UNITED NATIONS

ECONOMIC COMMISSION
FOR LATIN AMERICA
AND THE CARIBBEAN - ECLAC

Distr.
LIMITED
LC/WAS/L.4
17 March 1989

ORIGINAL: ENGLISH

INTERNATIONAL ECONOMIC HIGHLIGHTS 1988

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PRESENTATION

This is the second year that the weekly dispatches transmitted by ECLAC Washington to ECLAC Santiago, during a year, are gathered in a single document.[1] For their presentation here, they are classified by subject and ordered chronologically within each chapter.

The chapter headings under which the dispatches are presented reveal the saliency, during the year, of certain issues of the international economic agenda. Measured according to the number of dispatches transmitted, the evolution of the economy of the United States, as well as the indebtedness and adjustment of developing countries, appear more prominently, followed by the functioning of the multilateral financial institutions and the intensification experienced by the linkages of financial interdependence in the world economy. Finally, agricultural protectionism appears distantly behind these relatively more prominent issues.

During 1988, by contrast with 1987, there were no major surprises in the evolution of the world economy, equivalent for instance to the stock market crash of October 1987. The year was dominated by politics and at times by "high politics." Thus, the November election in the United States was not only responsible for the high degree of expectation which prevailed in all fronts throughout the year, but it also led to the postponement of certain issues, some of which were literally "placed on hold" by the successful incumbents. Moreover, the most crucial events of 1988 took place in the relations between the two super-powers, with economic issues in this context receding somewhat to the background.

The purpose of gathering these dispatches in a single document is to make them available for easy consultation, in case they still have some testimonial value.

As the readers know, sometimes these dispatches consist of summaries of the way in which a specific subject was covered by the newspapers monitored regularly by ECLAC Washington: The Journal of Commerce, The New York Times, The Wall Street Journal, The Washington Post, and The Wasington Times. Other dispatches summarize a document or a statement made by a prominent actor in the international economic scene. In every case, each dispatch tries to stay within the self-imposed limit of 750 words, with its objective fulfilled if it serves to focus the reader's attention on an issue that may or may not demand further consideration.

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[1] ECLAC, International Economic Highlights 1987 (LC/WAS/L.2) 17 August 1988.

I. THE U.S. ECONOMY

I. 1. 1988 LOOKS UNCERTAIN (WDW/1/88 - 20 January 1988)

Despite some fairly "good news," at the beginning of 1988, there is uncertainty in the air. The stock market does not seem able to recoup its staggering losses, the dollar remains volatile and, last but not least, this year economic policy is subject to the requirements of the electoral cycle.

Probably one of the main sources of present uncertainties can be found in the after-shock of October 19, 1986, which, besides the search for culprits, opened the door to the specter of recession. Market operators in stocks, bonds and currencies now anxiously expect the release of the trade deficit figures. Meanwhile, other rather more home-grown indicators relied upon in the past, such as the money supply, have moved to the background. Not even the fiscal deficit figures, admittedly linked to the trade figures, enjoy the dubious privilege of being the most sought-after market signal.

Some see in this an indicator of the increasing interdependence and consequent vulnerability of the U.S. economy. Market analysts only seem to recall how, on October 14, 1987, the news that the trade deficit, in August 1987, attained the then record-figure of $15.7 billion, unleashed a fall of 95 points in the Dow Jones industrial average and set the stage for the subsequent 508 point meltdown of October 19. Also, market analysts recall how, on December 10, 1987, when it was reported that the trade deficit attained the new record-figure of $17.6 billion, the Dow and the dollar sank once again to record lows.

Finally, the last time the figures were announced, on January 15, the results were considered "surprisingly favorable," because the trade deficit in November 1987 tumbled 25%, to $13.2 billion, with exports increasing by $2 billion, or 9.4%, to a record $23.8 billion, while imports fell $2.4 billion, or 6%, to $37 billion. The dollar responded by surging 2.5% against the German mark and 4% against the Japanese yen. The reaction in the stock and bond markets was also positive, with the Dow Jones gaining 39.96 points and bonds raising sharply as a result of hectic buying. An observer trying to explain this erratic behavior said, "basically, we still have memories of October."

This concern for the release of the monthly trade figures has been baptized as "the markets' newest fixation" and it obviously has to do with the dollar exchange rate. The major fear in financial markets is that a further increase in the trade deficit will generate a further fall in the dollar exchange rate. A weaker dollar raises the prospects of inflation, as foreign goods become costlier, which translates itself into further pressures upon the Federal Reserve to increase interest rates, affecting external investment flows into securities and bonds. But most of all, the dollar's fall increases the prospects of belt-tightening and the possibility of a recession. Thus, with the attention turned toward the policy domain, or rather as the focus moves closer to the political domain, uncertainties become even more intense and abundant.

In present circumstances, to expect that the dollar exchange rate will signal the direction of events, constitutes in itself an exercise plagued by uncertainty. For one thing, even if all the major central banks intervene, as they recently did to stop the dollar's fall, they are still seen as lacking a coordinated policy basis. Furthermore, the announcement of a formal communique by the Group of Seven (G-7), apparently has not been considered sufficient to reestablish confidence among currency traders. Thus, some sense of direction is expected from Federal Reserve Chairman Alan Greenspan. For no other reason than this one, Mr. Greenspan has been considered "1988's man on a hot tin roof," because he is seen as the person entrusted with the responsibility of deciding between protecting the dollar or averting a recession.

To complicate matters, at times, the present Administration does not appear coherent enough, as to make credible its determination to undertake the solution it considers appropriate for the so-called "dollar dilemma." To fuel uncertainties even more, the Administration is perceived as "totally divided" and its fragmented policies are often accused of being responsible of "spooking the markets."

For instance, on one side are seen the President's Chief Economic Adviser Beryl Sprinkel and the Budget Director James Miller. Both are said to be worrying out aloud about what they consider excessive tightness on the part of the Federal Reserve, as well as about its recessionary impact. On the other side appear Treasury Secretary James Baker and Fed Chairman Alan Greenspan, seen as determined to defend the dollar by driving-up interest rates.

By contrast, other observers see also a divided Administration on this issue, but along relatively different lines. On one side, the Federal Reserve Board on the basis of its "considered economic --not political--judgment," is seen as already decided to arrest a further dollar slide by means of raising interest rates. On the other side appears Secretary of the Treasury James Baker trying to stave off higher interest rates with the very political purpose of helping the Republican presidential candidate in the coming November elections. Obviously, these alleged rifts within the Administration, besides failing to enhance certainty in the markets, squarely place the issue within the realm of "high politics," which in itself constitutes the third source of present uncertainties.

Within the essentially politicized realm of the coming presidential elections, the Republican party is avowedly seen as "floating its campaign on the dollar." As evidence are mentioned the recent changes in the Administration's behavior towards the dollar exchange rate. Thus, after several weeks of witnessing its fall, finally, the Federal Reserve has begun to intervene actively in the foreign exchange market. The previous lack of convincing visibility in the exchange markets on the part of the Fed, as well as certain statements made by the Chief White House Economic Adviser, led to the belief that the last G-7 communique should not be taken very seriously. The Fed then decided to make its intervention both visible and unusually aggressive.

Also, the outcome of the recent meeting between the new Japanese Prime Minister Noboru Takeshita and President Reagan generated one surprise: the two governments disclosed that the United States had arranged to purchase yen from Japan to build up reserves that can be used by Washington to buy dollars whenever the exchange rate of the U.S. currency falls. This was interpreted as a clear signal that the Administration is now pursuing exchange rate stability, which could bring about a degree of calm and contribute to greater certainty.

Finally, these events were crowned by the latest news on the trade deficit, which were immediately seen as proof, by the Secretary of Commerce William Verity, of the emergence of an export driven economy, which promises to continue its sustained expansion well into 1988. Secretary Verity boldly stated, in one of the Sunday-morning television programs, "if we have a good economy, the party in power is likely to have a big advantage." Mr. Sprinkel concurred by saying that "the kick is coming from exports." Anyway, the economy's growth may still be modest, but the projected 2.4% growth, announced by Mr. Sprinkel, could be just enough to permit low inflation and stable interest rates in an election year. If such is the case, as it was admitted by one of the top former aides to President Carter, Mr. Stuart Eizenstat, the Administration has "been able to sustain moderate growth and reduced inflation despite very high budget deficits and trade deficits." Thus, Mr. Eizenstat concluded, "they've been able to pull it off this long, so you wouldn't want to bet against it."

These assertions place the whole matter in the predictive realm where, despite the usual apprehensions about the reliability of forecasts in these uncertain times, some very bold attempts can already be found. After all, if the Washington Analysis Corporation predicted recently that "George Bush will defeat Michael Dukakis to become the next president," it should also be easy to predict with the same degree of assurance other relatively more simple things, such as the growth of the gross national product, the dollar exchange rate, or the perspectives of financial markets.

I. 2. THE ECONOMIC STATE OF THE UNION (WDW/2/88 - 24 February 1988)

President Reagan has issued the last ECONOMIC REPORT of his mandate. In this year's message of transmission to Congress, the President offers an evaluation of the Administration's economic policies, divided in four parts: 1) the economic expansion; 2) the role of government in the economy; 3) the international environment; and 4) the challenges ahead.

Economic expansion is considered a major accomplishment, because "since November 1982, the U.S. economy has grown without interruption and without a resurgence of inflation." Furthermore, it is recalled that, in effect, this constitutes "a record economic expansion," since "only twice before --but never during peacetime-- has recorded economic growth continued for so long." The main consequences of this sustained expansion are described as "a strong increase in employment, combined with low rates of inflation and higher productivity growth," which led to "rising standards of living for the American people." For instance, as far as employment is concerned, the President mentions that "fifteen million jobs have been created during this expansion," of which 3 million were created in 1987. This is said to represent "two and one-half times as many new jobs as Japan and the major industrial countries of Europe combined."

