generation of electricity by nuclear fusion will be facilitated, because until now the crucial obstacle has been to create magnetic fields powerful enough to contain extremely hot reactions, as hot as the sun itself. Finally, some applications have been suggested in weapons technology, astronomy, medicine, and so forth.

To conclude, it must be mentioned that not all the interpretations of the significance of these discoveries coincide. For instance, on one side are found those who affirm that, as the United States exploited the jet engine, invented by the British, and the Japanese developed the VCR, invented by the United States, the Japanese will again prove their superiority by successfully commercializing these innovations. On the other
side appear those who assert that innovative capacity lies at the heart of a country's superiority.

III.3. THE "CHIP WAR" CAN BECOME A "FIERCE WAR" (29 April 1987)

An incident, related to alleged violations of an agreement on trade in semiconductors has transformed itself into a major confrontation. In the words of President Reagan, approval of the overtly protectionist legislation presently discussed in the U.S. Congress can set off a "fierce trade war."

In a way, the present intensification of threats and mutual recriminations between Japan and the United States constitutes a climax in the confrontation over trade and exchange rates, which has been raging among them since the subscription of the so-called Plaza Agreement of September 1985. This time, the debate intensified as part of the posturing preceding the visit this week to Washington by the Japanese Prime Minister Yasuhiro Nakasone.

The very brief communiqué approved, at the beginning of this month, by the Group of Seven (G-7) Ministers of Finance and Presidents of Central Banks referred only to the need for Japan to undertake efforts to reactivate its economy. This meant that the results of the so-called Louvre Agreement, of February 22, had been short lived, or that they merely constituted a pause in the ongoing confrontation. Also, the trade figures released for the month of March, showed that the U.S. trade deficit continued yawning, while the Japanese trade surplus continued reaching embarrassing proportions. Furthermore, the U.S. Congress, controlled by the Democrats, continued moving towards the approval of an overtly protectionist trade bill, which includes among other elements the "Gephardt Amendment." According to this last provision, the President would be required to retaliate against those trading partners that exhibit large trade surpluses with the United States, if they fail to reduce them by at least 10 percent yearly. Finally, the dollar's plunge against the yen and the D-mark continued, despite central bank intervention. In these circumstances, the lack of results in the negotiations about alleged violations of the agreement on semi-conductors was only another indicator, in an extensive list, of deterioration in the trade relationships between the major industrialized powers.

Thus, amidst loud and sometimes nasty recriminations, Japan and the United States find themselves deadlocked in confrontation. On one side, the United States complains that its trade imbalance can be partially explained by the fact that
the Japanese economy remains virtually closed and protected by an undervalued exchange rate, as well as by other barriers. On the other, Japan argues that the origins of the trade imbalance are found in the U.S. fiscal deficit, rather than in its relationships with Japan and West Germany. Furthermore, the lines of this debate furnish the background to the visit of the Prime Minister of Japan to the United States, to discuss what presently constitutes the top item in the economic agenda of the major industrialized powers.

Three distinct expectations have been mentioned regarding the outcome of these ongoing negotiations. First, there are those who see in these discussions an opportunity to arrive at an agreement to correct the imbalances existent among these two central economies, bringing to a halt the depreciation of the dollar, to avert inflation and a rise in interest rates, which would certainly sink the world economy into recession. By contrast, there are those who hold that the solution lies in allowing the market to set the dollar exchange rate. Finally, there are those who consider the U.S. deficit a normal consequence of the role of the dollar as a reserve currency. For them, the only way to avoid a deflationary collapse of the world economy lies in the re-establishment of a monetary asset that is not simultaneously someone else’s liability, which they find in the return to the gold standard.

III.4. TOSHIBA APOLOGIZES (22 July 1987)

Several clouds were already gathering above the economic relationships between the United States and Japan. For instance, the United States’ merchandise trade deficit increased to $14.4 billion in May. Also, in the wake of the vote on the trade bill, probably the loudest protectionist noises heard in a long time were emanating from the U.S. Congress. Finally, only the turbulent yen-dollar exchange relationship apparently had temporarily stabilized around 150 yen to the dollar.

Thus, it was probably in the worst of circumstances that Toshiba Machine, a subsidiary of the Toshiba Corporation, was accused of secretly and illegally selling, for years, to the Soviet Union—in association with a Norwegian company—strategically sensitive computerized propeller-milling machines.

The virulent reactions to this disclosure erupted with rapid-fire intensity. On May 15, Japanese investigators publicly confirmed that Toshiba Machine had sold advanced computer controlled machines to the Soviet Union, in violation of an international agreement restricting high-technology exports to
Socialist countries. Also, a state-owned Norwegian company, Kingsberg Vaabenfabrik, illegally provided the advanced computer software required to run the propeller-milling machines. The Japanese equipment, it was asserted, enabled the Soviet Union to build submarine propellers that generate much less noise, than those produced with conventional equipment, which in exchange sharply reduces the U.S. Navy's ability to track the Soviet submarine fleet. Furthermore, it was estimated that restoring these lost tracking capabilities could cost as much as $30 billion to U.S. taxpayers.

On June 30, the Senate voted 92 to 5 to retaliate by imposing, as part of the trade bill, a ban of two to five years on imports of Toshiba products to the United States. On July 1, it was announced that the two most highly ranked officials of the Toshiba Corporation, the Chairman and the President, had resigned. And although apparently the parent company had not known of the illegal exports of the subsidiary, it was recalled that in Japanese business circles resignation is considered "the highest form of apology."

Even so, also on July 1, a group of members of the U.S. House of Representatives vented their anger by granting to press photographers a photo opportunity, on the grounds of the Capitol, where they were seen smashing a Toshiba radio-recorder. "Treachery by any other name is still treachery," declared Representative Helen Delich Bentley (R-Maryland), "but if it had another name it would be Toshiba."

Probably stunned by the ignited reactions in the United States, Prime Minister Nakasone, on July 14, issued his strongest comment on the incident. Speaking before the Japanese Diet, Prime Minister Nakasone said that in making the sale "a Japanese company has not only damaged national defense, but also committed a crime of betrayal against the Japanese people because of its actions." On the same day, Mr. Hajime Tamura, head of the powerful Ministry of International Trade and Industry (MITI), departed for Washington to encounter a very cool reception. Meanwhile, the Toshiba Corporation addressed to several members of the U.S. Congress what was described as "an extraordinarily contrite letter," and published a full page apology in major U.S. newspapers extending "its deepest regrets to the American people."

These were some of the reactions constitutive of the latest skirmish between the two most powerful industrialized economies. It has to be said that, up to now, it had been either the yen-dollar exchange rate, or the dumping of semi-conductors, but with the addition this time of the sale of security sensitive high-tech products, definitely, the economic interdependence between Japan and the United States has attained
the category of the relationship of major tension of the present international political economy.

It is certainly not easy to try to find some of the reasons which have led to this sorry state of affairs. Because, for one thing, Japan is the country that has the most active and extended lobbying network in the United States. In fact, the number of hired firms and individuals, registered as lobbyists for Japan, is twice as numerous as those hired by the second most active government, Canada. Furthermore, this impressive network of lawyers, lobbyists and public relations specialists, has been estimated to cost yearly the staggering figure of between $50 and $60 million. In fact, according to the Justice Department, 109 individuals and firms are registered as "agents" of Japan, under the Foreign Agents Registration Act. Nonetheless, this figure does not include lawyers, who are exempt from registration requirements when they do simple legal representation, instead of direct lobbying. Neither does this figure include those who are employed by domestic affiliates of Japanese companies, which are also exempt from registration. Obviously, this high-powered network was immediately activated with the Toshiba incident, although it seems that this time it had relatively less success in controlling the damage. Nonetheless, Senator Lloyd Bentsen (D-Texas), chairman of the Senate Finance Committee, considers that Japan's lobbyists "have carried this to a degree of sophistication never seen before in lobbying." In his own terms, "it is as though MITI had allocated out to each company a different lobbying firm. It is a coordinated, concentrated effort."

On the other hand, it should also be recalled that sales of high-tech products to Socialist countries are supposedly controlled by the Paris-based Coordinating Committee for Multilateral Export Controls (COCOM). This organization licenses strategic exports to the Socialist countries and among its participants are found all the members of the North Atlantic Treaty Organization (NATO), except Ireland, as well as of course Japan. Nonetheless, with the Toshiba incident it has been highlighted that Japan submitted to COCOM, during the first half of this year, only 30 applications for license to export, in contrast with the 473 applications submitted by the United States, during the same period. Also, these figures appear as even more contrasting when it is considered that Japan contributes only $40,000 to the $3 million annual budget of COCOM, in comparison with the United States' contribution of 25%. Thus, it should be acknowledged that there existed some weaknesses in the organization to control high-tech and strategic exports to Socialist countries. Although, evidently, this acknowledgement does not help to understand the underlying reasons for the virulent reactions which the Toshiba incident generated in the United States.
The deepness of the reaction can be illustrated by pointing out what have been considered the strongest public criticisms of Japan made by the U.S. Treasury Department. These were made by Assistant Secretary David Mulford, in an address to the Japan Society of New York, in the aftermath of the Toshiba incident. The main complaint raised by Mr. Mulford, expressing what apparently is an ubiquitous impression, is that in the relationships between Japan and the United States there exists what he termed "an underlying note of frustration," because repeatedly Japan's "final achievement falls short of the initial promise." As the Secretary of Commerce, Mr. Malcolm Balridge, said more bluntly, "talk is not going to impress us."

Evidently, these frequent eruptions of troublesome incidents between Japan and the United States must be the result of deeper feelings of frustration basically generated by prevailing mutual misperceptions. For instance, it has become a feature in the media and in certain academic circles of the United States to portray the Japanese economy as a formidable and impressively efficient contender, that has definitely surpassed the United States. Naturally, to this alleged Japanese absolute superiority corresponds a mirror image of the United States as a declining economy. Be it as it may, these perceptions contribute to the "underlying frustrations," which in their turn give ground to the rather frequent eruption of recriminations. But as it was warned by the most recent appointee to the Federal Reserve Board, Mr. Edward Kelley, in an illuminating speech entitled A HISTORICAL HANGOVER, made at the Federal Reserve Bank of Atlanta on July 9, 1987, these perceptions may have dangerous consequences. The danger of the United States talking itself into "a lowered level of national confidence," or worse still, into "some type of hopelessness," according to Mr. Kelley, is that it "could easily lash back very destructively in the form of severe protectionist legislation or some bilateral slap at an ally that might do more harm than good."
IV. THE U.S. ECONOMY

IV. 1. THE TRILLION DOLLAR DRAGON (14 January 1987)

President Reagan has submitted to the Congress, now controlled by the Democrats, a budget proposal for fiscal year 1988. It amounts to $1.02 trillion, and the proposed figures yield a deficit of $107.8 billion, just below the ceiling set by the law. The "dragon's metaphor" was used by none other than the Director of the Office of Management and Budget (OMB), Mr. James Miller 3rd., when he presented the budget proposal to Congress. "Last year," he said, "we quenched the fire-breathing part of the deficit dragon. This year we will throw a net over the dragon."

The most remarked aspects of the budget proposal are: first, it assumes a rate of growth of 3.2%, higher than the 2.5% consensus forecast by most private economists; second, it increases military spending by 3%, after correction for inflation, which admittedly represents the lowest ever requested by the present administration; third, there are some cutbacks in Federal programs, but there also appear some increases in revenues --of the $ 42.4 billion in proposed savings, $ 18.7 billion come from program cutbacks, while $ 22.4 billion come from user fees and from the sale of government assets; fourth, while these cutbacks affect programs such as farm subsidies, Medicare, student loans and Civil Service pensions, some concern also appears for the homeless, displaced workers, AIDS victims, infant mortality or acid rain; finally, the revenue raising measures comprise Federal asset sales, under the banner of privatization, as well as specialized measures which, in the words of the Secretary of the Treasury, may be called "revenues, receipts," but "probably represent taxes."

Some of the reactions in the press were immediately negative. Leonard Silk, in The New York Times, considered the proposal "most boring:" Hobart Rowen, in The Washington Post, said it was "as irrelevant as the last one:" while The Journal of Commerce asked editorially if the whole effort was not a "charade."

By contrast, the reactions in Congress were considerably more restrained. On the one hand, probably some of the concessions were recognized as such. On the other hand, restraint might have also come from the recognition that the
presentation of the proposal merely signals "the beginning of a poker game with Congress over who gets the credit for spending and the blame for taxes."

Nonetheless, restraint might be derived as well from the admission that the budget deficit constitutes only another instance, coupled with the trade deficit, of a problem that defies common sense. In these last terms, the hope is that a healthier economy will emerge when both deficits disappear. But the road to attain this happy outcome is plagued with dangers and complications.

First of all, it should be recognized that the present fiscal deficit is part of an "unprecedented pattern." Previously, deficits existed at the beginning of a period of expansion could be safely predicted that they would disappear, or at least that they would diminish considerably. Presently, after more than four years of expansion, the deficit persists and it remains larger than during the previous recession.

Furthermore, fiscal budget reductions have to be very carefully undertaken, to avoid precipitating a recession, which would decrease revenues and increase counter-cyclical outlays. If these reductions are adopted simultaneously with measures to reduce the trade deficit, the influx of foreign capital would also decrease, which would only intensify the danger of recession.

Finally, to appreciate fully how deceitful common sense can be, to the previous considerations should be added other significant complications, such as the consequences a recession would have on the economies of the major debtor countries, or its impact on the international role of the dollar. At this point, such an exploration becomes a rather vertiginous experience. No wonder, Alfred Malabre concluded, in The Wall Street Journal, that instead of Carlyle's "dismal science," then, economics becomes a "dizzy science."

IV. 2. THE ECONOMIC STATE OF THE UNION (4 February 1987)

Every year, in January, the President of the United States addresses the citizenry to inform of the "State of the Union." Simultaneously, the Economic Report of the President is released, to describe the "economic state of the Union."

This year, in the message of transmission to Congress, of the Economic Report, the President describes two kinds of
highlights. First, obviously, the economic accomplishments and second, what are considered, the "remaining challenges of economic policy." Among the accomplishments, it is recalled that "the current expansion," of the U.S. economy has entered its fifth year. Also, during 1987, it is projected that the growth rate of the gross national product, adjusted for inflation, will be of 3.2%. If this is so, by October 1987, "the current expansion will become the longest peacetime expansion of the postwar era."

Another accomplishment is found in the fight against inflation, which "has remained below or near 4 percent for the past 5 years and, in 1986, declined to its lowest rate in 25 years." In short, the President expresses satisfaction for avoiding the economic problems of the recent past, "accelerating inflation, rising interest rates, and severe recessions." Finally, the list of accomplishments ends by mentioning the virtues of the limited role of government, as well as the advantages of tax reform.

Among the "remaining challenges" are: the reduction of the Federal budget deficit, through spending restraint; the reduction of the trade deficit, while avoiding protectionism; strengthening productivity and competitiveness; and the reform of agricultural programs, considered "costly, inefficient and unfair."

The President's message of transmission to Congress forcefully concludes promising to "pursue policies to encourage growth, reduce the Federal budget deficit, correct the trade deficit, and strengthen the competitiveness of American producers." It offers also "to resist proposals to adopt any economic policy that abandons the accomplishments of tax reform, stymies growth, fuels inflation, perpetrates needless government interference in the marketplace, or fosters protectionism."

The Economic Report itself is divided in seven chapters, where the previously mentioned accomplishments and challenges are dealt with in more detail. It begins by focusing on what it terms "the broad economic forces that shape the overall performance of the U.S. economy and of its major sector." Among these forces, it mentions how, during the present decade, "wide swings in relative product prices" have affected the oil and gas industry, as well as agriculture, due to the sustained decline experienced by the prices of their products. It refers to the way in which many trade-sensitive industries have been affected by the decline in the relative prices of imports, between 1980 and 1986, as well as by the downward pressure of a strong dollar on the relative price of U.S. exports. Another factor, considered critical for its influence on sectoral problems and structural change, is "the wide swing in real interest rates and real asset values that occurred in the 1970s.
and the 1980s." Furthermore, important structural changes are also attributed to differential rates of productivity growth. This part concludes by offering two forecasts for 1987. First, the growth of real GNP is projected to increase to 3.2%, and second, the inflation rate is projected to rise moderately.

From this analysis of the "macroeconomic setting," the REPORT turns to fiscal policy, reflecting the priorities set by the President. It refers to two elements of fiscal policy. First, the reduction of the share of Federal spending in GNP, and second, it extols the benefits of the Tax Reform Act of 1986, mentioning that, in the long run, it will increase net national product by 2%.

Under the heading of "international imbalances," the U.S. trade deficit is considered "a macroeconomic phenomenon," among other factors, related to: 1) the rapid growth of domestic demand in the U.S.; 2) the appreciation of the dollar, between 1980 and 1985; and 3) the deterioration of the U.S. national saving-investment balance. For the success of a global strategy to reduce international trade imbalances, three elements are considered critical. First, stronger internally generated growth in other industrial countries; second, the reduction of the U.S. fiscal deficit, "through spending restraint;" and third, policy reforms that encourage growth and restore credit worthiness in developing countries. This last is the only instance in which the Report refers specifically to developing countries.