Another major accomplishment is found in the role of government in the economy. Admittedly, the Federal government is said to have "an important role to play in the Nation's economy," but the "general proposition" is asserted that "economic decisions should be left to the private sector ... or to State and local governments when the issues cannot be handled satisfactorily by the private sector." All in all, the President concludes, "government intrusions in the Nation's economic life have been reduced, and the private sector has responded with an explosion of activity, creating new products and new jobs at a very rapid rate."

Internationally, many nations are seen following the lead of the United States in the adoption of market-oriented policies, as well as of tax reductions. "Even China and perhaps now even the Soviet Union," are seen "edging toward freer economic systems."

Developing countries are also following this same path. In the only reference to indebtedness, the President states that "the debt burden ~~carried~~ by developing countries is not just their problem," emphasizing that in those countries that "encourage investment and private enterprise, the ensuing economic growth should contribute to lessening their debt problem." To conclude that "we all have a vital interest in finding solutions that promote growth and protect open international financial markets."

Finally, as evidence of the U.S. commitment "to reducing further barriers that interfere with the free flow of goods, services and capital," are mentioned the free trade agreement with Canada, as well as the Uruguay Round. In these terms, the President asserts that "the United States has been a constructive force in the world economy, not only by demonstrating the benefits of private enterprise," but also by the "commitment to free trade and international economic cooperation."

Nonetheless, admittedly, several challenges remain. Among these appears first and foremost "the continued high level of Federal spending and the budget deficit." Once again, to fight against these deficits, the President requests the line-item veto and the approval of a constitutional amendment to balance the budget, "to force the Federal Government to live within its means."

Always optimistic, the President closes the REPORT's message of transmission asserting that his "confidence in America has been shown to be well-founded," because the economy has been revitalized and the original task of rationalizing the role of government in the economy are "richly rewarded."

The ECONOMIC REPORT itself is divided in six chapters: 1) the macroeconomic setting reviews the economic performance and prospects of the U.S. economy; 2) employment productivity and income; 3) external imbalances examines adjustment and growth in a changing world economy; 4) trade expansion and the avoidance of protectionism; 5) knowledge and the role of human capital; 6) airline deregulation.

Of these chapters, the analysis of the performance of the U.S. economy in 1987 has proved to be the most controverted. ~~Because~~, among the factors that shaped this performance, monetary policy before the stock market crash is criticized saying that "the extent of Federal Reserve tightening through mid-October was most dramatic." Furthermore, the President himself in his presentation to Congress says that "prospects for growth in the immediate future have been diminished somewhat by last year's plunge in the stock market, as well as by the increase in interest rates and monetary policy during 1987."

The chapter on employment, productivity and income views the benefits of economic progress as "widespread across major demographic groups and across regions." Manufacturing is said to have "experienced particularly strong productivity growth," while unemployment is seen as still not reaching "a natural barrier beyond which further reductions necessarily imply serious risk of accelerating inflation."

On the significance of the trade deficit, it is asserted that, given "the strong demand growth within the U.S. economy... the widening trade gap did not impair overall employment growth. Nor did it cripple the manufacturing sector." Thus, the following chapter describes the perils of protectionism, particularly mentioning those "threats to trade liberalization" that have "emerged within the United States." These are found in "pending legislation," which, even when it is said to include "some useful features, also contains numerous protectionist provisions." In this regard, the President in his message forcefully states that the Administration "is committed to working diligently with the Congress to draft responsible trade legislation, but if that legislation is not free of harmful protectionist measures, I will veto it."

The chapter on knowledge deals with investment in human capital, expenditures on research and development and the importance of economic incentives and flexible markets. The government is said to have "a constructive, but limited, role to play in ensuring that these building blocks of economic progress are strong."

Finally, the last chapter refers to the highly controverted subject of airline deregulation, which is said to have "led to a surge in air travel as a result of lower fares and greater choice." Although, admittedly, "more complaints about service and on-time performance, as well as safety concerns" are said to have "prompted calls for reregulation." Even so, the answer to these complaints "is not less reliance on market forces, but more."

I. 3. <u>MONEY AND POLITICS</u> (WDW/7/88 - 2 March 1988)

Recent verbal skirmishes between the Chairman of the Council of Economic Advisers (CEA) and the Chairman of the Federal Reserve Board (FED) have made evident some of the cracks existent within the Administration on how to manage the economy in this election year.

It all erupted with the criticism voiced by the CEA's Chairman, Mr. Beryl Sprinkel, about the FED's performance during 1987, particularly in the months which preceded the market meltdown of October 19. Mr. Sprinkel was held responsible for the assertion, which appears in this year's ECONOMIC REPORT OF THE PRESIDENT, that "prospects for growth in the immediate future have been diminished somewhat by last year's plunge in the stock market, as well as by the increase in interest rates and monetary policy in 1987." (WDW/6/88).

Also, the main indicator preferred by Mr. Sprinkel to decide the orientation of monetary policy --the money supply-- was considered challenged because allegedly, "during 1987, the Federal Reserve continued the eclectic approach that has characterized decision making within the Nation's central bank in recent years."

These criticisms did not elicit an immediate response from the FED's Chairman. The event against which Mr. Greenspan objected "quite strongly," a few days later during a Senate Banking Committee hearing, was a letter sent on January 21 by the Assistant Secretary of the Treasury for Economic Policy, Mr. Michael Darby, to the members of the Federal Reserve Board. This letter contained a complaint about the slower growth of the money supply, when contrasted with the targets previously set by the FED itself. Thus, Mr. Darby, who is the Treasury's chief economist, suggested to the members of the Federal Open Market Committee --the FED's highest policy-making body-- to accelerate growth by means of lowering interest rates.

Before responding in public, Mr. Greenspan, reportedly, phoned Secretary of the Treasury, James Baker 3d., and received "assurances from him that Darby would not send such a letter again." Only then, Mr. Greenspan made several points about these criticisms, at the subsequent Senate Banking Committee hearings.

First, the FED's Chairman admitted that Mr. Darby and Mr. Sprinkel have "a position on the relationship between the money supply and economic growth that he shares in principle but not in practice."

Second, Mr. Greenspan said he was not "particularly concerned" about being "unduly influenced by the Administration." What he was worried about, he said, was that "the concern of our responding to political pressures gets so extraordinary that we will feel the necessity to do precisely the opposite."

Finally, a few days later, the FED's Vice-President, Mr. Manuel Johnson, declared that the way the economy is monitored by the FED had changed to focusing on the markets, rather than watching exclusively the relatively more narrow indicator offered by the money supply. Mr. Johnson admitted that the FED has been paying closer attention to fluctuations in the markets, such as the differences between long-term and short-term interest rates, commodity price indexes and the exchange rates of major currencies. Moreover, the FED looks at these indicators simultaneously and not in isolation, in such a way that if interest rate differentials grow too far apart, commodity prices increase and the dollar exchange rate falls, inflationary pressures will be perceived as present and the FED will have to tighten by increasing interest rates.

With this last statement, the FED made clear that they are not only following an eclectic path, but that their present policy stance is much more pragmatic, because the money supply as an indicator is considered to have become "volatile and unreliable." Meanwhile, THE WALL STREET JOURNAL said editorially, "Mr. Sprinkel and his fellow monetarists sit in their temple, watching the flames flicker up and down around the M tabernacle."

But beyond the discussion about the most "appropriate" indicators to monitor the economy, there remains the very relevant question of how monetary policy will be managed during this election year. Recent memories do not seem to be very helpful for Mr. Greenspan's autonomous stance. For one thing, as Leonard Silk said in THE NEW YORK TIMES, "only the most politically naive could be shocked by news of pressure for economic expansion in an election year." To confirm this, it has been recalled how FED Chairman Paul Volcker is said to have contributed to the electoral defeat of then President Carter, by increasing interest rates to combat inflation. And it has been remembered how FED Chairman Arthur Burns is said to have contributed to President Nixon's victory in the 1972 presidential elections.

Probably the late Chairman Burns said it better, when he was asked to review his experience at the FED in the prestigious Per Jacobson lecture of September 1979, very illustratively titled "The Anguish of Central Banking." In conclusion, Mr. Burns said, the central banks "practical capacity for curbing an inflation that is continually driven by political forces is very limited."

I. 4. <u>THE U.S. TRADE IMBALANCE</u> (WDW/15/88 - 25 May 1988)

Last week, the release of the U.S. trade deficit figures for March provoked, once again, a reaction in the financial markets. Despite the positive results announced, the reaction was in the same direction than that provoked ~~by the rel~~ease a month before of the same figures for February. Thus, the good news that the trade deficit in March experienced a "dramatical shrink," to $9.7 billion, provoked a plunge in the Dow Jones Industrial Average of more than 21 points. The paradox is that last month, with the bad news that in February the trade deficit soared to $13.8 billion, from $12.4 billion in January, the markets also plunged. As Leonard Silk said in THE NEW YORK TIMES, "the stock market has obviously grown hypersensitive to the trade statistics, and it does not like what it sees, whether the deficit goes up or down."

Be it as it may, the March trade deficit was the lowest of the last three years and its improvement was mainly caused by a respectable 23 percent increase in exports, to a record $29 billion, as well as by only a 3.6 percent rise in imports, to $38.7 billion. Other positive signals included in the global figures were that exports of manufactures increased also by 23 percent, to $19.8 billion, in products such as telecommunications equipment, cars, office machinery, chemicals, aircraft and power generating machinery.

With almost all the U.S. main trading partners, except Japan, the trade deficit dropped with Canada by $400 million, to $1.1 billion; with Western Europe by $700 million, to $900 million; with OPEC by $600 million, to $700 million; with Taiwan by $800 million, to $500 million; with South Korea by $400 million, to $500 million; with Mexico by $300 million, to $350 million; and with Brazil by $50 million, to $440 million.

An immediate comment was offered by Mr. Jerry Jasinowski, from the National Association of Manufacturers, saying that "the export numbers indicate that American high technology and capital goods are becoming more competitive." Obviously, there were also other factors. For instance, the export figures include Taiwan's purchases of $600 million in gold bullion, a consequence of Taiwan's decision to convert some of its plentiful dollar reserves, to make less embarrassing its trade surplus with the United States. On the import side, the value of petroleum and related products experienced a fall of 15.2 percent, to $3.2 billion from 3.8 billion, with the average price declining to $15.70 from $16.42.

Despite its positive elements, the stock market skeptical reaction to these anxiously expected figures was to view them as evidence of economic strength and consequently of inflationary pressures, as well as of further interest rate increases. In its turn, the specter of recession also rises, although admittedly not in the very immediate future.

By coincidence or design, the Federal Reserve --those who "take away the punch bowl,"-- only one day before the release of the trade figures, announced that in April industrial output reached 82.7 percent of capacity, an increase from 82.4 percent in March and the highest level since March 1980. This figure was probably paired to those indicating that the U.S. economy finds itself at or very near full employment, since unemployment has fallen to a 14-year low of 5.4 percent of the work force. Thus, the identical reaction to good and bad news, illustrates a case of what

Mr. Norman Robertson, chief economist at the Mellon Bank of Pittsburgh, called "statistical hypochondria." Or, as the chief economist of the Boston Corporation, Mr. Allen Sinai said, the March trade figures were "a sweet and sour report," since "the clearing of one problem begets another."

Nonetheless, beyond these paradoxical reactions, the sharp reduction in the trade deficit indicates that the external adjustment process of the United States has begun, which in its turn raises several relevant questions about the future of the world economy.

The external imbalances prevailing in the world economy constitute the most serious threats to prosperity. As it can be recalled, these imbalances are relatively recent. In 1980, the United States exhibited a small surplus in the current account which amounted to $2 billion, while Japan and West Germany had current account deficits of $10 billion and $15 billion, respectively. Also in 1980, the oil exporting countries together exhibited current account surpluses of over $100 billion, while the industrialized countries experienced current account deficits of over $60 billion, with only the United States, the United Kingdom and Norway --all major oil producers-- showing small surpluses.

All this changed very rapidly, when the $103 billion surplus of the oil exporting countries, in 1982, became a $3 billion current account deficit. Only then, came the turn for the large imbalances among the major industrialized countries to become rapidly the salient trait of the international economy. In 1987, the current account deficit of the United States amounted to $161 billion, while Japan exhibited a surplus in its current account of $86 billion, West Germany $44 billion, and four newly industrialized countries taken together --Hong Kong, Singapore, South Korea and Taiwan-- $33 billion.

Admittedly, even when these imbalances constitute the main problem confronted by the functioning of the world economy, the swiftness of their evolution, briefly summarized, gives ground to the expectation that they can also be corrected in a relatively short period of time.

The main causes of these imbalances have been rather roughly quantified. As a general conclusion, there seems to be consensus that almost half of the decline in the U.S. current account can be explained by the strength of its economic performance, by contrast with the rest of the world. The other half is accounted by the loss of competitiveness of U.S. exports, as a result of the dollar's overvaluation during the first half of the present decade. Evidently, behind these immediate causes were more fundamental factors, such as the expansionary fiscal policy of the United States and the contrastingly restrictive fiscal policies of other major industrial economies.

However, several indicators have been recently quoted, to demonstrate that the U.S. adjustment process, as expressed by the Federal Reserve Vice-Chairman Manuel Johnson, "is already under way." Nonetheless, given the sheer magnitude of the U.S. economy and its relative weight in the world, it is crucial that world demand continue absorbing U.S. exports. Otherwise, any Latin American government can agree with the assertion made by the FED's Vice-Chairman about "the undesirability of real expenditure reduction and to the political difficulties associated with such a policy."

By definition, for the United States to reduce its external deficit, the major trading partners will have to reduce their external surpluses, but it better be by means of expansionary macroeconomic measures that increase the demand for U.S. exports, while maintaining the levels of demand for their own production.

In conclusion, the correction of these imbalances has to take place without unleashing world recession. In other words, by avoiding what can be termed "the Latin American adjustment pattern," characterized by compression of imports, instead of export expansion. For instance, from 1982 to 1983, in the ten heavily indebted Latin American countries included in the Baker Plan, the current account deficit decreased by more than $30 billion, while the trade surplus experienced an impressive increase from $13 billion to $36 billion. Also, imports declined in these ten countries by more than $20 billion, or 30 percent, while exports expanded by a meager $2 billion, or by 2 percent. Of course, this expenditure reduction caused what Vice-Chairman Johnson characterized as "a painful recession." Thus, clearly, the industrialized economies and the world economy better beware of following this "painful" Latin American alternative.

I. 5. INSIDE THE FED (WDW/19/88 - 22 June 1988)

Now that the dollar exchange rate is the most closely watched indicator in financial markets, it is required to have in mind how the monetary policy of the United States is made. What follows is a summary of a presentation on this subject by Mr. H. Robert Heller, member of the Board of Governors of the Federal Reserve System, at the University of Cologne, West Germany, on 27 April 1988.

With an institutional setting characterized by "centralized authority within a decentralized structure," the central bank of the United States --known as the Federal Reserve System, or FED--was established in 1913 and it underwent its most important transformation with the creation in 1935 of the Federal Open Market Committee (FOCM).

The Federal Reserve System is directed by a Board of seven Governors appointed by the President of the United States, with the advice and consent of the Senate, for 14 year terms. The system itself is composed of twelve regional banks, whose presidents are appointed by the boards of directors of each one of these banks, with the approval of the Board of Governors.

The key policy-making body is the FOCM, composed of the seven members of the Board of Governors, as well as by five of the twelve regional bank presidents, selected on a rotating basis with the exception of the President of the Federal Reserve Bank of New York, who is always a member given the role it performs as agent of the FOCM.

In making monetary policy, the FED has three basic tools: 1) the discount rate; 2) reserve requirements; and 3) open market operations. The utilization of these tools is not entrusted to a single body, which constitutes another decentralizing trait of the structure.

The Board of Governors determines the discount rate, upon the recommendation of the Boards of Directors of the regional reserve banks. Also, the board of Governors sets the reserve requirements, within the limits established by the U.S. Congress. Finally, the FOMC is vested with the authority to conduct open market purchases and sales of securities, the most frequently used policy instrument and consequently the most dynamic and flexible of all these tools.

Three reports, distinguished by the color of their cover, are drafted to perform a thorough analysis of the current economic situation and its outlook. The Beigebook is a compilation of information on current business conditions in each Federal Reserve District, obtained through informal surveys.

The other two reports are prepared by the staff of the Board of Governors. The Greenbook contains a sector-by-sector analysis of recent economic, financial, and international developments, along with a forecast of economic activity, prices and financial markets. Finally, the Bluebook presents several monetary policy alternatives, summarizes their economic and financial implications and analyzes the technical issues that may arise from their implementation.

A typical FOMC meeting begins with a review of open market and foreign exchange operations, based on the briefings presented by the Managers for Domestic and Foreign Operations of the System's

Open Market Account. Immediately afterwards, a presentation by the staff of the Greenbook's forecasts is followed by a discussion in the Board of current economic conditions and prospects. The staff also presents the policy alternatives contained in the Bluebook, which is followed by a round-table discussion of the monetary policy options. Finally, the meeting concludes with the formulation and voting of what is known as the System Open Market Directive.

The ultimate objective of FED's policy is to foster economic growth within a framework of price stability. For this purpose, the U.S. Congress mandates the FED to define its expectations regarding prices, economic growth and unemployment, by means of the specification of monetary targets. However, changing relationships between money, nominal income and other macroeconomic variables, have made the money supply --as an intermediate target-- a less reliable instrument for the attainment of these basic objectives.

The changing relationship between money and income manifests itself in major financial innovations, as well as in changes in the regulatory environment, such as the emergence, in the mid-1970s, of money market mutual funds and the deregulation of interest rates that banks and other depositories can pay on deposits.

Because of this increasing unpredictability of the link between money and economic performance, monetary targeting is complemented by monitoring other more judgmental, or less automatic indicators on the strength of economic expansion, commodity prices and financial variables, such as interest rates and exchange rates.

Monetary targeting is still considered useful over the long-run, because of the link between money growth and inflation. But, since 1982, the looser relationship between money and the economy has translated itself into operating procedures which eliminate automaticity. Instead, prevailing procedures rely more heavily on judgments about the strength of spending tendencies and of inflationary pressures.

The contents of the operating directive, issued by the FOMC, identify a controlling operating variable to guide the daily purchase of securities by the Trading Desk of the New York FED. The general course of this variable is specified in what is called "the principal instruction of the directive." This instruction indicates the way in which the short-run path of the control variable will be altered, according to the degree in which particular indicators of financial developments or of economic performance diverge from expectations. Also, the directivedescribes the scope within which the Desk is allowed to operate, in consultation with the FED's Chairman, without convoking the full Committee.

The evolution of the operating directive illustrates the response to changing circumstances. In 1970, explicit monetary targets were set by means of a narrow band within which federal funds had to be contained. Rising inflationary expectations, by the end of the seventies, led to the use of nonborrowed reserves, rather than the funds rate, as the FOMC's short-run operating target. This procedure, remained in effect from October 1979 until the fall of 1982, a period characterized by a severe recession and a dramatic fall in inflation. Over the summer and fall of 1982, automatic controls were gradually replaced by the more judgmental approach offered by borrowed reserves, whose implementation started in early 1983 and which remains in place to this day.