The analysis of trade imbalances leads to the subject of "free and fair trade." It considers protectionism "a false solution" and recognizes that "the massive deterioration of the U.S. trade balance clearly has NOT (emphasis added) occurred because foreign trade practices have become vastly more unfair." The policy of "free and fair trade" is then defined as "to avoid protectionism at home while opening markets to U.S. products abroad." A list follows of the major trade initiatives adopted to implement this policy, such as bilateral discussions with Canada, to establish a free trade area, and the new round of multilateral trade negotiations. It concludes by enumerating the purposes of the Uruguay Round: first, to secure a standstill or rollback of existing protectionist policies; second, to improve procedures within the General Agreement on Tariffs and Trade (GATT); and third, considered the most important, "to enhance or extend GATT rules in areas of critical interest to the United States: trade in services, protection of intellectual property rights, rules governing international investment, and trade in agricultural products."

Under the heading of "reform of agricultural policies," the REPORT criticizes policies to subsidize, directly or indirectly, agricultural production in the United States, as well as in other
industrial countries. The solution proposed to confront the
problems of overproduction and depressed prices consists in
"gradually decoupling farm income support from farm production
and linking it to financial need." Finally, the last two
chapters of the REPORT are dedicated to "risk, regulation, and
safety," offering examples of "excessive and inappropriate
regulations," and to "women in the labor force," considering
their participation "one of the most important structural changes
in the U.S. economy."

IV. 3. CHAIRMAN VOLCKER'S DEPARTURE (10 June 1987)

Very few decisions can serve to illustrate more poignantly
the nature of the "political cycles" which periodically influence
the functioning and management of the U.S. economy. The departure
of the person hailed as "the second most powerful man in
America," as well as "the most successful central banker" in the
history of the Federal Reserve, is hard to understand either in
strict "economic" terms, or less still if the explanation is
sought in the Chairman's record. None of these angles will
furnish the necessary perspective to understand the adoption of
such a fundamental decision for the health of the world monetary
and financial system. For such a purpose, it is relatively more
fruitful to observe the adoption of the decision in itself, as
well as to focus on some extra-economic factors.

For instance, Mr. Volcker's almost unanimously approved
performance, measured in terms of the number and magnitude of
disasters avoided, can be summarized as follows: stagflation has
not returned, the dollar has not collapsed, and Latin America has
not defaulted. Since these are only some of the accomplishments
credited to Mr. Volcker, it is obvious that this impressive
performance does not help at all to explain his departure.

The analysis of the way the decision was adopted sheds more
light on this extraordinary event. First of all, after months of
speculation and of numerous expressions of support from different
quarters and persuasions, Mr. Volcker is said to have announced,
in March to Mr. Howard Baker, his decision to leave by the end of
his second four year term, sometime in August. On May 26, in
another meeting with Mr. Howard Baker, this time in the
Chairman's office, Mr. Volcker ratified that he did not want to
accept reappointment. As a result of this conversation, where Mr.
Baker is reported to have tried to persuade Mr. Volcker to stay
for a third term, a meeting was set with President Reagan for the
following Monday, June first.
Besides the President and the Chairman, Mr. Howard Baker and Mr. James Baker were also present. The meeting started, at about four o'clock, with Mr. Volcker's presentation of a type-written letter, addressed to the President, who reacted immediately saying: "I would really like to be able to raise the whole question of staying, but probably this is not a decision that could be reversed." Mr. Volcker told the President, with "considerable definitiveness," as it was revealed later, that he did not want to stay. "After eight years as Chairman, a natural time has come for me to return to private life as soon as reasonably convenient and consistent with an orderly transition," read part of the letter later released to the press. From there on, the meeting turned to the search for successors. Mr. Volcker's first choice was Mr. Alan Greenspan, followed by Mr. John Whitehead, the Deputy Secretary of State. The president's list included the same persons, in the same order, as well as Mr. Beryl Sprinkel, the current Chairman of the Council of Economic Advisers, whose name reportedly was proposed by Mr. Howard Baker, "as a courtesy."

At five o'clock, the President telephoned Mr. Greenspan to offer him the job, which he immediately accepted. In the end, Mr. Volcker seems to have departed because he was not inclined to request reappointment and, probably of more importance, because the President did not urge him to remain. Consequently, as Mr. Volcker declared somewhat philosophically, "there is a time to come and a time to leave."

Unless Mr. Volcker spells them out, it is impossible to know precisely the personal reasons which led to his refusal of a third term. Probably more important is to try to identify the reasons for which the Administration indirectly invited, but did not press, Mr. Volcker to stay. One of the answers to this question may be found by contrasting the incumbent with the successor. Although the signs of continuity are the ones that have received more emphasis, because Mr. Greenspan is considered as pragmatic and conservative as his predecessor, the very important difference has also been emphasized that Mr. Volcker is a Democrat, while Mr. Greenspan is a Republican. From this perspective, it has been held that Mr. Volcker was not urged to stay for fear that he would not hesitate to raise interest rates, to slow the economy during the 1988 electoral campaign, if and when in his judgment this would be necessary to arrest inflation or to stabilize the dollar. In the end, the Administration seems to have chosen a more congenial and not so strong-minded, independent Chairman, with an eye on next year's election. Thus, for better or for worse, the political cycle seems to have decisively influenced, once again, the management and functioning of the U.S. economy.
V. THE U.S. DOLLAR

V. 1. THE DOLLAR'S PLUNGE (21 January 1987)

On January 14, the dollar started plunging to its lowest levels in relation to the German mark and the Japanese yen. It was also reported that the Bundesbank, during December, had spent around US$ 20 billion, and that the Bank of Japan, during January, had spent around US$ 10 billion, to avoid such an outcome. One week later, the yen crossed the 150 barrier, for the first time since 1949, to land at 149.88 to the dollar. Meanwhile, the German mark approached the 1.80 barrier, or its lowest level against the dollar in the last six years.

There were some consistently bad news behind these events, which received considerable attention during this past week. First, there was the trade deficit of the United States, which in 1986 reached the record figure of US$ 175 billion, about $30 billion greater than in 1985. Second, there was the over all performance of Japan in international trade. During 1986, Japan exhibited an embarrassing surplus of US$ 82.7 billion, in contrast to $46.1 billion in 1985. Of this global surplus, US$ 51.5 billion were with the United States, against $39.5 billion in 1985. Third, the Japanese government submitted to the Diet a budget proposal which entailed almost no growth.

On top of these news, the weekend's currency realignment of the European Monetary System (EMS), leading to a 3% revaluation of the German mark, was perceived by the already nervous markets as the detonator for the dollar's dive.

Furthermore, this time at least, market forces were assisted by a leak, in The New York Times, whereby "Administration sources, requesting that they not be identified by agencies or functions . . ." declared that "they want the dollar to decline still further." The following day, such comments were considered unauthorized, but a White House spokesman added that "we're not setting a target for the dollar." Thus, obediently, the market responded by the intensification of the dollar's slide against the mark and the yen.

This upsurge in the news, reflecting the turmoil in the money markets, was accompanied by the immediate profusion of contradictory explanations of the events briefly described. One of the most frequently mentioned explanations, particularly
in the surplus countries, attributed most of the responsibility for the U.S. trade deficit to the persistence of the fiscal deficit.

This interpretation was promptly challenged, in The Wall Street Journal, by Professor Robert Barro, from the University of Rochester, by considering "Budget Deficits: Only a Minor Crisis." In his opinion -- invoking the authority of none other than David Ricardo -- "there is no evidence that the excessive budget deficits after 1983 have had any serious consequences for the economy." To those who believe that budget deficits increase interest rates, he reminded that nominal interest rates have declined dramatically from their peak in 1981. Hence, Professor Barro finds "remarkable that most economists, not to mention journalists and government officials, still believe budget deficits raise interest rates." To those who believe that private investment spending would be "crowded out" by budget deficits, Professor Barro mentioned that, from 1984 to 1986, real private investment expenditures -- measured by purchases of consumer durables -- reached a post-war high of 28%; that real GNP grew at an average annual rate of growth of 4.2%, since the end of 1982; and that, measuring savings in the household sector as movements in the market value of wealth, including capital gains and losses on stocks, housing and other assets, the ratio of savings to GNP, from 1983 to 1985, averaged 13%. Finally, to those who believe in the "popular notion" that the deficit led to a strong flow of funds from abroad, Professor Barro recalled that "the link between budget and current account deficits failed to show up before 1984." Thus, he appeals to economists to be scientific enough to avoid the inference of causal relationships between two variables by focusing on data corresponding only to the last three years. Briefly, his conclusion is that "the current account deficit has nothing to do with the budget deficits," because "the alternative analysis ... doesn't explain the boom in U.S. investment expenditures."

From other quarters came a relatively more political, or a rather more bureaucratic, explanation. The dollar's fall was attributed to the lack of confidence generated, among other factors, by the emission of contradictory signals by the U.S. Government. On the one hand, the Treasury was "talking the dollar down." On the other, the Federal Reserve was declaring that the dollar had fallen enough. From these apparently contradictory statements was inferred the existence of a profound split within the U.S. financial team, which manifested itself in the search for candidates to succeed Mr. Paul Volker, when his term expires in August 1987. By contrast, a different conclusion was derived from these signals by Mr. Rimmer De Vries, chief international economist at the Morgan Guaranty Trust Company. According to Mr. De Vries, the Treasury and the Federal Reserve are playing "a harmonious duet" -- a rather more elegant term to refer to the tactics of "the good cop and the bad cop."
One supports a lower dollar, while the other objects, but in effect both are working together to guide the decline in an orderly way.

Finally, others found the explanation of the present exchange rate instability in the absence of commonly agreed rules to deal with surplus partners. In support of this assertion it was recalled that such deficiency led, in the seventies, to the demise of the system of "fixed but adjustable exchange rates," established by the Bretton Woods agreements. In these terms, the only alternative available to the leading economy, in the present system of flexible exchange rates, is to force the adjustment unilaterally upon its reluctant surplus partners, by means of devaluing the key currency. A German official commented, when he was asked about a Newsweek's report that the mark was expected to climb to 1.70 against the dollar, that the United States "has the power to destroy us." Nonetheless, still another viewpoint invokes the precedent of the British economy, during the last quarter century, to argue that devaluation offers only temporary relief for a declining economy, or that it represents only a poor substitute to avoid the adoption of unpopular internal decisions.

V.2. ON REFERENCE RANGES (18 February 1987)

Recently, The Wall Street Journal, following a lead from syndicated columnists Evans and Novak, announced that "a pact to stabilize currencies" was near completion. Quoting "U.S. officials," the Reagan Administration was said to have offered to cooperate with Japan and West Germany in stabilizing exchange rates, if in return those countries stimulated their economies. According to this proposal, the members of the so-called Group of Five (G-5) —those mentioned above plus France and England—would agree upon the establishment of "reference ranges," understood as upper and lower limits for their currencies. They would also agree upon undertaking concerted intervention to preserve the value of their currencies within the commonly agreed limits, thus bringing to an end the present volatility experienced by the exchange rates of the major currencies, particularly of the U.S. dollar.

For some observers, these signals constituted the dawning of a new era of exchange rate stability, as the one which prevailed throughout the time when the Bretton Woods agreements were in full force. Although admittedly, at that time, instead of oscillating within "reference ranges," exchange rates were considered "fixed but adjustable." Nonetheless, the principle was similar to the one inspiring the notion of so-called "target
zones," consistent in the agreement of upper and lower limits for the exchange rates of the principal currencies, whose attainment would trigger concerted intervention to preserve the commonly agreed currency values within these limits.

Other seasoned observers saw in these recent discussions on reference ranges, or on target zones, only the pouring of old wine into new bottles. In other words, these discussions were viewed by others only as the return of the basic confrontation between those who favor fixed or flexible exchange rates.

This debate, which seems to emerge every time discussions are held on the reform of the international monetary system, was recently witnessed by what is probably the largest gathering of economists that takes place, each year by the end of December, under the sponsorship of the American Economic Association (AEA). This time, as described in the IMF Survey (January 12, 1987), the confrontation pitted Mr. John Williamson, from the Institute for International Economics --the well-known Washington based think-tank-- against Mr. Jacob Frenkel, from the University of Chicago --almost immediately afterwards appointed Economic Counsellor and Director of the Research Department of the International Monetary Fund (IMF).

On one side, Mr. Williamson proposed the establishment of "target zones" based on "fundamental equilibrium exchange rates," which could be determined by means of an appropriate econometric model. In this context, coordinated macroeconomic policies would be applied to circumscribe deviations in exchange rates within the margins allowed by the commonly agreed targets.

On the other side, Mr. Frenkel argued that the focus should rather be on macroeconomic policies, instead of what he considered one of their manifestations in the form of exchange rate volatility. He mentioned, as fundamental, the present divergence in fiscal policies and the apparent difficulties in correcting fiscal imbalances among the major industrial countries.

In these terms, the debate seems to be still raging on the question if agreement upon exchange rates will impose macroeconomic coordination or if, on the contrary, exchange rate stability will be the result of macroeconomic coordination. Be it as it may, to recall this confrontation --at least--brings forth a degree of healthy skepticism to ponder the reports that an agreement on "reference ranges" seems to be upon reach.
V. 3. "THE DOLLAR IS AT THE LEVEL AT WHICH IT CAN BE TESTED"
(18 March 1987)

In these terms, Federal Reserve Board Chairman Paul Volcker let it be known, to those interested in speculating against the dollar exchange rate, that they are bound to hit a wall. In fact, what Mr. Volcker was describing were the results of the Paris agreement, of last February 22, among what ended as a Group of Six (G-6) --the United States, Japan, West Germany, France, Great Britain and Canada-- instead of the original Group of Seven (G-7), given the somewhat abrupt departure of the Italian delegation. The same message was conveyed at the meeting's conclusion by the Chancellor of the Exchequer, Mr. Niger Lawsone, when he said, "those who would wish to speculate would have better luck with horses."

Almost a month after the Paris agreement, known as the Louvre agreement, it can be safely asserted that the dollar's plunge has been halted, at least momentarily. In this way, also interrupted is the discussion --at times acrimonious-- among the three major industrialized powers over the exchange rate of their currencies --the dollar, the yen and the D-mark-- which raged during the second half of 1986.

A basic question raised by these events refers to what exactly was agreed at the Louvre, by the members of the G-6. The terms of the agreement can be briefly summarized in the following manner. First, the meeting was held "to conduct multilateral surveillance" of the participants' economies. According to the definition of the Group of Ten (G-10), "multilateral surveillance" should be understood as "analyzing the repercussions of national policies and of their interaction in the determination of exchange rate developments and international adjustment."

Second, positive and negative developments in the international economy were reviewed. On the positive side, among other factors, it was noted that the industrialized economies were in their fifth year of expansion; that interest rates have experienced substantial reductions; and that a high degree of price stability has been attained. On the negative side, large trade and current account imbalances in industrialized countries were considered "a matter of high priority." Also, concern was expressed because of continuing protectionist pressures, pledging to intensify efforts to resist them, as well as giving strong support to the new round of trade negotiations. In this same sense, addressing the "newly industrialized countries," it was agreed that they "should assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies to
reflect more fully underlying economic fundamentals." Also, in
the only reference to developing countries, on the matter of
indebtedness, it was recognized that "major industrial countries
had a special responsibility to follow policies which foster an
open, growing world economy in order to support the efforts of
developing countries, especially of debtor countries, to restore
steady growth and viable balance of payments positions."

Third, a trade-off was agreed on the matter of economic
policy coordination. On one side, surplus countries committed
themselves to follow policies designed to strengthen domestic
demand and to reducing their external surpluses while maintaining
price stability." On the other, deficit countries accepted "to
encourage steady, low-inflation growth while reducing their
domestic imbalances and external deficits." Fourth, each
participant enumerated the individual actions it agreed to
undertake to comply with the terms of this trade-off.

Finally, after spelling out a list of what were called
"additional refinements in the use of economic indicators for
multilateral surveillance arrangements," the communiqué concludes
announcing that the participants "agreed to cooperate closely to
foster stability of exchange rates around current levels." This
closing statement was considered the main deterrent against those
speculators who dare to test the level of the dollar.

There have been some different reactions towards the
agreement. Some have seen it as "a timely and encouraging step." Others have questioned it because they consider there remain good
reasons for a further depreciation of the dollar, given the
stubbornness of the trade deficit figures, while the promises
made by West Germany and Japan are viewed as "rather modest."

Beyond these short-term considerations, probably of more
importance is to interpret the contents of the Paris agreement in
terms of the nature of the existing monetary system. For this
purpose, it is better to avoid comparisons with text-book ideals,
such as a system of target zones, where concerted views on
exchange rates are accepted as compulsory, or with the other
ideal system, consistent in the adoption of objective indicators
for jointly managing the formulation and execution of a
coordinated macro-economic policy. Within the spectrum furnished
by these two extreme ideals, the present "system" can be found.
In the terms of the International Monetary Fund (IMF), the
present is a decentralized and discretionary system, where a
rather loose coordination prevails among the main players and
where dialogue and peer pressure are the main instruments used to
bring about adjustment and coordination, particularly in times of
crises.
Ever since the Secretary of the Treasury of the United States made known, on November 5, that the Administration's first priority consisted in avoiding a recession, even if this entailed a falling dollar, world financial markets have witnessed, during the following six weeks, the attainment of record lows by the U.S. currency against the Japanese yen and the West German mark. Thus, despite the active intervention of the Bank of Japan and of the Bundesbank, but in the face of the Federal Reserve's relative indifference, the dollar approached the post-war record of 130 against the yen and 1.60 against the mark.

Before a compromise was announced on the U.S. fiscal deficit, consisting of reductions of $30 billion during the present fiscal year, to be followed by reductions of $45 billion the next year, the dollar was already heading south, while the upward pressures against the mark and the yen were increasing considerably. The White House, for its part, was seen as "quite content" with where the dollar was heading.

Finally, after some procrastination particularly from the Bundesbank, the announcement was made last week of a coordinated reduction in interest rates by some of the main European central banks. The Bundesbank led the way by lowering its discount rate by one-half percentage point, to 2.5%. Switzerland followed by also cutting its discount rate by one half-point, to 2.5%. The Netherlands cut its discount rate by one-quarter point, to 3.75%, and lowered its key money-market intervention rate to 4.5%. Austria cut its discount rate also by one-half point, to 3%, as Belgium trimmed the discount rate by one-quarter point, to 7%. Finally, the French central bank dropped its money-market intervention rate by one-quarter point, to 7.75%, while the Bank of England triggered a reduction in commercial lending rates to 8.5%, from 9%. Commenting on all these decisions, a Bundesbank official was quoted as saying that they were "bowing to good reasons, not to pressures."

Secretary Baker was immediately reported as being "delighted" with the announcement made by the major European central banks, because in his view the rate cuts "should help to strengthen growth in Europe and reduce trade imbalances." He concluded by saying that these concerted measures "represent an important contribution to our international economic policy coordination efforts."

Japan, at some point before, apparently had resigned itself to let the dollar drift lower, while concentrating its efforts on making the decline as smooth as possible, through reliance on direct intervention in currency markets. The Japanese authorities
seem to have concluded that, in the present circumstances, the best they can do is to manage the decline, hoping that it will occur gradually rather than abruptly. Furthermore, this time, Japan was not pressed to adopt new measures because it had already embarked itself into a path of domestic-led growth, on account of a stimulus package adopted by the end of the summer, in response to early pressures exercised by the United States.

With these accomplishments in sight, it could be argued that Secretary Baker's gamble on the dollar had proven to be working satisfactorily. Nonetheless, some observers warned that dangers, as well as significant costs and substantial risks, may also be part of this otherwise successful strategy. Among them can be found those who recall that devaluation represents only a "quick-fix," that fails to go to the root of the problems, in this case the need to make the United States more productive and efficient. Moreover, in the same sense, as expressed by a Japanese banker, "America is the No. 1 country in the world. And the No. 1 country should have a strong currency."

Other dangers have been singled out, as potential contributors to turning the strategy into a "risky gamble," such as the perspective of a rise in inflation in the United States, or the more dangerous path of competitive devaluations and consequent trade wars, which would certainly sink the world economy into a depression.

Be it as it may, these relatively somber perspectives fail to point out what apparently constitutes the essence of the gamble, which can be found in "the primacy of politics." Once again, the economic policy of the United States sees itself submitted to the rigors of the domestic political cycle. One of the main reasons to explain why today a recession cannot be tolerated in the United States is found in the fact that 1988, as a commentator recalled, "just happens to be an election year." In this context, the Secretary of the Treasury is known to be supporting Vice-President Bush, the candidate whose hopes are based on President Reagan's successful record. Consequently, the basic question raised domestically by the gamble on the dollar is if the economy can be kept growing, at least until November 1988. Meanwhile, externally, another question remains unanswered: when will take place a meeting of the Group of Seven (G-7), to consolidate and stabilize what has already been accomplished in currency realignments, policy coordination and the correction of imbalances. Only the announcement of such a gathering can be interpreted as a signal that the United States has shifted its policy towards supporting the dollar, perhaps because then the fundamentals will be perceived differently.
VI. ECONOMIC POLICY COORDINATION

VI. 1. PRIME MINISTER NAKASONE'S VISIT: "PRETTY SHORT ON SPECIFICS" (6 May 1987)

In these terms, Presidential Chief of Staff Howard Baker characterized the results of last week's visit to Washington by the Japanese Prime Minister. This conclusion is warranted by the contents of the joint statement on economic issues, released after two days of meetings between President Reagan and Prime Minister Nakasone. Very few concrete decisions were in effect adopted, to confront some of the issues arising from the trade imbalances prevailing among these major industrial economies, which in the end constitute the relationship of major tension of today's international economy.

For instance, both leaders reaffirmed "their commitment to strengthen international economic policy coordination;" welcomed "the progress that has been made toward this end," in the Louvre Accord and the recent G-7 meeting; finally, after considering them "politically unsustainable," they agreed that "reducing the large trade imbalances of the U.S. and Japan is a key objective of their policy efforts." It is obvious that these joint pledges are quite far from constituting some of the expected breakthroughs. Neither can such breakthroughs be found among the pledges made by President Reagan, which refer to "his determination to reduce the U.S. budget deficit;" and finally, to his decision to resist firmly protectionist pressures. Evidently, these pledges only reaffirm policies already known. Nor can much novelty or concreteness be found in some of the policy changes promised by Prime Minister Nakasone. Among these last, for instance, appears: "to take vigorous action to stimulate domestic growth in Japan," by means of the "near-term enactment of a comprehensive economic package;" the adoption of "further measures to liberalize Japanese financial markets," as well as "redoubled efforts to implement recommendations for structural reform."

Finally, in closing, the President and the Prime Minister in reference to the sanctions imposed by the United States against the alleged dumping of semi-conductors, "agreed that outstanding trade issues between the two countries need to be resolved expeditiously." Also, in relation to exchange rates, both leaders "agreed that a further decline of the dollar could be counterproductive to their mutual efforts for stronger growth
in their economies and for reduced imbalances. Thus, they reaffirm "the commitment of their governments to continue to cooperate closely to foster stability of exchange rates."

There should remain few doubts that, in the terms of the final statement, the complaint of "shortness on specifics" is absolutely justified. Even so, other pledges were made by the Japanese Prime Minister, which exhibit some of the concreteness found lacking in the more general statement. For instance, progress seems to have been achieved with respect to the participation of foreign companies in the bidding for the construction of Kansai International Airport, located in the man-made island of Osaka Bay. Second, the commitment was reasserted, by the Japanese Government, to permit up to one third of foreign participation in a new telecommunications venture, to compete with the existent monopoly. Third, Mr. Nakasone declared that Japan had not yet decided what to do about building a fighter aircraft for the 1990's, a subject of particular interest for Senator John C. Danforth (R-Missouri), where both McDonnell Douglas and General Dynamics have their headquarters. Fourth, the intention was restated to buy more U.S.-made supercomputers and on the matter of imports of beef and citrus the Prime Minister declared that Japan "would like to make a major effort to import as much as we can." Finally, on the subject of coal, of interest for the Senate Majority Leader Robert Byrd (D-West Virginia), Mr. Nakasone said it was difficult to purchase U.S. coal, until the price differential with cheaper imports from China and Australia is narrowed down. But despite the specificity of some of these measures, most of them were already known and were being implemented before the Prime Minister's visit.

Somewhat paradoxically, the most concrete measure announced was adopted outside of the conversations between the President and the Prime Minister. It took the form of the concerted modification of interest rates agreed by the Bank of Japan and the Federal Reserve. This measure made evident the degree of financial interdependence existent among the United States and Japan. The "symbiotic relationship" among financial markets seems to be setting the limits to the confrontation on trade imbalances. As it was revealed by the turbulence experienced last March, the sale by Japanese investors of billions of dollars in U.S. Treasury bonds, unleashed a further plunge of the dollar as well as an increase in interest rates, which generated immediate warnings about the dangers of rising inflation and the threat of recession. Consequently, even when this time not many new, nor concrete results were accomplished, the intensity in the levels of interdependence existent among these two major industrial powers gives ground to the expectation that, for their own sake and for the sake of the world economy, policy coordination will be implemented to avoid the very real danger of a deflationary collapse.
VI. 2. NO NEWS FROM VENICE...? (17 June 1988)

It is relatively easy to be skeptical, if not outright cynical, about the role of ritual in international economic affairs. With few exceptions, this was the stance adopted by most observers to evaluate the results of the last Venice Summit. For one thing, economic issues were overshadowed by other matters, deemed more urgent, such as the protection of Kuwaiti tankers in the Persian Gulf, the coming arms control negotiations between the two super-powers, or the combat against the Acquired Immune Deficiency Syndrome (AIDS). Also, a majority of the participant heads of state or government were either lame ducks or were confronting elections. For instance, Mrs. Thatcher was in the midst of elections, which justified her brief appearance; the host government was a care-taker, dedicated to organize elections scheduled for the following Sunday; Mr. Nakasone is said to be due to depart next October; and President Reagan traveled to Venice "with the weakest hand he has played in years."

Nonetheless, there was a relatively good start, with the announcement of a partial lifting of sanctions against Japan, made by the U.S. President before the Summit. This gesture, although partial, was described as a compensation for the previous proposal by the Japanese government of a domestic stimulus package amounting to $43 billion. As President Reagan put it, in defense of this partial lifting of sanctions, "We have to recognize that there are people in Japan, like Prime Minister Nakasone, who have worked very hard..., and we think that they ought to be rewarded for their effort."

The economic agenda of the Summit was evidently top-heavy. Among the most pressing economic issues could be found the persistent imbalances among the most advanced industrial economies; the U.S. fiscal deficit; agricultural protectionism; LDC debt; the weakness of commodities; high interest rates; the return of inflation, as well as the specter of recession.

Obviously, from the vantage point of the problems comprised by this agenda, there is some justification for skepticism and disappointment, given the relatively meager results announced in the communique issued at the end of the meeting. Admittedly, it can also be considered unfair to evaluate the Summit's results in terms of what was left undone or unsaid. Thus, it is probably more fruitful to analyze the results in their own terms, as they are described in the final communique.

From this relatively more modest perspective, the following concrete outcomes can be pointed out. First, the participants decided that no further stimulus of their economies will take
place in the near future. It was agreed that "additional actions" will be undertaken only "if in the future world economic growth is insufficient." As if the present sluggish situation did not demand some action, tacitly, it was recognized that the worst recession experienced by developing countries in the last half-century, or the fact that non-fuel commodities are experiencing their lowest prices since the Great Depression, are still not considered sufficient conditions to demand the adoption of "additional actions." In fact, this consensus in favor of the status quo reveals how Western European governments seem to have become comfortable with high unemployment; Japan's concentration on the preservation of its dominant trading position; and the United States' satisfaction with its fifth year of sluggish but sustained expansion.

The second point on which there was consensus was on the handling of third world indebtedness. First there was an admission that the problem does not allow for homogeneous formulas. Second, the special case of the countries of Sub-Saharan Africa was recognized as specific and demanding the adoption of several unorthodox measures. Some of these measures deserve mentioning: lower interest rates; longer repayment and grace periods; and the approval of the proposal, submitted by the Managing Director of the International Monetary Fund (IMF), for increasing from $3 billion to $9 billion, over three years starting in January 1988, the resources of the Structural Adjustment Facility (SAF). Third, the problems of "middle income debtors" were also recognized, but in this case continued support was granted to the prevalent "growth-oriented case-by-case strategy." Three elements were identified as necessary for growth to take place among this other group of countries: first, the adoption of comprehensive macroeconomic and structural reforms by the debtor countries; second, the enhancement of lending by international financial institutions, in particular by the World Bank; and third, adequate commercial bank lending in support of debtor country reforms.

The third issue where the Summit seems to have produced its most concrete result was in the adoption of a mechanism for "multilateral surveillance and policy coordination." Even when previous agreement had already been reached among the Finance Ministers, the fact that the mechanism proposed was endorsed by the chiefs of state or government gives it considerably more weight. The mechanism agreed upon is not yet known in all its details, since one of the requirements for its acceptance was West Germany's demand that it be kept secret. Nonetheless, the communiqué indicates that the mechanism is based on medium-term objectives and projections, with the purpose of achieving mutual consistency, both for the group and for the countries individually. On the basis of these projections, the performance of each economy will be evaluated by means of a set of indicators, "to determine whether there are significant
deviations from an intended course that require consideration of remedial actions." The list of indicators constituting this "system of yellow signals" is: growth, budget disequilibria, trade imbalances, inflation, interest rates, and exchange rates.

A stark contrast also appears in the roles assigned to the major international financial institutions. For instance, the IMF is entrusted with the task of assisting the participant countries in carrying out the process of surveillance and policy coordination. Also, the IMF's "central role" in the adjustment process of developing countries is expressly recognized, and closer cooperation between the Fund and the World Bank is encouraged. But, while the IMF's Structural Adjustment Facility was increased, by contrast, a general capital increase for the World Bank is only supported "when justified by increased demand for quality lending", as well as by its "expanded role in the debt strategy and by the necessity to maintain the financial stability of the institution."

Finally, the Summit also ratified the commitment contained in the OECD's Ministerial declaration on the concerted reform of agricultural policies. It is recognized that the "long term objective is to allow market signals to influence the orientation of agricultural production," with the warning that consideration should be given to "social and other concerns, such as food security, environmental protection and overall employment."

In conclusion, beyond the headlines and the skepticism with which the media usually reports about these rituals of international economic relations, some agreements worth noting were achieved in Venice.
VII. INDEBTEDNESS, ADJUSTMENT AND GROWTH

VII. 1. CHAIRMAN VOLCKER ON INTERNATIONAL DEBT (27 January 1987)

Recently, a very interesting illustration was made public of the kind of discussion, going on among public officials in the United States, on the question of Third World debt. Part of this discussion is now known, thanks to the release, by the Federal Reserve Board and Senator Bill Bradley, of a letter and a document containing some "arithmetical computations," performed by the Board's staff at the Senator's request, of four examples of hypothetical debt relief.

The document, entitled "Illustrative Calculations of Examples of Hypothetical Debt Relief", reveals quantitatively some of the consequences which could entail the application of the notion of "debt relief." But perhaps more interesting are the comments contained in the letter of transmission of the document, from Chairman Volcker to Senator Bill Bradley and to Congressman Charles Schummer.

The calculations try to quantify some of the consequences of four hypothetical examples of debt relief. The four examples are:

i) if the interest spreads on all bank debt are eliminated;
ii) if 30% of bank debt is forgiven and written off over 10 years;
iii) if the proportion represented by the value of debtor countries' bank debt in secondary markets is forgiven and written off in 10 years;
iv) if, during three years, interest rates on bank debt are reduced by 3%, and each year 3% of bank debt is forgiven and written off.

It has to be admitted that even when some of the conclusions derived from these calculations are better than nothing, altogether, they are not very impressive. For instance, the elimination of interest rate spreads would represent savings of 2.4 billion dollars annually, during the next three years, or 2% of 1985 exports, for ten Latin American countries --Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela. Second, the forgiveness of 30% of bank debt would represent 3.7 billion dollars annually, during the next three years, or 3.1% of export earnings, for the same ten Latin American countries.
Third, it is also interesting to note that the forgiveness of bank debt, according to its discount value in secondary markets, for the same ten countries, would represent savings of 4.3 billion dollars during the next three years, or almost 4% of export earnings. Finally, the alternative of applying a program of interest and principal reductions of 3%, during the next three years, would generate savings of around 5.4 billion dollars yearly, for the same ten countries, or 4.5% of export earnings. These are briefly some of the consequences for some of the debtors which follow from the hypothetical application of these examples. The paper analyses also some of the consequences for commercial banks, as well as some methodological issues.

Nonetheless, interesting as these calculations are, the remarks made by Chairman Volcker, in his letter of transmission of the document, are more interesting. First of all, he recalls that a distinction has to be made between "write-offs" and "debt forgiveness," suggesting that both terms are not equivalent. He points out that, in the examples analyzed, "debtors' obligations to commercial banks would be reduced without any compensation to banks," or in other words, that debt forgiveness would be provided at the same time that the banks would have to "mark down the book values of their claims." Second, he considers that, the "forgiveness of principal is largely irrelevant since recent reschedulings," because these "do not call for the amortization of bank debt in the near term. Thus, these examples would call for bank recognition of loss, in the form of significant reductions in reported earnings, in instances where debtors would receive little near term benefit." Third, given "the limited nature of current secondary market trading, 'prices' in those markets are not reliable indicators of underlying value" and the write down and forgiveness of these obligations could entail that "their 'price' on these markets could well be depressed further." Consequently, "a policy of providing broad scale relief would inevitably operate to reduce the valuation of banks' remaining claims on all debtor countries."

Having made all these remarks, on the examples analyzed, Mr. Volcker's letter then turns to three aspects he considers fundamental. All three, center around the question of "how such proposals could be implemented." First, he raises the political issue of "what mechanism could be used to induce or force large numbers of commercial banks of various nations and their governments to provide the agreed concessions?" The answer to this question is important since, as it is mentioned in the Board's staff paper, U.S. banks hold only between one third and two fifths of the debts of what are called "financially troubled countries". The second aspect deemed fundamental has to do with the question of "how adoption of any across-the-board solution can effectively discriminate among
'deserving' and 'less deserving' borrowers." In defense of the case-by-case solution which he is known to prefer, Mr. Volcker doubts the efficacy of global solutions "in supporting and achieving necessary reforms in the economies of the debtor countries." Finally, he considers that "the short-term benefits of debt relief for a few debtor countries would be offset by the long-term adverse impact it would have on the supply of credit to all developing countries and, hence, on the health and vitality of the world economy."

To conclude, Mr. Volcker says that he is "extremely skeptical that the numerical examples of so-called debt relief . . . are really meaningful." He fears that "wholly mechanical and arithmetic calculations can well be more misleading than helpful, particularly as a measure of debt relief to the borrower." The letter then finishes by reminding that there are four main actors involved in the search for solutions to what is termed "the complex problem of international debt." This solution, Mr. Volcker remarks, "remains dependent upon a strong sense of mutual interest and common commitment by borrowing countries, commercial lenders, international institutions, and governments."