Through this procedure, the demand for required and excess reserves is forecasted, as it was under the nonborrowed reserve procedure. The key difference is that there is no automatic mechanism for controlling monetary growth. The policy directive identifies the key variables whose performance could demand a discretionary change, which besides the behavior of monetary aggregates include indicators on the pace of economic activity; the inflationary rate and expectations; conditions in financial and credit markets; and the foreign exchange value of the dollar.

For instance, concern about the persisting overvaluation of the dollar led, in the late summer of 1985, to grant priority to conditions in foreign exchange markets. This was also the case, in March 1987, because of the dollar's fall. By contrast, the possibility of accelerating inflation, in the summer of 1987, hurriedly was replaced by the collapse in stock prices, of October 1987.

In conclusion, the monetary policy of the United States by becoming much more discretional and judgmental has taken a pragmatic turn which was not fully anticipated.

I. 6. THE SUNSET SUMNMIT (WDW/20/88 - 29 June 1988)

Against a background furnished by a healthier world economy, by upward revisions of growth estimates, by low inflation and stable exchange rates, the leaders of the seven major industrialized economies --Britain, Canada, France, Italy, Japan, the United States and West Germany-- gathered last week in Toronto, to hold their fourteenth annual summit. This background was considered more than appropriate for President Reagan's eighth and last summit meeting.

For one thing, ample evidence exists that the October stock-market crash was not as damaging as some had expected. Rather, recent revisions in growth forecasts, by almost everybody, point in the opposite direction. For instance, the U.S. economy now is projected to grow at about 3.5 percent, instead of the 2.9 percent originally forecasted. The Organization for Economic Cooperation and Development (OECD) also lifted its growth forecast to 3 percent, for all the twenty-four leading industrialized countries. Moreover, for quite a few of these countries, this was another year of sustained economic expansion. For Japan, with its robust projected yearly growth of 11 percent, this will be the fourteenth year of uninterrupted growth; for France and Italy, this is the thirteenth and the twelfth year, respectively, of sustained expansion; while the United States has attained its sixth year of record-setting peacetime expansion.

In these conditions, the U.S. Secretary of the Treasury, James Baker III, anticipated that Toronto would be "a summit at which the leaders of the industrialized countries of the world will recognize the enormous contributions made by the Reagan-Bush Administration to the world's economic policy over the past eight years."

Apparently, almost everything went as expected. Because, with very few exceptions, the participants avoided most of the thorny issues which persist in the world economic agenda. Three basic issues appear presently at the forefront of this agenda and all of them were skillfully by-passed. First, the persistent imbalances among the major industrialized economies; second, the subsidization of agriculture; and third, the indebtedness of developing countries. On each one of these issues, the final communique either repeated previous agreements, as in the case of exchange rate stability or of agricultural subsidies, or dealt only with part of the problem, as with the debt of what were called "the poorest of the poor" --the countries of Sub-Saharan Africa.

For instance, on exchange rate stability, the final communique repeated the results of the last meeting of the Group of Seven, saying that "either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process, could be counterproductive by damaging growth prospects in the world economy."

Also, much was said about the controversy on agricultural subsidies. But, in the end, the communique only repeated the conclusion of the last Ministerial Council of the OECD, whereby the members of the European Community were able to set the goal that a "framework approach" should be followed to revise existingsubsidies, rather than a "framework agreement" to eliminate all subsidies at an agreed date, as the U.S. delegation had proposed originally.

Finally, on the indebtedness of developing countries there was a significant recognition in the sense that debt relief should be granted to the countries of Sub-Saharan Africa, by those creditor governments that so-decide, as some Western European governments had already announced. But to accommodate the objections raised by the United States against debt relief, it was also agreed that due-dates could be extended to alleviate some of the debt burden of the poorest countries.

By contrast, no equivalent breakthrough was registered on the debt of middle-income countries, since support was confirmed to the market-oriented, case-by-case approach of the Baker Plan. Although the final communique did recognize that "the problems of many heavily indebted developing countries are a cause of economic and political concern and can be a threat to political stability in developing countries."

Still, one of the few disturbances against the summit's "air of determined harmony" was related to the indebtedness of middle income developing countries. By what was immediately baptized as "the Miyazawa proposal," debtors would transfer part of their reserves to a special account in the International Monetary Fund, as a guarantee of repayment of some of their bank loans. In exchange for this promise of payment, the banks would negotiate with each debtor the transformation of part of their debt into securities, as well as the rescheduling of other portions of their outstanding debts. The proponents stated that the purpose was to encourage the banks to offer some kind of debt relief, within the bounds set by the Baker Plan. Apparently, this last requirement was considered insufficiently fulfilled, because the "Miyazawa proposal" was quietly set aside for future summits, without even receiving an acknowledgement in the final communique.

Nonetheless, the "Miyazawa proposal" was immediately seen as further evidence of a more assertive stance on the part of the Japanese delegation, also confirmed by the relative absence of criticism against Japanese economic performance. This time, the Japanese delegation came preceded by some very impressive signals, such as the vigorous measures of internal expansion; the announcement, only a week before, that official development assistance would be doubled; as well as the agreement, reached with the United States the first day of the summit, on the bitter controversy about beef and citrus quotas.

Even so, despite these carefully timed announcements, when Secretary Baker was asked to comment on these new signs of Japanese assertiveness, particularly on the "Miyazawa proposal," he said: "they are now the second-largest economy in the world. We are still more than twice as big as they are. We are still looked for leadership and we provide that leadership. But we welcome Japan's participation as the world's second-largest economy. We've been working at it. It's not a competitive thing." Finally, the closing ceremony was marked by laudatory statements celebrating President Reagan's accomplishments throughout eight summits. These can be best summarized by the words of the Canadian Prime Minister, Brian Mulroney, who said: "His leadership has been strong, his accomplishments most substantial and his place in history secure."

I. 7. <u>A TRADE BILL, AT LAST</u> (WDW/25/88 - 7 September 1988)

On August 23, after more than three years of intense debates and "labyrinthine processes," was signed the new trade bill. Standing in front of a U.S. flagged containership, the Sea-Land Explorer, at the Port of Long Beach, California, President Reagan transformed into law the 1,200 pages of the rightfully denominated "Omnibus Trade and Competitiveness Act of 1988."

Divided in titles, each of which is subdivided into subtitles, parts, subparts and sections, this huge bill is considered the most "sweeping" trade legislation approved in many years, although admittedly it does not contain any major shifts in trade policy.

To have an idea of its comprehensiveness, here are the headings of each one of the ten titles in which the bill is divided: I) Trade, Customs, and Tariff Laws; II) Export Enhancement; III) International Financial Policy; IV) Agricultural Trade; V) Foreign Corrupt Practices Amendments, Investment, and Technology; VI) Education and Training for American Competitiveness; VII) Buy American Act of 1988; VIII) Small Business; IX) Patents; X) Ocean and Air Transportation.

This is the legislative response to a number of trade related issues which have been at the forefront of the debate on international economic policy, during the second half of the Reagan Administration. Among these issues, first and foremost appear the record-breaking trade deficits; second, the stronger foreign competition faced by U.S. producers, as a consequence of the overvaluation of the U.S. dollar; finally, an essentially political rift between a Congress allegedly more responsive to special interests --dominated by the Democrats-- and the Republican Administration supposedly more committed globally to the principle of free trade.

The result of this confrontation is reflected in a bill that does not clearly tilt towards free trade or protectionism. Rather, the bill simply lays the procedural groundwork to allow for any of these alternatives to prevail.

A brief review and summary of the main highlights that appear in the bill will illustrate how the hard choice was avoided between these alternatives, basically by means of allowing for "tremendous presidential discretion."

For instance, one of the main reasons for the approval of the trade bill was the need to obtain negotiating authority to proceed with the Uruguay Round and enter into non-tariff and tariff agreements, as well as bilateral arrangements, all of which will be submitted to so-called "fast-track" congressional approval. These "fast-track" procedures limit debates, bar amendments and require Congress to complete action in 60 days after the bill has been introduced.

On the issue of unfair trading practices, the new law transfers from the President to the U.S. Trade Representative the authority to decide about the fairness of foreign practices hindering U.S. trade. Also, authority is granted to adopt the "harmonized" system of customs nomenclature, as well as to tighten the protection of intellectual property rights and to open telecommunications markets.

Extensive treatment is also given to import relief, in the form of training and education of workers, as one of the main components of trade adjustment assistance, as well as to export promotion and export controls.

In agriculture, the President is authorized to adopt certain measures, in 1990, such as new federal price-support loans for wheat, feed grains and soybeans, if he cannot certify that GATT negotiations have generated significant progress in the reduction or elimination of agricultural subsidies.

In matters of international finance, the President is required to promote the coordination of economic policies among senior trading partners and the Secretary of the Treasury is instructed to report on the status of these negotiations. Within this heading, the Secretary of the Treasury is also required to report to Congress on the feasibility of creating an international institution for the multilateral management of the indebtedness of developing countries. However, discretion is granted to the Treasury Department to judge if these discussions may cause reductions in debt values, disruptions in debt service, or outright defaults. If such is the case, the Treasury will only have to inform and consult Congress about its determination to suspend the discussions about the establishment of this new institution.

Other matters addressed in the bill are: technological competitiveness; the promotion of exports by small business; pesticide monitoring; foreign corrupt trade practices; the transformation of the National Bureau of Standards into the

National Institute of Standards and Technology; the negotiation of reciprocal agreements for access to research; as well as the promotion of the use of the metric system among federal agencies.