VII. 2. DEVELOPING COUNTRIES' INDEBTEDNESS: QUANTIFYING THE DEBATE (25 February 1987)

The World Bank has published, embargoed for release until February 27, 1987, an abridged version of the 1986-87 World Debt Tables. This publication constitutes the Bank's yearly contribution to the quantification of this issue, which this week, after Brazil's announcement of an indefinite interest payment suspension, regained some the salience it had lost, given the discussions among the industrialized countries on the subject of exchange rate stabilization.

The abridged version of the World Debt Tables is presented in a way which does not allow for the immediate identification of Latin American debtors. In fact, the main tables refer to 109 developing countries, although some specific references appear to the countries of sub-Saharan Africa, as well as to another group of countries, baptized as "highly indebted" (HICS). In this last group are found twelve Latin American debtors --Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Jamaica, Mexico, Peru, Uruguay and Venezuela-- accompanied by Cote d'Ivoire, Morocco, Nigeria, Philippines and Yugoslavia. Thus, relatively more specific and detailed analyses of Latin American
indebtedness, based on World Bank data, must await the publication of the complete version of the World Debt Tables.

Even so, some of the highlights brought forth by the publication of this abridged version are worth mentioning. First, in 1986, Third World debt surpassed the trillion dollar mark, since it amounted to $1,035 billion, up from $992 billion in 1985, resulting in a very modest increase of 4%. Projections for 1987 indicate a further increase of not more than 4%, to $1,080 billion.

Second, no change appears in the steady decline of new lending, which dates from 1981. Disbursements of long term loans to 109 developing countries fell from $81.7 billion in 1985, to an estimated $72 billion in 1986.

Third, in the absence of adequate financing, most problem debtors continued compressing imports, in order to achieve external balance. For most highly indebted countries, 1986 represented the fifth successive year of import reduction. In value terms, imports from this group of countries in 1986 were just a little more than 60% of the 1981 level, while non-oil commodity prices fell by 10% in 1986, to their lowest level in at least fifty years.

Fourth, despite the easing of international interest rates, in 1985, total interest payments on public and publicly guaranteed debt rose by 10.9%, basically due to the consolidation of significant elements of private non-guaranteed and short-term debt into long-term public debt. Thus, in 1986, interest accounted for approximately half the $101 billion debt service burden of developing countries.

Fifth, there was a sharp increase in the gap between disbursement inflows to developing countries and principal and interest flows from them. The "negative net transfer" from 109 developing countries grew from $10.7 billion in 1984, to $26.3 billion in 1985, and to an estimated $29 billion in 1986. It is also estimated that in 1986, disbursements amounted to $72 billion, of which $41 billion were from private creditors, while debt service amounted to $101 billion, of which $51 billion were principal repayments and $50 billion were interest payments.

Sixth, the volume of commercial bank rescheduling --apart from the 1986 agreement with Mexico-- remained at about the same level of 1985, while the amount rescheduled by official creditors in 1986 declined from the previous year. During 1986, twenty-four countries renegotiated their debts with official creditors or with commercial banks in multilateral forums. The total amount of debt so restructured is estimated at $73 billion, of which $43.7 billion comes from re-casting the terms of the 1984 multi-year bank agreement with Mexico.
Seventh, commercial banks' attitudes have hardened with the passage of time, as the perceived incentives for further lending have weakened, because commercial banks' risk exposure in developing countries has fallen dramatically. For instance, for the top twenty-four U.S. banks, it fell from 147% of capital to 118% in 1986, down from a high of 210% in 1981.

Finally, the abridged version of the WORLD DEBT TABLES contains three appendixes: I) debt trends in 1985; II) recent developments in debt-relief negotiations; and III) debt conversion schemes.

Beyond the descriptive data presented, it is even more interesting to focus on the main traits of the way in which the World Bank approaches the issue of developing countries' indebtedness. In the first place, for the Bank, as for the International Monetary Fund (IMF), four main actors are participating actively in this matter: debtor countries; commercial banks; creditor countries; and international agencies. Second, the World Bank views the problem of indebtedness from the perspective of the international economic system as a whole, to the point that its solution is considered a "common good." Third, considering this solution as a "common good" -- in the Bank's own terms -- "warrants the coordinated intervention of national governments and of international agencies through new public lending and through actions to strengthen private flows, both appropriately leveraged to reforms in the recipient countries." Consequently, the solution of debt problems constitutes a matter in which "the market, left to itself, will not provide the level of financing needed to sustain the debtor countries in their commitment to growth-oriented adjustment." Finally, the Bank proposes the search for solutions which move beyond the discussion of "burden sharing," favoring those which point towards a concern to minimize differences of treatment among debtors and that avoid encouraging imprudent behavior among both creditors and debtors. Thus, concludes the World Bank, "failure to create the conditions for growth-oriented adjustment would carry risks of a different and far more serious order: of a sustained setback to development in many debtor countries, of a growing breakdown in formal debtor-creditor relations, and of consequent lasting damage to the international financial system and world economy."
VII. 3. THE BRAZILIAN SAGA (24 March 1987)

Anyone who dares to venture a forecast on the possible outcome of the Brazilian debt negotiations is definitely undertaking a highly risky endeavor. For one thing, the negotiations themselves have not really begun, since the main actors still seem to be in the process of adopting preliminary postures, although admittedly, by now, their positions are fairly well known. Thus, presently, the most that can be done is to try to identify the terms of the interaction between the main actors.

According to the most authoritative opinions, four actors are participating actively in the debt negotiations. In the first place, of course, are found the debtor countries; second, the creditor countries; third, the commercial lenders; and fourth the multilateral financial agencies. Until not so long ago, these four actors cooperated actively to solve the problems which periodically erupted, according to the "case-by-case" approach sponsored by the United States Department of the Treasury, as for instance when the Mexican package was assembled.

This time, however, the situation appears to be somewhat different, for several reasons. First of all, the commercial lenders seem to have hardened their stance, to the point that the way in which these tougher positions were made known influenced the Brazilian decision of suspending the payment of interest on its commercial bank debt. Suffice it to recall here the statement made by Citicorp's Chairman, Mr. John Reed, in the sense that loan-loss reserves and total capital were being increased, because the trend toward making concessions to debtors had to be halted. These assertions, almost immediately, met the strong rebuttal not only of Brazilian Finance Minister, Mr. Dilson Funaro, but more importantly they earned the Citicorp's Chairman a reprimand from none other than the U.S. Secretary of the Treasury, Mr. James Baker III. Second, government officials from creditor countries have said that they consider the Brazilian payments suspension a problem between Brazil and the commercial banks. Furthermore, the adoption of this relatively detached attitude --quite unprecedented, to say the least-- seems to be linked to the fact that the Brazilian payments suspension was preceded, almost a month before, by an accord reached between seventeen creditor governments and Brazil --within the framework of the Paris Club-- on the rescheduling of around $4 billion, without requiring an agreement between Brazil and the International Monetary Fund (IMF). This left the commercial banks in a relatively isolated position to confront, a month later, the interest payments suspension decreed by the Brazilian President. Third, a perverse logic seems to be at work this time, since the exposure of commercial banks has decreased considerably, this also contributes decisively to a decrease in
the sense of urgency with which are perceived the negotiations that now appear as a confrontation between the Brazilian Government and the relatively strengthened commercial lenders. Consequently, today, there seems to exist less need for coming to the rescue of the endangered commercial banks, because their difficulties do not immediately jeopardize the functioning of the world financial system. Fourth, to increase the relative isolation of the commercial banks, some dissatisfaction seems to prevail with the slowness they have exhibited in fulfilling their assigned role of furnishing an important proportion of the fresh resources required by the growth component of the so-called Baker Plan. Finally, the recent measures taken by Citicorp, Bank America and Continental Illinois, to place Brazilian loans on a non-performing or cash basis, points toward the trend which could characterize what has already been baptized --perhaps somewhat prematurely-- as Phase III of the debt crisis. According to this viewpoint, the first stage of the debt problem consisted in the emphasis on stabilization and began with Mexico's financial crisis. The second phase was characterized by the emphasis on growth and it started with the announcement of the Baker Plan. Finally, the third stage seems to have been ushered by the Brazilian interest payments suspension, but it still seems premature to identify its main characteristic.

VII. 4. THE COMMERCIAL LENDERS' VIEWPOINT (8 April 1987)

Commercial lenders have been striving to act upon matters of world indebtedness with a single and coherent voice of their own. This translates itself into the existence of an appropriate institutional mechanism for the identification and approval of common positions, among this otherwise heterogeneous set of actors. From this perspective can be better appreciated the activities of the Institute of International Finance (IIF).

The IIF was established in 1983 and it groups, as full members, around 200 financial institutions from all over the world, primarily international commercial banks. In its own terms, the Institute's primary role originally was defined as "to collect and disseminate timely and impartial information and analysis on the economic and financial situation, policies and prospects of developing countries having substantial debts towards the banking community." The original objective consisted in providing members "with the factual basis to better evaluate country risk in making their international lending decisions."

With an annual budget for 1987 of $5.11 million, the Institute has recently undergone a significant expansion of its
original tasks, to include "the formulation and implementation of long-term constructive solutions to the debt problem while expanding its base of cooperation and liaison with key international organizations, national authorities and regulators, and government policy makers." Thus, to its original informative role have been added liaison and advocacy roles.

To perform all these tasks, the IIF makes available the information it gathers to its members, by means of country reports and through a country database which covers a wide array of relevant statistical information on almost 40 developing countries. This database provides information on approximately 150 category line-items, including fiscal and monetary policy, creditor groups, as well as debt servicing. The information is gathered by missions to the countries concerned, integrated by one or two IIF economists, accompanied by representatives of member banks. By the end of 1986, the IIF had sent missions to 32 debtor countries, it had issued 140 country reports and it projected that considerable increases in these activities would take place during 1987. The Institute also regularly provides its members with two kinds of surveys, one on "Debt Restructuring by Banks" and the other on "Official Reschedulings and Balance of Payments Support."

Besides an Economic Advisory Committee, which gathers the chief international economists of most of the member banks, the IIF has also two regular bodies: first, a Working Party on the Future of International Lending and second, a Task Force on Regulatory, Accounting and Tax Treatment of Cross-Border Lending.

The Institute also holds two membership meetings, in coincidence with the annual meetings of the World Bank and the International Monetary Fund, in the Spring and Fall of each year. Prior to the Spring meetings of the IMF Development Committee and of the World Bank-IMF Interim Committee, the Director of the Institute addresses a letter to the Chairmen of both Committees, to highlight the viewpoints and concerns of the IIF members "on the long term solution to the debt problem and on the various factors affecting the future of international lending." This year's letter is illustrative of the position adopted by the commercial lenders on several of these issues, as well as it is evidence of the functioning of this group as a coherent actor, endowed with its own articulate position, in the search for solutions to these problems.

In this year's letter, "the commercial banks of the world" describe themselves as one of the key participants in what they call "the debt problem," alongside "the governments of creditor and debtor countries and the international financial institutions." Also, a role is attributed to each one of these actors. For instance, it is considered that the governments of
creditor and debtor countries "have the central role to play," while the IMF and the multilateral banks are considered other principal players." Finally, it is said that "creditor banks are called upon to cooperate."

The letter tries to strike a balance between what are termed "accomplishments" and remaining "serious problems." For instance, among the successes, the letter mentions that "the system has not collapsed, governments have cut back on excessive borrowing, credit exposure has been maintained with rescheduling to defer debt repayment, and new credits have been made available." Also, it is considered of equal importance as an accomplishment, that "many countries continue to have market access and banks have helped them to finance continuing deficits and to refinance loans at more favorable interest rates or with more appropriate currency exposure."

Among the remaining "serious problems," the letter mentions that some countries are still in "perilous situations with large deficits and low reserves," that economic growth has been "slow" and "economic recovery is not in prospect." Finally, it is said that "continuous crisis management over a period of years has led to dissatisfaction with both the process and the outcome of current procedures." On the basis of all these assertions, it is concluded that "it is time to put debt management at the top of the agenda and for all the participants to seek more effective solutions."

Regarding the outlook, many difficulties are perceived. First, "growth in industrial countries appears likely to be even slower than in 1987." Second, debtor countries are advised to "make vigorous efforts to combine higher growth with strengthened payments positions." Third, on the subject of "additional financing," it is asserted that consideration should be given to the relative role of official and private creditors, considering that commercial banks "cannot be the dominant supplier of balance of payments finance," because "reviews of individual countries show the IMF withdrawing money in substantial amounts, and net repayments under its compensatory financing facility at a time when commodity prices are very depressed." Fourth, "the most intractable aspect of the debt problem" is estimated to be "setting policies and monitoring performance," recognizing that "the IMF is of critical importance in working out essential macro-policies for medium-term adjustment programs." Fifth, the Institute recognizes that "member banks have encountered many difficulties in the restructuring process and particularly in arranging new money on satisfactory terms." It also voices a complaint in the sense that "member banks would be easier to convince on the merits of new money if negotiations of programs were more transparent." On this matter, the letter concludes, "if progress can be made in consulting banks early in the negotiations, such consultations would both speed up the process
and help banks arrange more flexible financing packages that would be more attractive to existing creditors." Sixth, the banks express "concern about the impact of regulatory, accounting and tax policies on their ability to expand lending to debtor countries." Finally, the Board of Directors of the Institute is said to be "exploring what additional measures could be implemented to hasten the return to market borrowing," which is termed "the key to any long-term solution to the debt problem."

Some conclusions can be derived from this brief description of the performance of the institutional arrangement existent among one of the four main players that appear in the field of developing countries indebtedness. For one thing, the commercial banks seem to be quite well organized to design and make known their common positions. Also, their opinions seem to be rather clear, particularly on the different responsibilities they consider each one of these players must assume. Moreover, one of the main reasons why the commercial banks have set up their own institutional arrangement, to express their opinions, seems to be that they consider the governments of their respective countries unable to represent faithfully their own viewpoints. Finally, the existence of this relatively sophisticated institutional machinery, to assert the commercial banks' positions, contrasts with the relatively weak consultative mechanism which have emerged among debtor countries.

VII. 5. CITICORP BITES THE BULLET (3 June 1987)

It is extremely difficult to assess fully the significance of the recent decision, adopted by the President of Citicorp, of setting aside the staggering figure of $3 billion to cover possible losses in its foreign loans. The decision will result in a second quarter loss of $2.5 billion and in a whole year loss of $1 billion. To appreciate the magnitude of this figure, it should be noted that it constitutes the second largest quarterly loss in the history of any United States corporation, as well as the first yearly loss for Citicorp, since the Great Depression. Nonetheless, it should also be noted that this "startling decision" was adopted by a bank that has assets of $200 billion and total capital amounting to $25 billion.

The action was carefully prepared. Although Citicorp's President Reed informed that "this was our decision, no one asked us to do it," the corporation acknowledged that it had provided advance notice to the Treasury Department, the Federal Reserve Board and the Securities and Exchange Commission. Furthermore, shortly before the announcement, on Tuesday, May 19, Citicorp's officials abroad delivered formal letters explaining the action
to President Miguel de la Madrid of Mexico; President Jose Sarney of Brazil; President Raul Alfonsin of Argentina; and President Corazon Aquino of the Philippines. This is understandable, since about 80% of the $14.8 billion in Citicorp's outstanding loans to developing countries are to the countries mentioned and to Venezuela.

Nonetheless, if the magnitude and details of the decision are relatively clear, by contrast, when one tries to sort out the reasons and the consequences, the picture becomes blurred. It should be recognized that Mr. Reed went into considerable detail to explain the decision. For instance, he indicated that "the global economy is less robust today." Also, after describing the decision as "a forward-locking step," Mr. Reed boldly asserted his belief that LDC debt problems "are going to be with us into the 1990s." Moreover, Mr. Reed suggested how the decision should not be viewed. He said that it was not retaliation against Brazil's suspension of interest payments; neither should it be considered a bargaining tactic, nor a measure of the market value of the assets involved. The decision, he concluded, "is designed to strengthen Citicorp's balance sheet."

As far as the consequences are concerned, several have already been identified. Among them, it is considered that new lending will fall or, at least, that henceforward it will be on tougher terms. There are several reasons for this expectation. First, if Citicorp assesses the climate for lending as demanding the building up of loan-loss reserves, other banks will also be less willing to risk their own capital. Second, building reserves makes it more difficult to grant new loans at the same time.

Another consequence that has been identified concerns the possibility that future debt reschedulings will become nastier and more painful, given the reduced exposure on the lenders. On the other hand, borrowers will probably respond by seeking relief, arguing that the loans can be forgiven without further impact on bank profits. As a consequence, calls for governmental intervention will become louder, even when the banks' reduced exposure will make intervention appear as less urgent, since it can be assumed that losses by the banks will not endanger the financial system as a whole.

Finally, probably one of the most interesting consequences revealed by the decision adopted by Citicorp consists in the appearance of open differences among the commercial lenders. First of all, one week later, the Chase Manhattan Corporation --the third largest bank holding corporation in the United States-- added $1.6 billion to its loan-loss reserves, resulting in estimated losses of $1.4 billion, for the second quarter, and $850 billion for the year as whole. But, despite this manifestation of "herd instinct," the so-called "collegiality"
among the largest banks of the United States appears somewhat eroded by these decisions. On one side, admittedly, Citicorp acted on its own. Even so, Mr. Reed acknowledged, as it was reported "with a sheepish grin," that he had called his counterparts at BankAmerica and Manufacturers Hanover. But, on the other, because of their large troubled loan portfolios and relatively weak financial structure, singling them out was interpreted as a lack of solidarity with two of the most vulnerable of the big U.S. banks. Moreover, this was also seen as part of a settlement of previous differences, pertaining to contradictory stands adopted in the course of recent debt renegotiations. Thus, a fracture has become apparent between a group of "hawkish" banks, led by Mr. Reed and favoring tough conditions, as opposed to a group of "dovish" banks, led by Mr. John F. McGillicuddy from Manufacturers Hanover, in favor of a softer approach to debt renegotiations, including the granting of concessions on interest rates. To complicate matters, there also exist profound rifts between the relatively smaller regional banks and the big banks, as well as considerable differences between the Japanese and European banks with those of the United States.

This is evidently an incomplete listing of some of the most visible reasons and consequences that have begun to appear with the decision adopted by Citicorp. In a sense, their enumeration serves as an illustration of the impossibility, at this point, of arriving at relatively more definite conclusions. As of now, probably what can be concluded at the most is that Phase III of the debt issue is already evolving, even when its characterization still remains elusive. To a certain extent, this explains some of the responses offered to explain the present situation. As it was asserted by a frequently quoted expert in matters of indebtedness, when he was asked to characterize Citicorp's decision, he said: "the bottom line is, it has pluses and minuses."

VII. 6. GROWTH AND ADJUSTMENT: THE ROLE OF THE FUND
(24 June 1987)

It is not difficult to understand why it seems so odd to hear the following assertions within the walls of the International Monetary Fund:

- adjustment cannot take place without growth, consequently a growth component must be built into adjustment programs;

- Fund supported adjustment programs have placed excessive emphasis on the principle of temporary use of Fund's resources
and on a quick reversal of balance of payments deficits, without
due regard to prosperity and development in individual countries
and in the world economy as a whole;

- the Fund's approach to the design of adjustment programs
  is based on a restricted set of accounting identities, as well as
  on a set of assumptions whose theoretical and empirical validity
  is questionable;

- the control of fiscal deficits, by imposing limits on
  the borrowing requirements of governments, imposes the burden of
  adjustment on the public sector, disregarding if it is engaged
  in productive or welfare activities;

- no single model or set of policies is uniquely applicable
  to all countries;

- the obligation to adjust by debtors entails the
  obligation to finance by creditors;

- growth oriented adjustment programs take longer to
  mature, need larger amounts of finance, and demand that a
  consistent level of imports be maintained;

- in Fund programs, growth should not be obtained as
  residual;

- debt servicing capacity should be an integral part of
  the growth targets of Fund's programs, which should also address
  other objectives, such as improving income distribution and
  alleviating poverty.

These are some of the main conclusions which appear in a
recent report approved by the Intergovernmental Group of
Twenty-Four on International Monetary Affairs --better known as
the G-24-- entitled The Role of the IMF in Adjustment With
Growth. The report was drafted by a group of economists from
developing countries, appointed by the Minister of Finance of
Ethiopia, Mr. Tesfaye Dinka, on May 19, when he was President of
the G-24.

Chaired by Mr. A.K. Sengupta, Executive Director for India
at the IMF, among the members of the working group can be found
several well-known Latin American economists, such as Mr. S.
Amaral, from the Brazilian Embassy in Washington; Mr. Edmar
Bacha, from the Catholic University of Rio de Janeiro; Mr. Ariel
Buira, Director of International Organizations from the Bank of
Mexico; and Mr. Pedro Malan, Executive Director for Brazil at the
World Bank. In the performance of its mandate, the working group
also recognized the contributions made by several well-known
economists, who acted as consultants, such as Messrs. A.
Chrysdtal, R. Feinberg, C. Gwin, T. Killick, D. Sobol and J.
Williamson, as well as the participation of Mr. Sidney Dell, who acted as Senior Consultant to the working group.

The report was adopted by the Deputies of the G-24, acting on behalf of their Ministers, during the last meeting held in Washington, on June 4 and 5. It deals with the following subjects: the design of Fund supported adjustment programs; their implementation and conditionality; the financial resources of the Fund and their use; as well as the reorientation of existing Fund facilities.

Besides these headings, as if anticipating some of the opposition expected particularly from the Fund's staff, the report contains two technical annexes. The first one is a mathematical presentation of the macroeconomic framework underlying Fund programs and the second describes the mathematical relationships that underlie so-called "growth exercises," which the report proposes should become part of what are known as the Fund's "financial exercises." The purpose of these growth exercises is to provide estimates of the external finance needed to achieve a positive rate of growth, close to each country's potential, once the effect of adverse factors has been removed.

As anticipated, the response from the Fund's staff did not make itself wait. The last issue of the joint quarterly publication of the World Bank and the Fund, FINANCE AND DEVELOPMENT (June 1987), is dedicated to the subject of adjustment and growth. Among the contents of this issue, appears a lead article entitled "The Fund's Role in Adjustment," authored by none other than Mr. Manuel Guitian (Ph.D. University of Chicago), who is presently the Deputy Director of the Fund's Exchange and Trade Relations Department. This Department of the Fund seems to lodge some of the most faithful defenders of what Mr. Guitian describes as the Fund's "conceptual framework," as evidenced by the recent public resignation -- the first time in the history of the Board of Directors of the Fund -- submitted by the Australian economist, Mr. David Finch, the last Director of this Department. The resignation was presented arguing that the Fund's staff lately has been under pressure to include political considerations in the application of its "conceptual framework."

Precisely, this so-called "principle of political neutrality" is invoked by Mr. Guitian to explain the way in which the Fund regards "other domestic economic objectives, such as growth and price stability, and even more so... domestic policy objectives pursued for equity, social and political considerations." The explanation offered consists of the following elements. First, the Fund's mandate focuses mainly on external objectives, in particular on balance of payments viability; second, the principle of "political neutrality", as described above, is said to be observed out of respect for each
country's sovereignty in national policy decision making; third, observance of this broad principle has kept the Fund from entering areas that require judgment of social or political priorities; fourth, other objectives, such as growth or price stability, are considered only to the extent that they contribute to balance of payments viability; fifth, an essential consideration, behind the Fund's principle of political neutrality in domestic decision making, is the need to maintain an acceptable balance between protecting the interest of an individual member and safeguarding the interests of the whole membership; sixth, it is asserted that there exists a broad consensus that the external objectives and consequences of members' economic policies are subjects of legitimate international concern; seventh, it is feared that if the Fund were to widen its focus beyond the external areas, the general acceptance of the Fund's priority on external objectives would be less assured, if not contested.

In conclusion, the recent report of the G-24 does not seem to be a traditional case of IMF-bashing, based on cliches or slogans. It has been drafted by a group of economists who express themselves in a language familiar to the Fund's staff. Paradoxically, the almost immediate reaction generated by the G-24 report, is expressed in political terms, but promises to open the door to what hopefully will be a lively debate on the substantive issues, between the Fund's staff and the authors of the report. Also, a relatively more relevant discussion can be expected among the participating governments of the Fund's Interim Committee, where the report has been transmitted to be considered in the forthcoming examination of the Fund's role.

VII. 7. ADJUSTMENT AND GROWTH: MR. CAMDESSUS JOINS THE DEBATE
(1 July 1987)

It is not a coincidence that just a few days after the forty-ninth meeting of the Deputies of the G-24 approved the document on the role of the Fund in adjustment and growth, the Managing Director of the IMF used the opportunity given to him in the United Nations Economic and Social Council, on June 26, to address the same question. Mr. Camdessus comments in detail almost all the basic issues raised by the G-24 document.

The Managing Director begins by admitting that "the challenge of development," lately, has "decidedly become tougher." Several reasons are offered to illustrate this point. For instance, primary commodity prices are said to have weakened considerably. This is substantiated by mentioning the fact that non-oil commodity prices have fallen "to their lowest level in
real terms in the postwar period". Also, the availability of new bank credit to developing countries is said to have "tapered off", all of which has made it difficult to sustain "policies of restraint."

Two consequences are recognized as ensuing from these well-known circumstances. First, the external position of developing countries is said to have "weakened anew." Second, given the substantial deterioration in the terms of trade, it has been necessary to "channel a very significant proportion of output gains into preventing a larger worsening of the balance of payments." Admittedly, the "resources remaining for basic domestic needs have been meager," which in its turn has led to the consequence that "standards of living and expenditures devoted to developing human capital have continued to decline, and investment ratios have remained at levels barely sufficient to keep the physical capital stock from falling."

On the basis of this assessment, the Managing Director addresses a basic question, if the objective is growth, what does the Fund propose should be done to achieve it?

First of all, in relation to sustainable growth, Mr. Camdessus starts from an interesting circularity, or as he recalls, "there are two sides to the coin." On one side, "if a country's balance of payments position is unsustainable, it will not be able to restore and maintain a satisfactory rate of growth unless it adjusts." On the other, although he considers this side less well known, "an appropriate balance of payments position is likely to prove sustainable only if it is attained in the context of durable expansion." The conclusion derived is that "growth is thus as necessary for adjustment as adjustment is for growth."

From this reasoning, Mr. Camdessus draws "two far-reaching conclusions." The first one refers to the need "to bring the balance between demand and supply into a more sustainable pattern," warning that "such efforts need to be accompanied by measures that will promote the expansion of supply," and that "lessen any inescapable impact on output of measures that aim at restraining demand."

Immediately after this conclusion, the Managing Director counterattacks against three of the most salient criticisms expressed against IMF policies, particularly in the G-24 document. The first is the uniformity of IMF's programs; the second has to do with the primary emphasis on demand restraint; and the third pertains to the Fund's alleged insensitivity to social realities. All of them are dismissed by Mr. Camdessus as misperceptions of the Fund's role.
As far as uniformity is concerned, admitting that "some of the same policy measures feature in a good number of programs," Mr. Camdessus states his preference for "a case-by-case approach," considering it "the only possible strategy." In relation to the "primacy of emphasis on restricting demand," even when it is viewed as "an unavoidable element in adjustment programs," Mr. Camdessus declares that "it has never been the exclusive element." Finally, on the Fund's alleged "insensitivity to social realities," Mr. Camdessus recognizes that this is understandable because often "the poorest segments of the population have carried the heaviest burden of economic adjustment." On this matter, he expresses "two convictions." First, that adjustment "does not have to lower basic human standards," and second, that "the more adjustment efforts give proper weight to social realities -- especially the implications for the poorest -- the more successful they are likely to be."

The second conclusion derived from the interrelationship between growth and adjustment refers to the conditions considered essential for the realization of this dual aim. In Mr. Camdessus' opinion, two other conditions must be met. First, growth-oriented adjustment must be pursued universally, and second, "adjustment efforts must receive more effective financial support." By the universality of adjustment and growth, Mr. Camdessus means that all countries, not only those which request the Fund's support, "must make an effort." In particular, he singles out "those which, by their sheer size, determine the level of growth in the world." The second requirement to sustain the mutual complementarity of adjustment and growth refers to the need for "adequate financing, in timely fashion and on appropriate terms." The meaning of adequate financing is further clarified, demanding that "two realities" should be taken into account: first, "the substantial magnitude of the structural adjustment," as well as "the time lags that are necessary before structural policy action registers its effect," which admittedly takes "longer than those associated with adjustment based only on demand restraint."

These assertions are not expressed without warning against several "illusions." First, "policies oriented to growth are not easier to implement than simple policies of demand restraint;" second, "bad economic policies must not be allowed to add to the miseries of the world," third, "adjustment programs are not Fund programs, only Fund-supported programs;" fourth, "if governments do not live up to their responsibilities, but instead attribute the adoption of corrective measures to external forces rather than to the country's own needs and its own initiative, the prospects for success will be jeopardized;" fifth, robust growth of demand in the industrial countries, together with improved access by developing countries to industrial country markets, is therefore essential;" finally, the Managing Director asserts
that "if growth-oriented adjustment is not to be merely a slogan, all parties—governments, multilateral financial institutions, commercial banks—must recognize their responsibilities." But, perhaps to dispel any doubt about the acceptance of the complementarity between adjustment and growth among the Fund's staff, he concludes by saying: "the Fund is committed to playing its part to the fullest, with all the resources that governments put at its disposal and, above all, by drawing on the wealth of intelligence, devotion and goodwill of its personnel."

This very illustrative way of concluding this important statement points in the right direction. Only future practice will tell if the clear orientation towards adjustment with growth, sponsored by the Managing Director, will also be followed by the staff of the Fund.

VII. 8. FINANCIAL DEREGULATION AND THIRD WORLD INDEBTEDNESS
(15 July 1987)

Optimists and pessimists apparently have had their say on the defects and virtues of the decision adopted by the big commercial banks—following Citicorp's lead—of increasing their loan loss reserves. Both have pondered the consequences of these decisions from the viewpoint of either the costs and benefits for creditors and debtors. Nonetheless, only until very recently, the decision was placed within the context of the domestic debate raging in the United States on the merits and disadvantages of financial deregulation.

At the center of the debate appear the issues of geographic and functional diversification. On geographic expansion, it is well known that in the United States truly national banks do not exist. In fact, it has been argued that here the banking system is more fragmented geographically, than that of any other industrialized nation, because it is structured along state lines, rather than on the nation as a whole. Thus, interstate banking acquisitions, as well as interstate branching of banks are forbidden by law. On functional diversification, also by law, the range of services which banking organizations are permitted to offer in the United States is based on a separation between commerce and banking, which specifically prohibits banks from engaging in the sale and acquisition of securities. This last prohibition keeps banks effectively separated from presumably risky commercial endeavors, in what amounts to a "divorce decree" distinguishing between commercial and investment banking.

The intention of these dispositions is better understood by focusing on the origins of the legislation. The prohibition is contained in what is known as the Glass-Steagall Act, one of the
central legislative components of the New Deal. The legislators' intention was to bring under control the "stock gamblers," who allegedly had obtained control of the banks and were responsible for the Great Crash. As it was forcefully asserted in 1932, in a campaign speech by Senator Glass criticizing then President Hoover, the Depression happened because "with insatiable avarice, great banking institutions, through their lawless affiliates," sold billions of dollars of worthless securities to the American public.

Today, the depressed conditions prevalent in the banking sector explain the dynamics of the debate on banking reform in the United States. It is well known that "serious stresses" exist in the financial system. For instance in 1986, out of a total of 14,000 federally insured banks, almost 140 failed, while nearly 20 percent reported losses. Also, the performance of thrift institutions has been considered "dismal," while it is estimated that approximately 200 commercial banks will fail in 1987.

One of the main causes of this poor performance allegedly is the inadequate diversification of loan portfolios, given the excessive concentration of bank failures in distressed farm and energy states. In its turn, this is considered a result of banking legislation that limits the scope for diversification among financial intermediaries. None other than Mr. Robert Heller, a member of the Board of Governors of the Federal Reserve System, offered this explanation in a speech on "The Shape of Banking in the 1990's," given at a meeting of the Forecasters Club of New York, on June 26, 1987. He indicated that barriers to geographic expansion, as well as limits on the range of services that can be offered, "erected for what were once perceived to be legitimate reasons, have outlasted their usefulness." Thus, Mr. Heller unequivocally concluded, "they should be removed, so that banks can compete on an equal footing with other types of financial service institutions."

Clear and terminant as these explanations sound, when the focus moves towards the participants in the debate, it becomes evident that these issues have provoked the emergence of profound fractures within the financial community of the United States. To mention only some of the principal contenders, for instance, on one side can be found the big money center banks, in favor of deregulation. On the other, opposing deregulation, can be found the investment, the regional, as well as the smaller banks. The big banks are represented by the American Bankers Association, while the small and medium sized commercial banks are represented by the Independent Bankers Association of America. Obviously, investment banks, as well as the securities industry, are definitely opposed to the emergence of what have been called "financial supermarket chains."
Given these rifts among the interested parties, it is only natural that the government itself appears pulled in different directions. On the one hand, the Treasury Department favors the abolition of barriers and the emergence of what Under Secretary of the Treasury, Mr. George Gould, has called "big American financial institutions," or superbanks. On the other hand, opposed to the measure is the departing Chairman of the FED, Mr. Paul Volcker, as well as Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York.

Recently, these forces clashed, with those in favor of deregulation suffering what was termed as "the biggest and most decisive setback," because Congress approved legislation putting a temporary rein on deregulation. Among the most salient features of this legislation approved in Senate-House Conference by a very narrow margin, appears a rule forbidding the authorization by the Treasury of limited service banks, or nonbank banks, by which commercial corporations were authorized to enter the banking business. The legislation also halts several other court and regulatory measures which have been used to allow commercial banks to slowly move into new areas of securities underwriting. Some of the legislators who voted in favor argued that in this manner Congress will have "a chance to study the issues and come up with some overarching concept of what would be done."

Within the context of this debate has to be placed the recent decision, initiated by Citicorp, of increasing loan-loss reserves, which has resulted in the fact that "commercial banks have taken their biggest bath in red ink ever." First, not all the money center banks have welcomed Citicorp's initiative. Particularly, this move has been reluctantly followed by those big commercial banks which find themselves in a relatively weaker position, among which can be found BankAmerica and Manufacturers Hanover.

Moreover, one of the direct consequences of the increase in loan-loss reserves is that those weakened by the measures are less capable of participating actively in acquiring smaller banks, to test the limits of the prevailing legal limitations. Also, what apparently is only an accounting entry, by which funds are shifted from net-worth accounts to loan-loss reserves, might lead to requests for capital increases on the part of banking regulators. In its turn, this capital increases could probably strengthen the pace of those favoring the emergence of "superbanks," or of those who consider that access to bank ownership should be broadened to allow for well-capitalized industrial corporations to participate in banking operations.