This cursory review of the contents of the new trade bill gives only an impression of its widespread coverage. As expected, negative reactions were immediately heard, with particular loudness from the European Community, even when the bill has been said to contain "no significant tariff increases or new quotas and erects no major new trade barriers." Anyway, the least that can be said is that the contents of the bill are being carefully scrutinized throughout the world.

Consequently, at this point, one of the few warranted conclusions was drawn by Leonard Silk, in THE NEW YORK TIMES. Given that one of the bill's salient traits is that it increases presidential discretion in trade matters, Silk said, "everything depends on how the next Administration, whether Republican or Democratic, administers the new law." By contrast, Professor Raymond Vernon, of Harvard, precisely because of this delegation of authority to the President, considers the new bill "a 1200 page recipe for trade disaster."

II. THE NEXT FOUR YEARS

II. 1. THE NEXT ADMINISTRATION'S ECONOMIC AGENDA (WDW/33/88 - 16 November 1988)

The only appointment announced by President-elect George Bush, after the election, was that of Mr. James Baker III --better known these days as "the ultimate pragmatist"-- as Secretary of State. Mr. Bush told reporters that this early announcement was made because "it gets the whole process off on the right foot."

Since no other appointments were announced, this set off a wave of speculation about the composition of the new Administration. Among the different conjectures, probably the most frequently heard is that Mr. Baker's expertise in economic matters, because of his experience as Secretary of the Treasury, means that he will be in charge of both domestic and foreign affairs. This would make him, in effect, the equivalent of a "deputy President."

This is only one example of the sort of speculation often found today in this power-hungry city, particularly among resident "Washingtonologists," to compare them to their infamous counterparts, the "Kremlinologists," all of them experts in interpreting the esoteric art of positioning.

Nonetheless, beyond this city's present favorite pastime --to guess who is standing in line in front of the 5,000 political appointments, that the President-elect will have to make in the next eleven weeks-- there remain the issues that constitute the agenda of the next Administration.

What follows is a very brief description of the three most important economic issues of this agenda. They are listed according to the order in which they still appear prominently in the present economic landscape, despite the efforts made by the incumbents, during the campaign, to keep them in the limelight, at least until the day of the election.

First and foremost appears the budget deficit, individualized "the morning after" the election, by almost all the member governments of the Group of Seven (G-7), as the single most important issue that has to be confronted by the new Administration. "The new President will have to keep himself busy with the deficit problem," declared Mr. Onno Ruding, Netherlands' Minister of Finance and also chairman of the IMF's Interim Committee.

Several factors are complicating this issue. Among the most salient is the forceful assertion, made by the President-elect throughout the campaign, that "no new taxes" will be approved. Rather, the victorious candidate proposed "a flexible freeze" in spending, by which increases in outlays would not exceed the rate of inflation.

Another complication comes from the Democratic Party's reassertion of its control of Congress, which points more towards a continuation of the fiscal stalemate, than to a negotiated agreement on deficit reduction.

Also, expected to intervene actively in the fiscal debate is Chairman Alan Greenspan, from the Federal Reserve Board, setting the priority of slowing down growth, essentially by means of interest rates increases. Of course, this collides frontally with the President-elect's "flexible freeze" in spending, because this campaign promise rests on the rather heroic assumption that, as soon as the program is announced, interest rates will fall by at least two percentage points.

Finally, expenditure curtailment is at loggerheads with the President-elect's intention of making the United States "a kinder and gentler nation," by means of expanding the role of government in areas such as education, child care and health care for the poor.

The second most important issue in the agenda is the trade deficit. This is considered "a king-size problem" for the next Administration, because several complications appear also on this front.

First, despite the dollar devaluation, apparently the deficit has been narrowing too gradually. This has led some of the President-elect's economic advisors --particularly Professor Martin Feldstein, of Harvard-- to demand that the dollar be allowed to fall even more. This discussion was in part responsible for the fall experienced, immediately after the election, by the markets and by the dollar.

Moreover, if there is not a drastic reduction in sight of the trade deficit, Mr. C. Fred Bergsten, Director of the Institute for International Economics, has calculated that the U.S. economy will "require net capital inflows of about $10 billion a month for the indefinite future."

This leads straight into the area of relationships with the surplus trading partners. Also, it poses the question if these investment flows will continue in the same magnitudes, without a sharp increase in interest rates. An alternative that, besides being excluded by the President-elect, might sink the United States and thus the world into a recession.

In the last place of the agenda, still lingering, appears the issue of the indebtedness of developing countries. Admittedly, not much has been said about this issue recently, which might cause the distorted impression that it has lost some importance. Even during the electoral campaign, when thorny issues were placed on hold by the incumbents, as soon as Mr. James Baker left the Treasury, some flexibility began to emerge on this matter.

First of all, a rift erupted between the World Bank and the International Monetary Fund (WDW/29/88), which according to most observers was a consequence of a difference between the U.S. Treasury and the management of the IMF.

In one case, this led to the approval of a $50 million structural adjustment loan (SAL), by the World Bank to Honduras, without previous payment by the recipient of its arrears with the Fund.

The rift really burst open in Berlin, at the annual meetings of the Bank and the Fund, with the announcement that the World Bank was granting a $1.25 billion loan to Argentina, without previously requiring the signature of an agreement with the IMF.

The "coup de grace" came when the U.S. Treasury announced that it had granted a bridge loan to Mexico, for $3.5 billion, without clarifying previously the terms in which the recipient had to come to an agreement with the Fund or the Bank.

Second, there is the hope that these departures from standard operating procedures are indicative that the pragmatism, which is said to inspire the new Administration, is already prevailing in the management of the indebtedness of developing countries.

Finally, tempering somewhat the hopes emanating from this pragmatism, it is recalled that the father of the "Baker Initiative" is also considered the most powerful member of the new Administration. Even so, hopefuls assert that in his new position, Secretary of State Baker will have the responsibility of viewing matters of indebtedness in more political terms.

We shall see.

II. 2. THE NEW ADMINISTRATION'S FOREIGN POLICY AGENDA (WDW/34/88 - 23 November 1988)

Now that have become evident some of the limits to some of the campaign promises made about the domestic front, such as those confronted immediately by a rapid and consensual way-out of the budgetary maze (WDW/33/88), the attention has turned to the international arena.

Some observers hold that, contrary to "conventional wisdom," the President-elect will not deal with "domestic policy first and foreign policy second." They recall that the President-elect "always displayed a preference for foreign policy," enumerating in support of this assertion his credentials as envoy to China, delegate to the United Nations and Director of the Central Intelligence Agency. Furthermore, the first announcement made by the President-elect was the appointment as Secretary of State of his closest friend and political associate, as well as top campaign strategist, which led to the conclusion that "big action" is expected in the field of foreign affairs. Finally, with all the new administration's economic team already appointed --Mr. N. Brady, as Secretary of the Treasury; Mr. R. Darman, as head of the Office of Management and Budget (OMB); and Mr. M. Boskin, as chairman of the President's Council of Economic Advisers (CEA)-- most unanswered questions correspond to the areas of security and external relations.

Beyond these signals, in some of the most important issues of the foreign policy agenda, the President-elect seems to be moving more swiftly, demonstrating a sense of forward motion.

First of all, relations with West European allies were almost immediately addressed, by means of separate personal encounters with Prime Minister Thatcher and Chancellor Kohl, both of which were paying farewell calls on President Reagan.

Second, the most impressive of these early movements in the international arena is yet to come and it has to do with what still constitutes the relationship of major tension of the present international system. It will take the form of an informal luncheon, scheduled for December 7, in New York, between President Reagan and President-elect Bush, when the Soviet leader will visit the United Nations, to participate in the ongoing General Assembly.

This meeting was obtained by the Soviet leader in what is considered "a typically bold display of tactical prowess." Evidently, it represents the most significant foreign policy action taken by the President-elect and his appointed Secretary of State.

Finally, a meeting between President-elect Salinas of Mexico and President-elect Bush was held on November 22, in Houston, reflecting the special relationship that exists between both neighbors. Nonetheless, probably the most decisive action in the field of relations with Latin America has been taken with regards to the very divisive and controverted issue of Nicaragua.

To some observers, the appointment of the new Secretary of State indicates that the next Administration will follow a more pragmatic stance in Central America. This is said to consist of launching a serious diplomatic effort before confronting the Democratic-dominated Congress with a request of support for military options. Therefore, the new Administration's initial predilection for diplomacy in Central America was one of the main topics discussed during the first meeting held by the President-elect with House majority leader, Jim Wright (D-Texas).

All these activities are seen as reflections of the President-elect's temperament and background, which assure that his Administration will be more flexible, less prone to confront Congress and ready to execute a more pragmatic foreign policy. All of this has been more than confirmed by the appointment of Mr. James Baker as Secretary of State, well-known in Congress as the foremost representative of the pragmatism that is said to prevail in the President-elect's team.

Furthermore, by contrast with previous Secretaries of State, Mr. Baker's closeness to the President-elect is almost unprecedented, comparable only to that between Dean Acheson and President Truman, while his power is said to exceed even that of Henry Kissinger.

Finally, although not an economist as his predecessor, the new Secretary of State is expected to integrate better international economic matters into foreign policy, making economics a more important ingredient in the foreign policy mix.

Nonetheless, despite these signals pointing towards a more pragmatic stance in the foreign policy arena, there still remain some crucial appointments which could still confirm or deny this trend. First, in the security area, there remain the crucial choices of Secretary of Defense, as well as of National Security Adviser and of Director of the Central Intelligence Agency. Second, there is also the appointment of Mr. Baker's own Deputy Secretary of State, charged with running the State Department on a daily basis, to allow Mr. Baker to perform a broader policy-making role. Finally, crucial for inter-American relations is the appointment of Mr. Elliot Abrams' successor, as Assistant Secretary of State for Inter-American Aaffairs.