Nonetheless, despite the recent legislative setback experienced by those who favor deregulation, there are clear signs that sooner or later the "superbanks" will emerge. For one thing, the appointment of Mr. A. Greenspan to succeed Chairman
Volcker, warrants this conclusion. Mr. Greenspan stated, in an interview before his appointment, that the "separation of commerce and banking at this stage is simply not helpful." Also, among Mr. Greenspan's "extensive business relationships" appears a ten-year tenure as director of Morgan Guaranty Trust Company, one of the most dynamic of the big commercial banks.

In conclusion, as it was stated by Mr. R. Simmons, Vice-Chairman of Chemical Bank, the fourth largest commercial bank of the United States, as well as one of the most active in the rush to acquire smaller banks: "by the mid-1990s there will be five major United States banks with assets of about $500 billion each." This obviously is in stark contrast with Citicorp's almost $200 billion in assets, presently the biggest bank in the United States. Finally, it is not difficult to imagine the consequences of finding on the other side of the table, negotiators that have assets that exceed by far the debtors' gross national product.

VII.9 SECURITIZATION (16 September 1987)

Several consequences have followed from the recent rejection of the Brazilian proposal for the conversion of half of its debt to commercial banks into long-term, fixed interest bonds, valued according to their secondary market price. Among these consequences, one of the most immediate has been to turn the attention towards the often mentioned, but slightly substantiated possibility of the issuance by debtors of securities to finance the purchase of their debts to commercial banks. This alternative is known as securitization and apparently has always been recognized as such, but as it was poignantly illustrated by the fate of the Brazilian proposal, until now, its implementation has encountered formidable obstacles.

For one thing, the phenomenon of securitization is fairly recent. It emerged, only a few years ago, with the packaging of loans -- household mortgages or car loans -- to support the sale of other more marketable securities. In effect, securitization has consisted in the direct issuance by borrowers of bonds to back-up the issuance of other financial instruments. This has led, among other consequences, to the erosion of the intermediary role traditionally performed by commercial banks. Also, considered as securitization is the creation of what are known as "junk bonds," or high-risk and high-yield securities, issued to finance the growth of emergent corporations which lacked the credit ratings required to gain access to relatively more normal bond markets. More often, "junk bonds" were also issued to finance some of the
operations which led to the recent boom in corporate takeovers throughout the United States.

Consequently, given all these relatively successful instances of securitization, a frequently asked question is why not transform the debt of developing countries into securities that can be traded among investors? Supposedly, this alternative would contribute to alleviate some of the present difficulties of commercial banks, as well as hopefully furnishing a source of much required new financing for growth in debtor countries.

Recently, several events have been signaled as evidence of an increase in the focusing on securitization of Third World indebtedness, particularly among investment bankers in the United States. For instance, at Shearson Lehman Brothers, a team of more than 25 persons is reportedly trying to design a "securitized loan product." At Merrill Lynch, a team of more than a dozen experts is working on inventing a "Latin loan security." But what has attracted most attention is the fact that, at Drexel Burnham Lambert, Mr. Michael Milken is said to have been working for the last three years on a set of proposals to "securitize Latin debt."

Why Mr. Milken's presence has provoked such a stir? Simply, because he is considered a modern J.P. Morgan, or the financial wizard who singlehandedly created the $140 billion junk bond market for Drexel Burnham Lambert. Thus, it has been said, "where Mr. Milken chooses to go, others are rushing in as well."

Apparently, the signal which activated the investment bankers' appetite was the mid-year announcement by the major commercial banks --following Citicorp's lead-- of their setting aside billions of dollars in reserves, to cover potential losses in their Latin portfolios. This was interpreted as an indicator of the banks disposition to unload some of these loans, particularly after Mr. John Reed, Chairman of Citicorp, indicated his willingness, over the next three years, to get rid of as much as $5 billion of its $14.7 billion in Third World loans. This signal was perceived as the transformation into a true market of the incipient secondary market in discounted Latin loans, where presently there are virtually no takers, aside from the swaps among commercial banks performed to achieve better balances in existing portfolios. Mr. Milken himself has recognized that "it has been this ingredient which has allowed the market to now create the opportunity to be implemented."

Also, in agreement with this interpretation appears a respected academic, Professor Rudiger Dornbusch from the Massachusetts Institute of Technology (MIT), for whom Third World loans "are trapped in the banks because they are not fully negotiable securities."
Unfortunately, not many details have as yet been revealed about these proposals to securitize the debts of developing countries. The most ambitious plan apparently entails the creation of a fund, with money from a group of Mr. Milken's influential customers, to purchase Latin American debt at secondary market prices, to be exchanged for equity based bonds issued by the debtor countries. For instance, it is said that Mexico could issue an oil-backed security, or Bolivia could issue a tin-backed security, which supposedly would support the issuance of new bonds to be sold by Drexel Burnham Lambert. The details seem to vary with each proposal, but the general thrust seems to be the same, the repackaging of bank loans into a security tradeable in the market. Furthermore, these packages can represent the debt of one or several countries.

Obviously, infinite questions have been generated by the presentation of these proposals. Among them, for instance, on the creditors side appears the question if the commercial banks are willing to dump their loans and, if such is the case, at what price and who would be willing to buy the securities? On the debtors side, a basic question still awaits clarification, what is in it for them? Finally, there are certain apprehensions derived from the fact that Mr. Milken and Drexel Burnham Lambert are under federal investigation, because of their alleged participation in some of the recent insider trading scandals. Also, there is certain apprehension because one of Mr. Milken's collaborators, hired to work in the securitization of Latin debts, is serving prison after pleading guilty of bank fraud and tax evasion, in connection with unauthorized withdrawals of several million dollars from customers' accounts, when he worked as head of Latin American operations at J.P. Morgan and Company.
VIII. INTERDEPENDENCE OF FINANCIAL MARKETS

VIII. 1. THE GLOBALIZATION OF FINANCIAL MARKETS
(11 February 1987)

Ever since the Chairman of the Bank of Tokyo, Mr. Yusuke Kashiwagi, was asked to give the prestigious Per Jacobson Lecture of 1986, on "The Emergence of Global Finance," the subject seems to have attained the recognition deserved by what constitutes probably one of the most important economic transformations of the present decade.

Recently, the main issues raised by this transformation were discussed by Mr. Rimmer de Vries, Senior Vice-President of the Morgan Guaranty Trust Company. He analyzed some of the facts and forces which appear behind the global linkage of financial markets, as well as its consequences on the effects of monetary policy, on the functioning of the exchange rate system, and upon the stability of the world financial system. What follows is a brief summary of a paper presented by Mr. de Vries to the Wallenberg Forum, at the School of Foreign Service, Georgetown University, entitled Global Capital Markets: Issues and Implications (October 1986).

Among the facts and forces leading to internationalization, presently, capital flows surpass in magnitude the amounts of trade flows. In the equities sector, companies are issuing stocks in other countries stock markets, while in credit markets, bonds are also denominated in foreign currencies. Furthermore, the phenomenon of securitization is becoming dominant. It consists of the direct issuance by borrowers of bond instruments and credit facilities to back up the issuance of other financial instruments, which is leading --among other consequences-- to a pronounced erosion of the banks' traditional intermediary role.

All these circumstances are generating more intense levels of integration of capital markets, which have facilitated, for instance, the financing of the present large U.S. current account deficit. The issuance of new instruments, such as options, futures and forward-rate agreements, has also grown significantly, contributing to a reduction of exposures to interest and exchange rate volatility.

Behind these intense transformations appear powerful macroeconomic forces, pushing financial markets into innovation and reducing the powers of governments to regulate their
functioning. For instance, large government deficits have contributed to the internationalization and liberalization of capital flows. Inflation has also contributed to these trends, by pushing investors to find more adequate nominal returns. Finally, the present volatility in exchange and interest rates has led to the search of hedging mechanisms to reduce the exposure to such instability.

There appear also equally powerful forces pushing the banks toward innovation. For instance, LDC indebtedness has considerably lowered the credit ratings of major banks. Thus, presently, some large corporate and government borrowers enjoy higher credit ratings than their banks, which enables them to borrow directly at lower costs. This, in exchange, has forced the banks to look for other profitable alternatives, such as fee-based services, as well as several off-balance-sheet activities.

Innovation has been forced upon the banks by competition. In its turn, competition has forced the banks to seek deregulation, to allow for diversification into presently forbidden domains. Meanwhile, technological innovations in data collection, coupled with the acceleration of communications, are rapidly making obsolete many existent regulations. Some of these restrictions have already been abolished, for instance in London after the much commented "Big Bang," allowing banks to own securities houses and leading to the emergence of financial supermarkets to provide for banking and securities services.

Some of the implications of these transformations are only beginning to be discovered. First, in the field of monetary policy, financial integration lessens the predictability of money demand, which in its turn hinders the efficacy of monetary targeting. Second, by affecting exchange rates, the internationalization of capital influences the tradable goods sector, as well as, by making easier the financement of current account balances, it allows for more discordant macroeconomic policies. Third, less developed countries, given commercial banks' reluctance to increase their already pronounced exposures, may resort to securitization, by means of the direct issuance of marketable assets. Furthermore, the utilization of interest rates and currency swaps, forwards, options and futures, may enable LDCs to achieve reductions in borrowing costs, as well as decreases in exposure to increases in interest rates or to exchange rate instability. Finally, some of the capital that has flown out of these countries might be persuaded to return by means of innovative financial instruments. To conclude, concerning the stability of financial markets, monetary authorities are being forced to coordinate their supervisory functions and will have to agree among themselves on a distribution of responsibilities for the efficient performance of their role as lenders of last resort.
VIII. 2. FINANCIAL MARKET STRUCTURE: Deregulation or Reform?  
(4 March 1987)

One of the main consequences of the globalization of financial markets manifests itself in the present financial structures of the most advanced industrialized economies. Recent transformations are generating pressures upon the functioning of these structures which, until now, had remained relatively stable.

In the United States, a debate is going on about banking reform. It centers around the degree of congruence of the prevailing structures, instruments and mechanisms, with the accelerated transformations taking place in world financial relations. The terms of this debate have become relatively more clarified by the publication of a study, authored by probably one of the most qualified participants in these vertiginous transformations.

The President of the Federal Reserve Bank of New York, Mr. Gerald Corrigan, has recently published a study entitled: Financial Market Structure: A Longer View (Seventy-Second Annual Report for the Year Ended December 31, 1986), in which some of the most important issues raised by these transformations are authoritatively addressed.

Mr. Corrigan begins by describing some of the changes that have taken place in financial markets and offers an explanation of their main causes. He also describes the functioning of the largest electronic payments systems and focuses on four alternatives available to respond to these transformations.

Among the most important changes taking place in financial markets, several are briefly mentioned. First, capital markets are now international or globalized; second, the separation between commercial and investment banking is being increasingly blurred; third, the other separation between "banking" and "commerce" is also subject to challenge; fourth, interest rate, exchange rate, and credit risks are being shifted in ways that are changing their nature; fifth, securitization is also spreading rapidly, in basically two forms: the direct issuance of securities or by means of packaging loans for sale in the form of other securities; sixth, for large banks the profitability of intermediation activities is under stress; seventh, spreads and fees may not be providing returns commensurate to risks; eighth, an explosion is taking place in financial transactions, as well as in the short-run volatility of the prices of most classes of instruments; ninth, payment
and settlement risks have increased sharply; and tenth, all these changes have taken place in the very brief time-span of the last three or four years.

Some of these transformations are naturally associated with also relatively recent world-wide patterns of economic performance. But beyond these underlying forces, there appear innovations in the application to the financial marketplace of mathematics and computer technology, which have permitted the design of new techniques, new instruments, and world-wide reading and funding strategies. Also, world-wide differences in regulatory treatment have spurred competition and induced the exploitation of loopholes, as well as the by-passing of supervisory policies.

While taking into account these changes, Mr. Corrigan reminds that one of the main functions of any financial and banking system, besides that of bringing together savers and investors to facilitate the allocation of scarce capital resources, consists in providing an efficient mechanism to channel payment flows. In the United States, this last function has attained impressive dimensions. For instance, the size and speed of daily payments, channelled through large-dollar electronic payments systems, are well in excess of $1 trillion, or about one fourth of GNP. The operations of these payments systems are centered in two institutions: the Federal Reserve Banks, which operate the FEDWIRE system, and the New York Clearing House Association, which operates a payments system called CHIPS. The daily volume and value of funds and securities transfers made over FEDWIRE, at the New York Federal Reserve alone, approximate $400 billion and $250 billion, respectively, with peaks of around $500 billion per day on both the funds and securities wires. Daily payment flows on CHIPS average $450 billion, with peak volume days of about $800 billion.

No wonder, these staggering figures generate "a nagging sense of unease," when the question is raised of what are the requirements of a more stable financial market. Mr. Corrigan suggests that four alternatives are available and pronounces himself in favor of one of them. First, "re-regulation," to reverse the technologically driven globalization. This alternative is considered the "easiest to discard," since "it would be highly impractical both politically and substantively." Second, "to muddle through," or to stay the present course of piecemeal change, is promptly dismissed as dangerous. Third, "wholesale deregulation," to allow the unbridled market forces to run their course, which would entail basically the abolition of the separation between banking and commerce, insofar as ownership and control of banking institutions are concerned. Finally, Mr. Corrigan offers as his preferred alternative the reform of the financial system, accepting the blurring of distinctions
between classes of financial institutions, but preserving the
distinction between banking and commerce.

In conclusion, the debate is thus reduced to two
alternatives, deregulation or reform, clustered around the basic
issue of ownership of banks and raising three basic questions:
1) can supervisory oversight functions be extended to all those
who wish to own and control depositories; 2) can the official
safety net financial apparatus --including liquidity support from
the central bank --be made available to part of a firm, without
it being available to the firm as a whole; and 3) how can the
impartiality of the credit decision-making process be preserved.
9

IX. THE STOCK MARKET CRASH

IX. 1. VERTIGINOUS INTERDEPENDENCE (21 October 1987)

Tempting, as it is, to find an explanation about what is happening in the stock markets throughout the world, it has to be admitted that, at this point, it is virtually impossible to realize such an ambition. Least still, is it possible to anticipate the consequences for the world economy of the present turmoil in financial markets. At this stage, only some of the salient events can be hastily and arbitrarily lumped together, at least, to try to order their vertiginous succession, which started in the middle of last week and does not seem to come to an end. The readers' indulgence is thereby requested, because most certainly events themselves will overtake much, if not all of what follows.

It all started last Wednesday the fourteenth, when the much awaited monthly figures on the United States' trade deficit were issued by the Commerce Department. The figures in themselves were, admittedly, not encouraging, but neither were they off the mark, as to generate great surprise. Thus, it was reported that during August the U.S. trade deficit remained at a near record level of $15.7 billion, as both exports and imports had declined. And even when the August figure was less than the record July deficit of $16.5 billion, it seemed to confirm the forecasts that the trade deficit in 1987 would reach about $170 billion, up roughly 10 percent from the record deficit of $156 billion, experienced during 1986.

The financial markets' reaction was swift, the dollar slipped in foreign exchange dealings, short-term interest rates immediately soared, while bond prices plunged and the Dow Jones industrial average plummeted 3.81 percent to its second record one-day decline in a week.

On Thursday the fifteenth, despite reassurances from several quarters including the Department of the Treasury, the stock market continued to fall, although still moderately, by 57.61 points or 2.4 percent. This time, an announcement in the afternoon by the Chemical Bank, lifting the prime rate by half a percentage point, to 9 3/4, made while the Secretary of the Treasury was meeting with President Reagan, seems to have intensified the fall. Most of the losses took place during the last thirty minutes of trading, only two hours after the
conclusion of the meeting between the President and the Secretary of the Treasury.

On Friday the sixteenth, the Dow Jones industrial average dropped once again by 108.36 points, or 4.6 percent, in what amounted to the sixth largest percentage decline since the end of World War II. The news which aggravated the plunge this time were contained in an article, published the day before in The New York Times, by which Secretary of the Treasury James A. Baker 3d. was said to have "raised the possibility of pushing down the dollar in reaction to recent increases in West Germany's (interest) rates."

Thus, concluded a week during which, according to some observers, the stock market found itself "at a crossroads," after experiencing "five years of almost sustained euphoria."

On Saturday the seventeenth, with the markets closed, The Washington Post quoted "a key administration official" admonishing West Germany that the U.S. Federal Reserve "will not follow them into deflation," by duplicating the recent burst of higher interest rates in that nation. He added, "we are not going to sit back and let them raise rates, and have them expect that the Fed here will follow along."

If need be, this only confirmed the worst fears that the value of the dollar would be allowed to fall, as well as it made manifest that serious rifts persisted among the major industrialized economies, despite the repeated assurances that the agreements on exchange rate stabilization were still in full force.

On Monday the nineteenth, the already nervous market opened under the menace uttered on Saturday by a seasoned observer. "You can't suspend the laws of gravity forever," said Mr. Felix Rohatyn, from Lazard Frères. He added, "some day there was going to be a day of reckoning. I don't know if this is the beginning of the reckoning, at least it is a sobering recognition that elevators don't always go up." And the reckoning came on Monday, when the Dow Jones closed after experiencing a loss of more than 500 points, the equivalent of 22.6 percent, or a loss almost twice as large as the one it experienced sixty years before, on Friday, October 28, 1929.

This time, the Cassandras that were on the point of total discredit, because of the arrival of the U.S. economy to sixty months of sustained expansion, saw some of their worst predictions fully confirmed. For instance, focusing on the trade deficit as an indicator of a preference for consumption, Mr. Peter G. Peterson previously concluded that the United States had to consume less. By contrast, Professor Robert Heilbroner saw in the trade deficit one of the symptoms of the collapse of
imperialistic capitalism. While Professor Ravi Batra, author of the best selling book "The Great Depression of the 1990s," with a little help from the inspiration provided by an Indian Guru, reminded that the sixty year cycle of the U.S. economy is due in 1990. Nonetheless, with the benefit of Monday's events, the truth is that only mystics and psychics can appear certain amidst the present volatility.

Even so, at the most, what can be done with some degree of certainty is to identify some of the present events' characteristics. First of all, there is the speed of the changes, which The Wall Street Journal, on Friday, still did not find "surprising in this age of programmed trading and rapid international capital movements." Although later the Journal described the whole episode as "computerized panic." Second, there used to be a time when financial markets in the United States reacted more to domestic indicators, such as the money supply figures, the consumer price index or the unemployment rate. Today, by contrast, the most closely watched figures are the trade deficit, as well as inflation and the corresponding increases in interest rates. This is in part due to the fact that, during the first half of 1987, net foreign investment in the U.S. stock market amounted to $18 billion, while overall foreign activity amounted to $222.4 billion, or about ten percent of the total traded in equities during the same period. Finally, if an immediate lesson can be drawn, as it was reminded by Ms. Sylvia Ostry to the audience of this year's prestigious Per Jacobson Lecture, "what interdependence entails is amplified risk and --since knowledge usually lags behind complex change--amplified uncertainty." In her own terms, as some perplexed observers recently confirmed, "interdependence means that opportunities for joint gains are enhanced but vulnerability is also greatly amplified."

IX. 2. AFTER THE MELTDOWN (28 October 1987)

The stock market in the United States has not yet recovered from last week's staggering losses. Nonetheless, this does not seem to have deterred the avalanche of explanations which have been offered almost instantaneously.

For one thing, more is known about the events which allows, at least, for the pronouncement of relatively more informed judgements. For instance, there already exists a preliminary estimate of losses, exceeding $500 billion in stock market value. This gives credence to the expression used by the Chairman of the New York Stock Exchange (NYSE), Mr. John Phelan, to describe what happened, on Monday the nineteenth, as the
"nearest thing to a meltdown." Evidently, this global figure does not permit to appreciate fully the magnitude of individual losses, which only now are beginning to be published. There is, for example, the case of a big drug manufacturer, Pfizer Inc., whose shareholders are said to have lost, on Monday only, $1.7 billion in the value of their shares.

Also, the chronology of events appears clearer as time goes by. Now it has been learned that at Monday's outbreak before the markets opened, around Mr. Phelan's desk at the NYSE, gathered a group of the most influential men in U.S. finance, persons who literally control billions of dollars in assets. Among them were William A. Schreyer, chairman of Merrill Lynch & Co., John F. Gutfreund, chairman of Salomon Brothers Inc., Peter T. Buchanan, chief executive of First Boston Corp., S. Parker Gilbert, chairman of Morgan, Stanley and Co., as well as about ten others who were not identified.

At the time of the meeting, the London stock market was concluding its worst day ever, while Tokyo's market had closed just hours before suffering a record-setting collapse. "We decided to let it bounce around and see what happened," Mr. Phelan later declared. The meeting ended shortly before the stock market opened to experience the worst one-day plunge in its history. "We knew it could be a bad day," recalled afterwards First Boston's Buchanan, "but I don't think anybody anticipated what actually happened."

It has also been established that, on Monday, the market plunged in two distinctive waves. The first one, characterized by an unprecedented number of sell orders, was unleashed when complex computerized trading programs dumped huge blocks of stocks as fast as proceeded the collapse in their prices. This was the impressive fall that confronted traders when the markets opened. The second wave came after a statement, made in Washington by the Securities and Exchange Commission Chairman, Mr. David S. Ruder, in the sense that "there is some point, and I don't know what point that is, that I would be interested in talking to the New York Stock Exchange about a temporary, very temporary, halt in trading." Immediately, the statement was picked up by Reuter's financial wire and in the hour that followed the market plunged 100 points, to decline almost vertically for the rest of the day and to conclude by losing 200 points in the last hour of trading. It must be added that it was impressive that the decision to keep the markets open was maintained throughout the journey.

But so much for the events, how about some of the explanations that have been offered.

As far as causes are concerned, most opinions can be said to be in search of a culprit. Some blame or try to exonerate
individuals or institutions. For instance, one of the first criticized, particularly by representatives of the securities industry, was Secretary of the Treasury, James Baker, 3rd. --considered President Reagan's number one problem solver. His open accusations against West Germany of violating existing monetary agreements have been said to have acted as "catalysts" of Monday's plunge. One columnist went as far as to suggest "Fire Baker, Hire Volcker."

The new Chairman of the Federal Reserve Board has also come under fire. Mr. Greenspan is said to have focused too much of his attention on inflation. Although a different but more institutional criticism has come from some well-known supply-siders arguing that the Fed had been practicing too tight a policy and thus it was causing increases in interest rates. On a less personal basis, by contrast, Mr. Lee Iacocca has openly faulted the budget and trade deficits, saying that "the borrowing has to stop." This has also been the stance adopted by most Democratic Party members.

It has been somewhat surprising that amidst this flood of criticism not many have been heard against "foreign scapegoats." On the contrary, foreigners have been credited with contributing to the markets rebound. They are said to be "back in the market looking for good values." This perhaps is due to the consideration that at this point it is a first priority to avoid "panic flight from the dollar into other currencies." Although some opinions have been heard in the sense that "Black Monday was triggered (not caused) when West German authorities raised interest rates four times in a rapid succession." Furthermore, such a policy has been considered "idiotic", while U.S. monetary policy has been considered "irresponsible."

Still more impersonal have been some mechanistic interpretations, basically centered around the role of computerized trading, accused of being responsible of the decline's acceleration. In support of this comes the decision, adopted on Tuesday after the pronounced fall by the NYSE, placing program trading under severe restrictions. As Mr. Phelan declared, "when the market is at extremes, program trading does add to volatility, and that has everyone worried." Nonetheless, a "futuristic perspective" was immediately offered by Mr. Alvin Toffler, better known for his writings on "future shocks", as well as "third waves." Mr. Toffler suggested that what happened to the stock market might be better understood according to the rules that apply to the functioning of "unstable systems." Thus, he asserts, by a combination of "speed, diversity, and complexity" the system is said to be expanding and "building a single completely open financial system," which is also accompanied by a "shift from paper to electronic currency." All this is considered part of "the larger transition from an industrial to a 'third wave' or 'post-industrial' economy." On
the basis of this reasoning, Mr. Toffler concludes that "the time has come for the design of 'third wave' financial institutions," because he considers that "the mindless drive to create a barrier-free financial market is a product of industrial-era thinking." Unfortunately, Mr. Toffler has not yet specified the nature and shape of such institutions.

Finally, one of the most recurring arguments heard throughout the week has to do with the similarities and the differences between 1929 and 1987. For instance, Alfred Malabre in The Wall Street Journal has asserted that the economy and stocks are "separate but linked." From this the conclusion is derived that "sinking stocks do not necessarily imply a sinking economy." Although Mr. Malabre also asserts that during the eight recessions experienced by the U.S. economy, during the post-World War II era, "the stock market has entered sustained declines, signaling their approach, by lead-times averaging just under eight months." Nonetheless, in this respect, it has also been recalled, by none other that Mr. Richard G. Darman. former Deputy Secretary of the Treasury and presently managing director of Shearson Lehman Brothers, that "this is not a repeat of 1929." The reasons for the difference are found by Mr. Darman in the existence of "insurance of deposits, increased margin requirements, improved capacity of the Federal Reserve System, social insurance, etc." In his opinion, "the very fact that these safeguards are widely recognized tends to put a floor under falling confidence."

Be it as it may, probably the best description of present circumstances has been a headline in last Sunday's New York Times saying that the U. S. economy is "beset by uncertainty."

IX. 3. THE MAGIC OF THE MARKET (4 November 1987)

These days, not very much has been heard from the vaunted magic of the market. Evidently, this has to do with the fact that in good times Wall Street prefers to be left alone, while in bad times it urges Washington to act.

Apparently, in these trying times, enough government actions have been witnessed to verify that in order to operate adequately, the magic of the market requires the presence of the magician. Even so, complaints are still heard that government actions have been insufficient and that much more intervention is required to ensure the functioning of the markets.

Nonetheless, immediately after the "meltdown," the Federal Reserve Board assumed "its role as guardian of the nation's
financial system," by acting openly as well as behind the scenes, "to soothe the nerves of financiers and prevent a full fledged panic." With this purpose, the Fed adopted a two-pronged approach. On the one hand, on October 20, the Fed announced its "readiness to serve as a source of liquidity to support the economic and financial system." To make this liquidity available, the Fed buys Treasury securities from some forty banks and securities firms, recognized as primary dealers. If the transaction is with a bank, the Fed's payment becomes part of the bank's reserve account at the Federal Reserve Bank of New York, adding to the bank's liquidity thus enabling it to make more loans. If the transaction is with a securities firm, payment from the Fed is received through a commercial bank. These transactions are temporary, ranging from overnight to three days and up to now the Fed has been renewing them upon maturity.

Behind the scenes, the Federal Reserve Bank of New York has also been meeting with executives from leading New York banks, urging them to increase their lending to those securities firms, considered "credit-worthy," which are experiencing temporary liquidity shortages, as a consequence of the markets' plunge.

The other element of the Fed's two-pronged approach has been the encouragement to commercial banks to reduce, even by modest amounts, the interest rates they charge for overnight lending among themselves. Of course, Mr. Richard Hoey, chief economist at the securities firm Drexel, Burnham Lambert Inc., acknowledging that "the Fed has no obligation to protect stock market profits," because "that is not its job," also believes that the Fed "does have an obligation to limit the secondary effects of a decline in stock prices."

Another consequence of the "meltdown" has been to bring back the need for the regulation of certain activities, particularly those linking futures trading with the stock markets, which have been considerably intensified by the design of so-called "portfolio insurance" strategies. By means of methods such as complex computer programs, or program trading, there exists the capability of triggering staggering operations in multi-million dollar lots.

These strategies seem to fare relatively well in good weather, but complications begin to appear when the stock market begins to fall. Then, if the value of the stocks falls below the value of the matching futures index, programme traders briskly start selling stocks and buying futures, thus depressing stock prices even more. This sort of vicious cycle was the one that sent the stock market into a downward spiral. Now there seems to be agreement that the "meltdown" took place because computerized trading programs moved the market inexorably and vertiginously in a single direction. Fortunately, the movement was brought to a halt by none other than the Chairman of the New York Stock Exchange (NYSE), Mr. John Phelan. He literally
"pulled the plug" of the $100 million computer system, installed by his initiative at the NYSE, and then proceeded to request from member firms the curtailment of futures trading. Thus, Mr. Phelan was praised because he withstood "immense pressures on him from all sides" to halt trading by closing the market, although he actually found a close equivalent by switching off the computer system to stop computerized trading. Apparently, this constitutes the modern equivalent of shutting the doors of the stock exchange.

In a certain sense, closing the market constitutes the ultimate intervention, as it happened in Hong Kong, where the authorities panicked and decided to shut the doors, supposedly, "to allow the brokers to have time to settle the backlogs." This excuse was dismissed by The Wall Street Journal because "when prices were soaring on high volume, no one demanded that they be frozen so the brokers could catch up on paper work."

In the end, the whole issue almost belongs into the realm of magic, when the difficult question of building confidence is addressed. As President F.D. Roosevelt remarked in 1929, "this is what happens when fear feeds upon fear." Losses of confidence, as the one experienced recently, seem to leave the markets "clamoring for political leadership," even if admittedly it is asking too much from governments. As R.W. Apple concluded in The New York Times, "in this largely secular century, it falls to government to offer words and symbolic or substantive actions of reassurance when something happens that few had expected, fewer still are able to explain and everyone finds threatening." No wonder, George Washington's statue overlooks the New York Stock Exchange.

IX. 4. LOOKING FOR BRIGHT SPOTS (11 November 1987)

Now that the search for a culprit for the stock market meltdown seems to have abated somewhat, the turn seems to correspond to the finding of some bright spots. Thus, even when The Wall Street Journal admitted "it may sound crazy," more and more is being heard that the stock market's collapse "just might, in the end, prove to be good for the economy." Several positive consequences are thus derived from this shattering experience, to support the previous assertion.

First of all, it is considered a positive sign that the Federal Reserve Board decided, however reluctantly, to abandon its tight credit policy, because one of the definite casualties of Black Monday were previously exaggerated inflationary worries. Furthermore, even the market itself is said to have
performed relatively well, once the central bank decided to move quickly to pump money into the economy, generating confidence and driving down interest rates.

Second, the market's nose dive is also credited with the hardly negligible feat of pushing the President and Congress, Republicans and Democrats, to the negotiating table, to address the stalemated issue of the persistent fiscal deficit. Although the results of this new disposition to negotiate have been protracted and apparently remain far down the road.

Third, there is also the specter of recession, which presently haunts the U.S. economy. Even on this legitimate worry, the Secretary of the Treasury is said to have successfully stepped in to calm down some of these apprehensions. His statement in The Wall Street Journal, of November 5, made it very clear that the Administration's first priority is to avoid a recession caused by high interest rates, even if this entails a falling dollar. In what probably constitutes the most profound and significant policy turnaround, caused by the market's collapse, the dollar "will not be maintained within certain ranges, at the expense of the monetary policy of the United States." Moreover, the Secretary of the Treasury considered that the international agreements to stabilize the dollar, "may have encouraged the Fed to be too tight in its policies." Consequently, Secretary Baker emphasized that "any U.S. agreement to help stabilize the dollar's exchange rates wouldn't involve any willingness to defend the dollar by raising domestic interest rates and risking recession."

This statement was received with rare unanimity among economists from different persuasions. For instance, Mr. Anthony Salomon, former president of the Federal Reserve Bank of New York, said: "now we've got a situation where the dollar is slipping, and my advice would be you shouldn't resist it too hard." The Nobel laureate in economics, Yale Professor James Tobin, stated: "we just don't need a high value dollar. It hurts our trade position with other countries. We should let the dollar fall against other currencies. Our aim should be to get the dollar down to a level people begin to expect it to rise, not fall." Other well-known economists, more closely identified with the present Administration, also expressed similar opinions. For instance, Mr. Herbert Stein, a senior fellow at the American Enterprise Institute, warned against "a possible immobilization of fiscal and monetary policies." He asserted that if monetary policy is committed to defending the value of the dollar and fiscal policy is geared to decreasing the budget deficit, at a time when the economy needs the stimulation of increased government spending, the present crisis would be greatly exacerbated. Also, Harvard professor Martin Feldstein, former chairman of the Council of Economic Advisers during the present Administration, went as far as to demand "the end of policy
coordination." He said, "it is frightening to the American public and upsetting to our financial markets to believe that the fate of our economy depends on the decisions made in Bonn and Tokyo." Professor Feldstein forcefully declared that everybody should "be reassured that we are not hostages to foreign economic policies, that the U.S. is the master of its own economic destiny."

Finally, MIT Professor Rudiger Dornbusch --well-known in Latin American circles for his positions on the debt issue-- considers that "a 24% cut is needed in the dollar's value against currencies of major U.S. trading partners to shrink the trade deficit to about $50 billion." On the basis of a model, Professor Dornbusch has calculated that "for every 16% gain in the competitiveness of U.S. export prices and every 8% rise in net foreign spending levels, the U.S. gains net exports equivalent to 2% of GNP."

Of course, the fundamental question raised by this policy shift in the United States leads to asking what will be the reaction it may provoke in Bonn and Tokyo. Initially, although reluctantly and insisting that the United States should solve the problem of its fiscal deficit, interest rates came down in Germany, Japan and Switzerland. Even so, the atmosphere of looming crisis persists among the major industrialized economies, because it is not certain at all that Bonn and Tokyo will make the accommodations demanded by the devaluation of the dollar and the economic reactivation which is being requested from their policy-makers.

Finally, even within the Administration two different perspectives seem to be competing for the upper-hand. On one side, there are those who think that, after the completion of the budget negotiations, a new agreement to manage and stabilize key exchange rates will have to be negotiated. On the other, appear those opposed to such agreement because it will allegedly impose a tight monetary policy on the Fed and consequently, it will increase the danger of recession. The Federal Reserve Board seems to find itself in the middle of these crosscurrents, trying to avoid two undesirable extremes, or the rather "grim alternatives" represented by the free fall of the dollar or a surge in interest rates to defend it.
X. MULTILATERAL FINANCIAL INSTITUTIONS

X. 1 WORLD DEVELOPMENT ACCORDING TO THE WORLD BANK (8 July 1987)

Every year, the World Bank issues its annual report on the state of world development. Usually, besides the evaluation of the current condition and prospects of the world economy, the Report addresses a specific subject. As it did last year, when agricultural protectionism was highlighted, this year the report deals with the very complex and relevant issue of the role of foreign trade in industrialization.

Divided in two parts, the first one contains a single chapter where the Report touches upon recovery, adjustment and long-term growth of the world economy. The second part can be considered the Report's core. It is dedicated to industrialization and trade and focuses on the following subjects: industrialization trends and transformations; the role of government; trade policy and industrialization; trade policy reform; complementary policies in industrial development; the threat of protectionism; a more open trading system; and finally, a proposal for what is called a policy agenda for industrialization in the world economy. Evidently, the scope of the Report is ambitious and controversial.

To refer briefly to each one of these headings, necessarily, sacrifices the depth as well as the breadth of the analysis. Nonetheless, it is still worthwhile to summarize the content of each one of these chapters.