Most observers agree that only when all these other appointments will be known, it will be possible to conclude that Mr. James Baker's presence indicates--as THE NEW YORK TIMES said-- the prevalence of "pragmatism over zeal."

II. 3. THE BATTLE OF THE BUDGET DEFICIT (WDW/35/88 - 30 November 1988)

Those who expected a relatively calm Presidential transition have been deservedly surprised and proven wrong by the intensity of the bickering about what unquestionably has become the foremost item of the next Administration's economic agenda (WDW/33/88).

The issue is how to narrow the budget deficit. The debate has taken the form of an impressive array of suggestions, better characterized as demands for clarification of the President-elect's position. Although, admittedly, the intensity of this quest is only commensurate to the victorious candidate's promise that "no new taxes" will be approved.

From abroad, immediately after the election, statements from officials of the other industrialized economies made clear that the budget deficit was one the few issues about which immediate signals were expected from the new Administration.

Domestically, the first indicators of anxiety, paradoxically, came from the markets, with the dollar plunging and the stock market falling, despite the positive news about the U.S. merchandise trade deficit for September.

These fears were intensified because of a statement made by none other than the Chairman of the Federal Reserve Board, Mr. Alan Greenspan, before the bipartisan National Economic Commission, established by Congress precisely to search for alternatives to bridge the budget deficit. Mr. Greenspan said that "the deficit already has begun to eat away at the foundations of our economic strength." His statement was aimed at dispelling what he termed the "minority opinion" that "deficits do not matter much, or in any event that there is no urgency in coming to grips with them." Although Mr. Greenspan stayed short of identifying specific measures, asserting only that "how it is done is far less relevant than that it be done," he added that cutting spending was better than raising taxes, because this last option does not restrain expenditures.

Finally, the General Accounting Office (GAO), empowered to investigate how are spent the funds appropriated by Congress, issued an extraordinary set of 26 reports about the issues faced by the new Administration. One of these reports states that higher taxes "are probably an unavoidable part of any realistic strategy for reducing the deficit." Furthermore, the GAO warned that "there are no quick or painless solutions to the federal government's budget problem" and went as far as to identify possible tax increases, as well as to quantify their potential yield.

This GAO report, said THE WASHINGTON POST, was "strongly worded" and it meant a "departure for an agency that normally avoids sweeping policy pronouncements and concentrates on relatively narrow studies of federal spending programs requested by individual lawmakers or committees."

Even former Presidents Ford and Carter jointly offered to the President-elect "some blunt advice," they urged him "to face reality" by raising taxes. This proposal was part of an "American Agenda," where the two former Presidents suggest that the President-elect should invite congressional leaders to a "long December weekend in the country," to discuss a bipartisan solution to the budget deficit.

Replies to some of these assertions came immediately. The President-elect himself stated that deficits "do matter," adding that he is "determined to get that budget deficit down." Even so, he declared, "I am not going to change my view as to how we get this deficit down," because the American people voted for "no new taxes."

Professor Martin Feldstein, of Harvard, one of the President-elect's closest economic advisers, argued that the deficit was but one aspect of what he termed "the broader problem of our low national saving rate." For Professor Feldstein, a major reason why "Americans save so little is that taxes still take most of the real return of additional savings," therefore, Mr. Bush was going to be "a national savings President."

More candid was Ms. Sheila Tate, the President elect's spokeswoman, when she said about Mr. Greenspan's statement, "for every economist you cite we can trot out one who is diametrically in opposition."

Meanwhile, the markets' verdict was discussed by Mr. Herbert Stein, one of the most respected economic voices from the Republican camp and also former Chairman of the Council of Economic Advisers of Presidents Nixon and Ford. Mr. Stein wrote --of all places-- in THE WALL STREET JOURNAL that the "record of The Market as an economic adviser is not good," because, in his opinion, "The Market only tells us what has already happened in The Market. It does not tell us why it happened, what is going to happen next, or what to do." For Mr. Stein what "The Market" reflects are "the opinions of a group of men who put their pants on one leg at the time and who make a lot of money talking into the telephone." Moreover, because "policy cannot be read out of the flickering numbers on the electronic screen," what is needed, said Mr. Stein, is "a broader view of the economy, of economic history and of economic analysis." He concluded, "the country is in no crisis," what existed were "long-term problems" and advised "don't be spooked by The Market's moves."

The statement by the General Accounting Office (GAO) received a strong editorial rebuttal from THE WALL STREET JOURNAL. First, the GAO report on the budget deficit was called "an unsolicited 16-page lecture." Second, the JOURNAL said it could "live without all the GAO's high-minded, nonpartisan, no-one-here-but-us-accountants pretensions." Finally, the GAO report was criticized because "it fails even to mention the congressional budget process," allegedly one of the major culprits of the budgetary mess.

These statements illustrate the sharpness and intensity of the confrontation raging between a Republican Administration and a Democratically-controlled Congress. On one side, the Administration insists that "budgets are always political documents." No wonder Congress, on the other side, would like to see the President-elect submit a budget proposal, which would require the specific identification of how the deficit will be reduced. No wonder also, the President-elect, apparently following the advice of his newly-appointed director of the Office of Management and Budget (OMB), Mr. Richard Darman, has decided against submitting his own budget proposal for next year. Rather, the last budget proposal from the Reagan White House will be submitted to Congress on January 9, to serve as the basis for discussion. This will allow the new President to appear conciliatory towards Congress, in the closed negotiations with congressional leaders that are expected to follow.

Perhaps the bottom line about all these debates and maneuvers is that they reflect the electorate's preference for a Democratically-controlled Congress and a Republican Administration. Therefore, respondents to a recent national Media General-Associated Press poll firmly opposed most new or higher taxes to address the deficit, but most also opposed cuts in domestic programs, such as welfare or a freeze in social security benefits.

In a certain way, worrisome as it is, this only anticipates the kind of gridlock that can be expected, during the next four years, every time that it will prove impossible to arrive at some kind of bipartisan consensus.

III. FINANCIAL INTERDEPENDENCE

III. 1. THE WORLD'S LEADING CREDITOR AND CAPITAL EXPORTER (WDW/5/88 - 17 February 1988)

As a result of its persistently substantial current account surpluses, Japan has become the world's leading creditor nation, as well as the number one exporter of capital. These current account surpluses have gone from US $49 billion in 1985, to $86 billion in 1986, and they are estimated to stay at about the same level in 1987. By definition, these surpluses correspond to capital outflows and have been projected to remain significant, even in the face of the expected decline of Japan's trade surplus. This is so, because the increasing income generated from the growing stock of holdings overseas will certainly compensate for the decreases in the merchandise trade component of the current account.

Here are some of the consequences of this relatively recent transformation in the world economy, which have been described recently by a source that requested not to be quoted.

Japan's net external assets amounted to $129.8 billion in 1985 and $180.4 in 1986. Such dramatic increases in Japanese investment abroad are in stark contrast with the figures for 1981, when Japan's external assets amounted to $10.9 billion and its private sector had external liabilities amounting to $18.5 billion.

Capital account transactions have also experienced significant changes. For instance, portfolio investments have soared from a slight inflow in 1982 to a huge net outflow of 102 billion in 1986. Also, direct investments abroad increased by $10 billion in 1986, with these amounts representing more than double the 1985 figures. At the same time, net short-term capital inflows have experienced considerable increases, from $9.7 billion in 1985 to $58.9 billion in 1986, since Japanese banks borrowed short-term in international financial markets to finance long-term investments abroad.

The composition of these long-term capital flows reveals some of the main characteristics of Japanese overseas investment behavior. First of all, the largest component of Japan's capital exports are portfolio investments, defined as bonds and ownership of less than 10 percent of company stock. Second, Japanese overseas direct investments have been climbing throughout the world, except in the Middle East. For instance, the United States in 1986 was the recipient of 45 percent of total Japanese direct investment, amounting to $10.1 billion, of which 75 percent was invested in the commerce and service sector, including $3.7 billion in real estate. Latin America and the Caribbean came in second, since in 1986 the flow of Japanese direct investment almost doubled from 1985, amounting to $4.7 billion, or more than 20 percent of the total. About half of these flows went to the banking and insurance sectors in Panama, the Cayman Islands and the Bahamas, while $1.5 billion went to the transportation sector in Panama. In third place, in 1986, Western Europe received 15.5 percent of total Japanese direct investment, amounting to $3.4 billion, almost two thirds of which was invested in financial institutions. By contrast, also in 1986, Japanese direct investment in Asia amounted to $2.3 billion, or 10 percent of the total, with one third of this flow going into productive activities, especially electronics. The so-called East-Asian newly industrialized countries (NICs), in the same year, absorbed 65 percent of Japanese direct investment in Asia, with both South Korea and Hong Kong receiving the largest increases of the year.

In comparison with other industrialized countries, the Japanese pattern of capital flows reveals some interesting differences. For instance, driven by the predilection for portfolio investment, Japan's $58.1 billion in overseas direct investment still is considerably behind the United States' $260 billion and the United Kingdom's $100 billion.

Another salient trait of Japanese investment patterns can be found in its high geographical concentration in the United States, with relatively less propensity to invest in less developed countries. Nonetheless, between 1982 and 1985, net financial flows from Japan to developing nations increased by 28 percent, from $8.7 billion to $11.2 billion, while in 1986 net long-term capital flows to developing countries amounted to almost $20 billion. Thus, in 1985, private sector capital flows from Japan accounted for 38 percent of all private flows from the developed countries that are members of OECD's Development Assistance Committee (DAC). Investments in securities issued by multilateral financial institutions accounted for about 60 percent, while direct investments represented 12 percent of these private sector flows. Furthermore, mainly because of the yen's appreciation, official development assistance (ODA) from Japan increased substantially to $5.6 billion in 1986, from $3.7 billion in 1985. Meanwhile, Japanese export credits to developing countries were negative in 1985.

Finally, probably because of some of these last figures, during Prime Minister Nakasone's visit to Washington, in April, 1986, the Japanese Government promised to recycle some of its current account surpluses towards the developing countries. The announced plan amounts to $30 billion, to be recycled through fiscal year 1990. One third of these funds were previously pledged subscriptions to the multilateral financial institutions, and these are the only amounts that will come directly from the government's budget. The rest will be money raised in Japanese capital markets or from private banks, of which $8 billion will be made available in the form of greater access by multilateral development banks to Japanese capital markets. The other $12 billion will be lent by the Japanese Export-Import Bank (JEXIM), the Overseas Economic Cooperation Fund (OECF), and by private banks, of which $9 billion will be used as co-financing with World Bank loans and $3 billion will be lent by OECF to the poorest developing countries.

These are only some of the facts which illustrate the ascension of Japan to the position of leading creditor and capital exporter. Obviously, the consequences of this transformation depend upon the policies which will be applied to perform this role in a way which contributes to the growth and prosperity of the international economy.

III. 2. FINANCIAL MARKET GLOBALIZATION, U.S. BANKS AND INTERNATIONAL COOPERATION (WDW/16/88 - 1 June 1988)

There is ample evidence that the globalization of financial markets is one of the key traits of today's international economy. Foreign exchange transactions can be taken as an indication of this trend, because the turnover in these markets has increased ten or twelve-fold, during the present decade. Today, the total value of foreign exchange transactions is close to $400 billion per day, almost twice the amount of the total annual exports of the United States. New participants have also appeared in these markets, with the Japanese yen assuming increasingly the role of a key currency, along with the U.S. dollar and the West German mark. Furthermore, other significant changes are related to the emergence of around-the-clock trading, or 24-hour transactions, given the development of new Asian trading centers that perform the role of bridges between the business hours of Tokyo, London and New York.

Obviously, this is only one among the many different transactions taking place today in international markets, which make any country vulnerable to events that escape from the traditional controls exercised by central banks and national supervisory institutions.

An example of these increasing levels of interdependence and consequent vulnerability can be found in the recent evolution of the U.S. banking system. First, the relative weight of U.S. banks in the international arena has diminished. In 1972, the three largest banks in the world, ranked according to deposits, were based in the United States. Today, the largest U.S. bank ranks only number 17 in the world.

Moreover, the banks of the United States have not only declined in relative standing in relation to their foreign competitors, but also in terms of the size of their foreign performance. Thus, the foreign branch assets of U.S. banks grew from $10 billion in 1965 to a peak level of $391 billion in 1981, when they started declining to $331 billion at the end of 1987.

The same decreasing trend can be found in the physical presence of U.S. banks abroad. Foreign branches of U.S. banks quadrupled from 211 branches in 1965 to 917 branches in 1984, to decline to 899 branches by the end of 1987.

Simultaneously, an increase was taking place in the participation of foreign banks in the commercial lending market of the United States. In 1978, foreign-controlled banks held $33 billion in loans to U.S. commercial and industrial borrowers, amounting to almost 13 percent of the U.S. business loan market. By 1986, the volume of lending by foreign banks to U.S. businesses increased to $127 billion, amounting to 23 percent of the U.S. credit market. Thus, during the last decade, foreign banks have almost doubled their participation in the U.S. business loan market.

Several factors have been held responsible for this situation. Not all of them are external, as the domestic regulations which allegedly hurt the competitiveness of U.S. banks. For instance, existent restrictions on the products that banks can offer, as well as interstate or geographical restrictions, are said to have hindered the formation of a broad home base to sustain the international competitiveness of U.S. banks. No wonder, the ongoing debate about eliminating these home-based restrictions by gaining approval in the U.S. Congress of the Financial Modernization Act, which supposedly will allow U.S. banks to respond more efficiently to the challenges generated by the globalization of financial markets.

Still, not all the present difficulties of U.S. banks are domestic. Despite the fact that the U.S. economy is now experiencing its longest peace-time expansion in postwar history, several externally induced difficulties have affected the performance of U.S. banks. At the beginning of the decade, for instance, the rise of the dollar affected export-dependent firms in the Northeast and the Midwest. Furthermore, internationally induced weaknesses in the energy and the agricultural sectors have affected the Midwest and Southwest regions, particularly hurting the conditions of real estate lending. And, last but not least, there is also the impact of the indebtedness of developing countries.

These adverse circumstances reflect themselves in the relatively weak performance of U.S. banks, particularly in 1987. First, asset quality has been the greatest problem faced by the banking industry. For all federally insured banks, at the end of 1987, the ratio of non-performing assets to total assets rose to a record high of 2.1 percent, from 1.6 percent in 1986. For the 17 multinational bank holding companies of the United States, this same ratio increased from 2.2 percent in 1986 to 3.6 percent of total assets in 1987.

Second, this high level of problem assets has eroded the profitability of the U.S. banking industry. In 1987, the average return on assets for all federally insured commercial banks declined to 0.12 percent and the average return on equity dropped to 2.02 percent. The relative weight of the indebtedness of developing countries can be better appreciated by noting that the average return on assets for the 25 largest banks declined from 0.51 percent in 1986 to a negative 0.79 percent in 1987, as result of the provisions adopted to increase loan loss reserves.

Third, because of the heavy losses experienced in 1987 by the largest banking organizations, the average ratio of equity capital (excluding loan loss reserves) to total assets for the largest 25 commercial banks declined from 5.1 percent to 4.3 percent, a decline after six years of steady improvement.

Finally, the number of problem and failed banks has been increasing since 1981. Institutions listed as problem banks or thrifts rose from 223 in 1981 to 1575 at the end of 1987. Also, last year, 184 federally insured institutions were closed and another 19 were granted open bank assistance, compared to 138 and 7, respectively, in 1986. By stark contrast, in 1981, these figures were 7 closings and 3 assistance operations.

To counter some of these trends, international cooperation was sought. A joint initiative by the Bank of England and the U.S. Federal Reserve, last December, led the central banks and the supervisory authorities of the Group of Ten --Belgium, Canada, France, Germany (West), Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States-- plus Switzerland and Luxembourg, to the adoption of an international framework for assessing the capital adequacy of commercial banking institutions. The purpose of this coordinated effort, to "level the international playing field," is to reduce the sources of competitive inequalities stemming from differences in national supervisory requirements.

The agreement defines a bank's capital base, emphasizing stockholders' equity, in a way that makes measures of capital

adequacy more sensitive to the different risks associated with bank's assets, including the existence of off-balance sheet exposures.

To achieve this objective, first, an international definition of core or common equity capital has been agreed, as well as a list of recognized non-common equity components that can supplement the equity capital base, at the discretion of the national supervisory authorities. Second, the framework also contains a schedule to attain a minimum ratio of total capital to weighted risk assets of 7.25 percent by 1990, of which at least 3.25 percent should be in the form of common stockholders' equity. This ratio should increase to 8 percent in 1992, of which at least 4 percent should be in common stock. Third, transitional provisions also grant a reasonable amount of time to enable banks to bring their capital positions to the standards set in the risk based framework.

These measures are already under public scrutiny in all the member counties and, when enforced, will represent the initial response of regulatory authorities to the increasing globalization of financial markets.

III. 3. <u>THE PERFORMANCE OF U.S. BANKS IN 1987</u> (WDW/23/88 - 20 July 1988)

Besides the debtor and creditor governments, as well as the multilateral financial institutions, the commercial banks constitute one of the four principal actors that actively participate in the search for solutions to the debt problems of developing countries.

Now that the issue seems to be on the verge of moving into a different stage, apparently characterized by a mixture of debt relief and secondary market debt values, the situation of the commercial banks will have to be closely monitored.

As it may be recalled, the exposure of U.S. commercial banks to developing country lending was one of the central factors motivating the active management by the U.S. Treasury of the debt issue, in order to avoid a generalized failure which could imperil the whole financial system. Accordingly, until very recently, the commercial banks had not experienced important direct losses derived from developing country lending.

In 1987, this situation underwent considerable change, since this was one of the worst years in the performance of U.S. commercial banks. Last year, the financial results for the banking industry of the United States were emphatically negative, in large part because of several factors that had been building over previous years.

For instance, bank closings exceeded the record attained in 1986, with a total 182 failures registered among the commercial banks insured by the Federal Deposit Insurance Corporation (FDIC). Also, more than two thousand banks --or around 15 percent of the total-- ended 1987 in the red.

Aggregate banking profitability continued its decade-long decline. The return on assets, in 1987, reached 0.13 percent, or the lowest rate of return attained since the Great Depression. These rates of profitability varied according to the type of activity, as well as according to the size of the banks. Thus, in general, credit quality was the main determinant of the earning performance of all banks, with the profits of the largest banks decisively affected by the provisions for possible loan losses derived from lending to developing countries. These loss provisions reduced the returns on assets and equity, for all the industry in 1987, to about twenty percent of 1986 levels.

Among smaller banks, increasing difficulties in the Southwest or in the Dallas Federal Reserve District, related to loans in the real estate and energy sectors, led to a second consecutive year of losses. Energy industry borrowers were affected by lower oil prices, while overbuilding of commercial properties and a weak regional economy depressed real estate values and consequently also the collateral backing of real estate loans. Most of the bank failures were located in the Southwest, where more than forty percent of the region's banks reported net losses in 1987. One third of all unprofitable banks were located in this region, which accounts for 14 percent of all U.S. banks and for almost 7 percent of all U.S. bank assets.