On the state of the world economy, the Report points out the present sluggishness in the rates of growth of industrialized and developing countries. As far as the industrialized economies are concerned, on the negative side appear the large current account imbalances, as well as the persistence of high interest rates; while on the positive side it is noted with approval that inflation has been kept at low levels. By contrast, for the developing economies few positive signs are found. To low commodity prices and reduced levels of commercial lending is attributed the virtual impossibility of restoring growth, particularly for the indebted countries. No wonder, the conclusion of this summary of the conditions of the world economy is that global economic recovery continues to slow down and warns that unless governments take action, economic stagnation, if not decline, lies ahead.
To illustrate the alternatives confronted by the world economy, two possible scenarios for the period 1986-1995 are depicted in the Report. A "low case" projects annual GDP growth rates of 2.5% for the industrial countries and 3.9% for developing countries. A "high case" projects annual rates of GDP growth of 4.3% in the industrial economies and 5.9% in the developing countries. The assumptions corresponding to each alternative scenario are worth summarizing. The "high case" assumes that fiscal and payments imbalances are reduced in the industrialized countries and that unemployment and protectionism are curtailed. For their part, developing countries are assumed to undertake adjustment programs that stimulate employment and income growth. By contrast, the "low case" scenario assumes no major policy changes in unemployment, protectionism, with unchanged fiscal and trade imbalances. This is the alternative which portends at best stagnation and at worst decline.

Once the examination of the situation and prospects of the world economy is accomplished, the Report moves into relatively more controverted territory. Characterizing in rather traditional terms the main historical trends and transformations in industrialization, as a succession of "industrial revolutions," the Report draws from this description several "lessons of history." For instance, it is asserted that "there is no unique path to industrialization;" that countries with large domestic markets are in a better position to establish industrial plants and take advantage of economies of scale; that a rich endowment of natural resources provides the financial means necessary to support industrialization efforts; it is also recognized that all countries have protected industry at some time or another, although admittedly the successful early industrializers benefited from periods of free trade; finally, all countries that have industrialized are said to have begun the process with relatively skilled labor forces and all except Britain acquired technology abroad.

At this point, the Report moves into the more politically controverted subject of the role of government, exhibiting the same moderate and qualified stance. For instance, markets and governments are said to have complementary roles in industrialization; while markets are credited with more capacity for dealing with the growing economic complexity that comes with industrialization, governments "must sometimes intervene to achieve an efficient outcome." Furthermore, the role of government is described by means of listing some of its main functions. Governments are assigned the role of setting the rules of the game, recognizing that the more these rules are certain, well defined, and well understood, the more smoothly the economy can work. Governments also "must continue to be the main providers of certain services," such as education, physical infrastructure, economic information and the regulation of
standards, as well as the main promoters of certain activities, such as scientific and technological research. Even on the subject of state-owned enterprises, the Report admits that "some have performed well, while many have disappointed." Other forms of less direct intervention in the form of management of the economy are also listed as necessary, such as fiscal incentives, price controls, trade policy investment regulations and financial and macroeconomic policies. Capital market failures and externalities are recognized as the most cited justifications for direct intervention, but also as arguments to defend policies toward infant industries. Finally, in what constitutes a rare admission, it is said that, in principle, "import protection is never the best form of intervention... but sometimes there may be no practical alternative."

If the reader of the Report stops at this point, the conclusion would be warranted that the recent reorganization which the World Bank has been undergoing has also meant a radical change in philosophical orientation. Nonetheless, the following chapter on trade policy and industrialization appeals to a study of 41 countries, which allegedly demonstrates that "outward-oriented economies tend to perform better than inward-oriented economies," because overall output is said to have grown faster and industrialization evolved more smoothly. From this study an "important lesson" is derived, in the sense that "the strongly inward-oriented economies did badly." Also, in a rather contrasting and absolutist manner, the report concludes that "outward orientation is always likely to be the best economic choice for developing countries," although this assertion is immediately qualified by saying that this may be politically difficult to implement and its benefits reduced in the face of mounting protectionism in industrialized countries.

Finally, after forcefully denouncing the global threat of protectionism, as well as strongly supporting the Uruguay Round, the Report concludes proposing a policy agenda for industrialized and developing countries.

After this very brief description of the contents of this year's World Development Report, it should be obvious that probably its most salient characteristic can be found in the attempt it makes to balance its judgments and advise between extremes which are often considered anti-thetical. For this reason, some readers will run the risk of finding interesting only those parts that suit their preferences. Nonetheless, this wavering between supposedly antagonistic alternatives, which characterizes this year's World Development Report, may be more indicative of the transition which the World Bank is experiencing towards what appears to be a relatively more pragmatic, as opposed to its more recent ideological, posture.
X.2 THE WORLD ECONOMY, ACCORDING TO THE IMF (23 September 1987)

The publication of its Annual Report 1987 gives to the International Monetary Fund (IMF) an opportunity to cover a lot of ground. The Report begins by passing judgment on the world economy's performance, which is considered "mixed"; it also identifies "subjects of increasing concern" in the evolution of the world economy, such as the current account imbalances among industrialized countries, as well as the external financial situation of many developing countries; it makes some suggestions about what is to be done, admonishing rich and poor countries; and it closes with a description of the Fund's activities in each one of its areas of activity.

The performance of the world economy is considered "mixed", after the Report strikes a balance between what it considers negative and positive aspects. Among the negative appear: 1) slow economic growth in industrial countries; 2) continued decline in real primary commodity prices; 3) widened external imbalances; 4) intensified protectionist pressures and actions; and 5) further deterioration in the external financial situation of many developing countries.

Among the positive aspects, the Report mentions: 1) continued progress in the control of inflation; 2) relatively rapid output growth in many non-fuel exporting developing countries; 3) downward movements in interest rates; 4) strengthening of policy coordination among the major industrial countries; and 5) the attainment of a pattern of exchange rates among key currencies that better reflects economic fundamentals.

As far as growth is concerned, these circumstances are said to have led to an outcome considered "clearly disappointing," because in industrialized countries real output growth slowed from 3 1/4 percent in 1985 to 2 3/4 percent in 1986. The explanation for this slowdown is found in two sorts of asymmetries. First, while the "terms of trade gains of industrial countries were relatively slow to feed through to domestic demand, the corresponding reduction in real net imports of developing countries was comparatively rapid." The other asymmetry is found in responses to exchange rate changes, "with growth weakening more quickly in countries with appreciating currencies than it strengthened in those with depreciating currencies."

The growth performance of developing countries is said to have accelerated moderately, with remarkable differences among groups of countries. For instance, output stagnated among fuel exporting countries, while it is said to have "firmed somewhat" among the larger non-fuel exporting developing countries of Asia
and the Western Hemisphere, with deceleration and decline found among most countries of sub-Saharan Africa.

From the preceding description, the Report highlights two "areas of increasing concern." The first one is the "widening of current account imbalances, particularly among the three largest industrial countries." The other area of concern is found in the further deterioration of the external situation of many developing countries. This is considered "partly attributable to slippages in the implementation of adjustment policies," but it is also admitted that "many countries were faced with a sharp worsening of their external environment." This last is characterized by the cessation of private international lending, amidst exceptionally large losses in the terms of trade of developing countries, which in 1986, as a whole, are estimated to have reached $100 billion.

After describing the situation and the concerns, the Fund proceeds to admonish rich and poor countries alike. Industrial countries are said to need "policies conducive to non-inflationary growth, stable exchange markets, and a gradual reduction in payments imbalances." Then, in what has been probably the most quoted remark from the Report, the admonition becomes concrete when it says that "in particular, there is a need for firm action to reduce the federal budget deficit in the United States, and for industrial countries with large external surpluses, particularly Japan and the Federal Republic of Germany, to promote an adequate rate of growth of domestic demand." Indebted developing countries are not spared, they are advised to adopt "policies to mobilize and retain domestic savings to promote adjustment and growth." Finally, everybody is said to need "structural reforms aimed at removing market rigidities and improving economic efficiency while encouraging resistance to protectionism."

For its part, the Fund offers to perform the following tasks. First, to exercise surveillance over the exchange rate policies of member countries, by the use of indicators as a means of promoting policy coordination, as well as by its concern over trade policies, including protectionism. Second, the Fund intends to continue performing "a central role in the management of the debt situation at the global level," by means of "monitoring and addressing the actual or potential debt-servicing difficulties of members," as well as by supporting adjustment programs. Last, the Fund will survey and complement the international liquidity system of reserve creation.

To better appreciate the magnitude of all these tasks, it has to be taken into consideration that, during the fiscal year 86–87, the Fund required administrative expenditures of approximately $200 million, of which almost 70 percent were for
personnel expenditures; 10 percent for travel expenses; and the rest for other administrative expenses, such as communications, books and printing, supplies and equipment, data processing, and building occupancy.

X.3 RITUAL AND SUBSTANCE (30 September 1987)

In a certain sense, expectations generated by ritual are often disappointing, particularly among those seekers of instant, overarching, comprehensive and definite "solutions." This is the case of the annual meetings of the International Monetary Fund and the World Bank, presently being held in Washington. Evidently, when 9,000 members of the world's financial community meet, for a week and in a single place, "something" has to happen.

The problem is that the verification of this apparently "safe" prediction is complicated by several factors. For one thing, there is the sheer size of the meetings. The week starts with the deputies of the Ministers of Finance of twenty four developing countries (G-24), to analyze the different items included in the agendas of another two meetings, known as the Interim and the Development Committees. The purpose of the G-24 meeting of Ministers is to prepare the position that the representatives of the developing countries will assume during these other two meetings. This position is expressed in an extensive "communique", accompanied by a briefer statement of immediate action, issued at the conclusion of the meeting of G-24 Ministers. Immediately afterwards, follows the meeting of the Interim Committee, whose objective is to advise the Board of Governors of the IMF on supervising the management and adaptation of the international monetary system, as well as to deal with those disturbances that might threaten the system. To complicate matters a bit more, the Interim Committee meeting is preceded by consultations among the members of the Group of Ten (G-10), the Group of Seven (G-7) and of the Group of Five (G-5). The results of almost all these consultations are also announced in formal, but rather cryptic and at times extremely brief communiques. Then follows the meeting of the Development Committee, whose purpose is better illustrated by its full name: "Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries," and whose results are also announced in a relatively more extensive communique. Finally, the whole ritual culminates with the plenary meetings, inaugurated by the President of the United States and held for three days in one of the city's
largest ballrooms. These plenary meetings listen to the speeches of the Governors of the Bank and the Fund, either in representation of individual countries or of regional groupings.

But so much for the ritual, how about the substance? In order to find some of the substantive results generated by all these meetings, certain suggestions are better kept in mind. First of all, do not despair from contradictions, for they might be indicative of different negotiating postures. For instance, the statement on immediate action issued by the Ministers of the G-24, on the very important subject of indebtedness, reads: "the present debt strategy is not viable under current economic conditions." By contrast, the communiqué of the Interim Committee, reads: "Members emphasized the importance of continuing the case-by-case approach to debt problems, and noted that this is the only way in which adjustment programs and financing flows can be tailored to individual country circumstances."

Another useful suggestion is to pay attention to politely worded deferrals, as admissions of inability to agree. For instance, the Interim Committee urges "Executive Directors to pursue their work on the Ninth General Review of Quotas so as to be in a position to make appropriate recommendations in due course." In exchange, try also to find clear, even if qualified, designations, as evidence of solid agreement. For instance the Interim Committee "reaffirmed the central role that the Fund had to continue to play in helping indebted countries develop appropriate growth-oriented adjustment strategies and in mobilizing finance." Even so, beware of clear designations followed by qualifying innuendoes, as indicative of still prevalent disagreements. For instance, the Interim Committee "strongly endorsed the initiative of the Managing Director for a substantial increase in the resources available for lending in association with programs supported by the SAF (Structural Adjustment Facility), noting the complementarity between this initiative and those already taken under consideration elsewhere in the international community, particularly in the World Bank group."

It is also fruitful to try to find expressions of concern where those responsible are clearly identified, as evidence of dissatisfaction with an existent situation. For instance, the Interim Committee expressed "renewed concern about the apparent slowness in the recognition of strengthened creditworthiness," particularly when it has translated itself into "delays in the provision of adequate commercial bank financing." It is convenient as well to try to identify concessions, even when their results might be slow in maturing, as evidence of reluctantly admitted flexibility. For instance, the Interim Committee "welcomed the decision by the Executive Board to carry
out a comprehensive examination of adjustment programs and of supporting Fund arrangements in the context of growth-oriented strategies." This by no means can be dismissed as insignificant, even when admittedly the examination was postponed, because it is considered an "opportunity to consider whether the Fund's policies regarding conditionality need to be re-examined in light of changes in the conditions facing member countries since the last comprehensive review in 1978-79, and in light of the increased emphasis being placed on growth-oriented adjustment." Finally, mistrust all rumors, until confirmation is available, preferably in writing. For instance, it was rumored that a G-24 document on the role of the Fund in adjustment with growth had not even attained the privilege of being included in the agenda of the Interim Committee. Nonetheless, the closure of the communique indicates that "the Committee welcomed the recent report of the Group of Twenty Four on the role of the Fund in adjustment with growth. It noted that the Executive Board had begun its examination and requested it to report on the status of its work for the consideration of the Committee at its next meeting," agreed for April 14, 1988. Obviously, this last assertion is not evidence of rejection, as the rumors were implying.

X.4 HIGHLIGHTS FROM THE BANK-FUND ANNUAL MEETINGS
(7 October 1987)

Now that the dust has settled, with the departure of almost all the 9,000 participants in the annual meetings of the World Bank and the International Monetary Fund, it becomes simpler to try to sort the highlights out of the feverish activity and the flood of speeches witnessed during the past week.

The first question that has to be asked is where to look for these highlights. Obviously, the nature of the present international economic system helps to answer this question, because most of these highlights are mainly found in the statements made by the representative of the system's leading economy. Indeed, until the Secretary of the Treasury of the United States addressed the meetings, these main points were difficult to identify, with some degree of certainty. Basically, because almost everybody agrees that those proposals which enjoy the support of the leading economy are the ones that have more viability.

This is not to say, of course, that other statements were not expected with the same degree of interest, as were those made by the representatives of other industrialized economies, or those made by the major debtor countries. In the end, these
statements did not question prevailing circumstances, as it was illustrated by the speech made by the Brazilian Minister of Finance, which aroused great expectation, particularly because it was made in the name of Latin America and the Philippines. Even so, just a single phrase suffices to indicate that the speech did not represent any real challenge to existing conditions, because, as Minister Bresser declared, Brazil had "no intention of confronting its creditors."

By contrast, most of the highlights from the meetings can be found in the statement made by the Secretary of the Treasury, James Baker, III, and not even in the rather more optimistic inaugural speech made by President Reagan. For instance, Mr. Baker referred to the three main issues constitutive of the meetings' real agenda, that is, to the process of economic policy coordination among industrialized economies; to the achievement of sustainable growth among developing countries and the international debt strategy; and finally, to the corresponding institutional requirements.

In each one of these issue-areas, the speech made by the Secretary of the Treasury contains either surprising disclosures, or confirmations of previously announced positions. For instance, probably the most surprising and most commented statement dealt with "the predictability and stability of exchange rates." In this area, the United States is said to be "prepared to consider utilizing, as an additional indicator in the coordination process," the relationship between the major currencies and a basket of commodities, including gold, "as an early-warning signal of potential price trends."

On the international debt strategy, after mentioning the virtues of the "case-by-case approach," the Secretary of the Treasury referred, once again, to the "menu of financial options to facilitate commercial bank financing packages." This time, he even went as far as to list some of the items which can be part of the "menu," such as trade and project loans, new money bonds, notes or bonds convertible into local equity, exit bonds, debt/equity swaps, interest capitalization and balance of payments loans. The present "debt strategy" is said to provide "a flexible, case-by-case framework for responding to individual debtors' needs and changes in the global environment." Nevertheless, it is also recognized that, still, "problems remain." Among these last are mentioned "the reductions in commodity prices and export earnings," as well as "the recent firming of interest rates and continued strong protectionist pressures," all of which are considered "matters of serious concern."

On institutional matters, the Fund and the Bank are discussed separately. In the case of the Fund, Secretary Baker proposed "the creation of a new external contingency facility,"
to protect stand-by programs from the adverse effects of "external, unforeseen developments such as weaker commodity prices, lower export volumes, natural disasters and sustained higher interest rates." This new facility would replace the existing compensatory financing facility and "it would be funded out of existing resources."

With the purpose of reinforcing "the growth orientation in Fund programs," semi-annual performance criteria and disbursements were suggested in programs lasting eighteen months or longer, but without neglecting the usual quarterly monitoring, "to detect problems at an early stage." Henceforward, these changes are to be coupled with "greater use of structural reforms as performance criteria in Fund programs, to complement the Fund's macroeconomic and exchange rate emphasis." Among these reforms are mentioned market-oriented pricing, privatization and reform of public enterprises, as well as trade and foreign investment liberalization. Finally, the proposal to triple the resources of the Fund's Structural Adjustment Facility (SAF) was welcomed, although Mr. Baker indicated that "the best source of new funding for this purpose is the surplus countries."

By contrast, as far as the World Bank is concerned, the Secretary of the Treasury confirmed that "the time is now right to begin negotiations on a general capital increase."

To conclude, a remark made by the IMF's Managing Director should be highlighted, since it has to do with the very controverted subject of the Fund's conditionality. First of all, Mr. Camdessus recognized that "ten years have passed since the Fund last reviewed in comprehensive fashion its policies on the conditional use of its resources," and admitted that "it is time we reviewed them again." Furthermore, he offered that this process of comprehensive revision of conditionality will take place during "the months ahead."