According to the type of activity, bank profitability varied also in 1987. Overall, a $15 billion loss was registered in international operations, while in domestic activities profits rose by $3 billion. These results were not uniform. The largest banks experienced the steepest declines in profits, primarily because of the decision to increase substantially their loan loss reserves for credits to developing countries, as well as because of Brazil's moratorium on interest payments. By contrast, the profits of smaller banks, unencumbered by foreign lending, were relatively higher.

The most profound changes were experienced by the nine largest money center banks --BankAmerica, Bankers Trust, Chase

Manhattan, Chemical Bank, Citibank, Continental Illinois, First Chicago, Manufacturers Hanover and Morgan Guaranty. Their consolidated return on assets dropped to -0.86 percent and their return on equity fell to -19.37 percent.

Large banks, other than the money center banks, with assets of more than $5 billion, also lost money in 1987. International operations accounted for almost two-thirds of their loss provisions, which overwhelmed the profits from domestic operations.

Banks with assets of between $300 million and $5 billion continued being profitable, although their return on assets fell to 0.59 percent. This decrease originated in almost equal proportions from higher loss provisions, smaller capital gains on securities and greater tax payments.

Finally, for banks with assets of less than $300 million profits after taxes rose in 1987 to 0.66 percent of assets. A significant contribution to the improvement of these banks came from the reversal of conditions in agriculture.

Thus, in 1987, credit quality was the driving force behind the performance of all sizes and sectors of U.S. banking. The most salient event of the year was the accounting by the large multinational banks of their problems with developing country debts, while the persistence of difficulties in the real estate and energy sectors primarily contributed to the poor performance of banks in the Southwest. Authorized observers, from the Federal Reserve Bank of Chicago, concluded that the bottomline is "the year 1987 will go down as a dismal year in the financial record books." Nonetheless, in the first half of 1988, these conditions seem to have improved, although admittedly "the problems of developing-country debt, poor asset quality, and troubled banks have not disappeared."

At first sight and very tentatively, certain consequences derive from this situation. First, the increase in loan loss reserves by the large money center banks, in fact, diminishes the sense of urgency of their demands for protection. Second, given the differences originating from their relative strength, as well as regional differences, the banking coalition might experience some strains in its cohesion. Third, as if there was any need for confirmation, no new lending can be expected from the commercial banks, given the severe direct losses they have begun to experience in their international operations, as opposed to their performance in domestic activities. Finally, this situation may be seen as another indicator that a change of course in the present debt strategy is at hand.

III. 4. THE CAPITAL ADEQUACY OF INTERNATIONAL BANKS
(WDW/24/88 - 27 July 1988)

As if demonstration was needed that regulation follows interdependence, or that form follows function, the supervisory authorities and the central bankers of the Group of Ten ~~--Belgium,~~ Canada, France, Germany (West), Italy, Japan, Netherlands, Sweden, Switzerland-- and Luxembourg signed, two weeks ago in Basel, an agreement to regulate the capital adequacy of international banks. This is one response of regulating authorities to the accelerated process of innovation and globalization that is taking place in international financial markets (WDW/16/88).

Avowedly, several fundamental objectives are pursued by this process of regulatory convergence, expected to take place within the framework agreed upon in Basel. First, to strengthen the soundness and stability of the international banking system. Second, to eliminate an existing source of competitive inequality among international banks. Furthermore, the framework agreement is designed to establish minimum levels of capital adequacy, leaving to the discretion of national authorities the setting of higher standards of behavior.

In its presentation, the Committee of Banking Regulations and Supervisory Practices emphasized that "capital adequacy as measured by the framework is only one in a number of factors to be taken into account when assessing the strength of banks." Capital, for the purpose of the agreement, is only assessed in relation to credit risk, or "the risk of counterparty failure."

Other risks, notably interest rate risk, as well as investment risk in securities, have to be taken into consideration, it is suggested, in order to assess fully the overall capital adequacy of banks. Even so, these other risks are not covered by the approved framework.

The agreement deals specifically with: 1) the constituents of capital; 2) the risk weighing system; 3) the target standard ratio; and 4) transitional and implementing arrangements.

On the "constituents of capital," the Committee considers that "the key element of capital on which the main emphasis should be placed is equity capital," defined as "issued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock." However, other elements ~~of a bank~~'s capital are included. For supervisory purposes, capital is defined in two tiers. The core element -- or tier 1-- will represent at least 50 percent of a bank's capital base, in the form of equity capital and published reserves from post-tax retained earnings.

The other elements constitute "supplementary capital" --or tier 2-- up to an amount equal to that of core capital. Within these limits, secondary elements comprise: undisclosed reserves; revaluation reserves; general provisions/general loan loss reserves; hybrid debt capital instruments; and subordinated term debt.

The method for assigning "risk weights" consists of setting a ratio by which capital is related to different categories of exposure, weighted according to broad criteria of relative riskiness. This framework of weights is relatively simple and uses five weights: 0, 10, 20, 50 and 100.

The categories of risk captured by the framework are centered around credit risk. Also, country transfer risk is addressed according to the criteria that a group of countries should serve as the basis for the application of differential weighing coefficients, instead of following a simple differentiation between claims on domestic institutions and claims on foreign countries. In this select group of countries appear those full members of the Organization for Economic Cooperation and Development (OECD) which have concluded special lending agreements with the IMF's General Agreements to Borrow.

Thus, claims on central governments from this select group of countries --referred to as OECD in the rest of the agreement-- will attract a zero weight. Claims on non-central government public sector entities of these countries will attract a low weight. Moreover, claims on central banks and central governments of non-members of this select group will also attract a zero weight, provided such claims are protected from foreign exchange risk.

Interbank claims are treated without differentiating between short-term claims on banks incorporated within or outside OECD. However, a distinction is set between longer-term cross-border loans to banks, with a 20 percent weight applied to long-term claims in OECD incorporated banks. By contrast, these same claims on banks incorporated outside the OECD will be weighted at 100 percent.

Finally, collateral and guarantees are not specifically recognized in the agreement, while loans fully secured by mortgages on occupied residential property are assigned a 50 percent weight risk.

It is recognized that there is limited experience available in assessing the risks entailed by off-balance-sheet activities. Nonetheless, all these activities are to be converted to top credit risk equivalents, by multiplying the nominal principal amounts by a credit conversion factor.

The "target standard ratio" of capital to weighted risk assets is set at 8 percent, of which the core capital element will be at least 4 percent. This "common minimum standard" will be observed by the end of 1992, allowing a transitional period of some four-and-a-half years for any necessary adjustment by banks who need time to build up those levels. In addition, there will be an interim minimum standard to be met by the end of 1990, of 7.25 percent, of which at least half should be core capital.

The reactions to the agreement immediately reverberated throughout the world financial community. First of all, it was explained that the pressure in favor of standardization emanated from those who complained that Japanese banks were operating at much lower capital levels than other international banks, enjoying a competitive advantage.

Second, the position of U.S. banks to comply with the agreement was considered mixed. On one side, 37 of the top 50 banks in the United States already meet the Basel guidelines. For instance, twelve of these banks have core capital ratios of 7.5 percent or more, well above the 4 percent required by the Basel agreement to be reached by 1992. These banks are known as "superregionals" and among them appear: First Alabama Bancshares; State Street; Boatmen's Bancshares; Society National; Banc One; First Wachovia; PNC; U.S. Bancorp; United Jersey; National City; CoreStates; and J.P. Morgan.

On the other side, 13 U.S. banks fall below the 1992 capital requirements and will have to increase their capital. Among these appear some of the big money center banks, such as: BankAmerica; Bank of New York; Chase Manhattan; Chemical; Citicorp; Continental Illinois; First Chicago; Irving Bancorp; Manufacturers Hanover; Mellon; and Wells Fargo. These are estimated to need to raise as much as $15 billion in new capital.

Also, the 35 internationally active Japanese banks are said to require as much as $50 billion in new capital by 1992, while 18 French banks active internationally will have to raise $13 billion of capital by 1992. By contrast, West German and Swiss international banks are said to be well placed to comply with the new rules. Finally, the expansion of these regulations to all European Community members is anticipated, while off-shore financial centers, such as Singapore and Hong Kong, have expressed interest in aligning their capital requirements with those approved in Basel.

IV. AGRICULTURAL PROTECTIONISM

IV. 1. THE REFORM OF WORLD AGRICULTURE (WDW/18/88 - 15 June 1988)

Since President Reagan, at last year's Venice summit, proposed the abolition of agricultural subsidies by the year 2,000, the debate raging among the industrialized economies has revealed the obstacles confronted by this ambitious objective. Some of these arguments surfaced recently, at the last Ministerial Council of the Organization for Economic Cooperation and Development (OECD), held in Paris on 18 and 19 May.

The protection of agriculture in the major industrialized economies presently causes some of the most blatant distortions against free trade and consequently against world efficiency. Suffice it here to recall, for instance, that the cost of farm subsidies in the OECD countries has been estimated to have attained, between 1984 and 1986, more than $200 billion annually. A disproportionate amount when contrasted to the small numbers represented by farming in these economies, which range from 3 percent of employment in the United States to almost 9 percent in the European Community.

This heavy subsidization and protection of agriculture has generated some impressive aberrations. For instance, the European Community, hardly known for its tropical climate, has become the world's largest exporter of sugar, while Japan's self-sufficiency in rice rests on the operation by part-time farmers of what have been called "the industrialized world's least efficient farms." Similar examples also abound in the United States, where federal agricultural spending will reach $25 billion in 1988, or the equivalent of $60,000 for every full-time subsidized farmer. As described in THE NEW YORK TIMES, the average full-time farmer, whose net worth is ten times greater than the average American family, gets the equivalent of almost one week a year of work from the average non-farm head of household.

Also, besides the economic difficulties these policies impose on the producers of non-subsidizing, particularly developing countries, there is what a group of twenty-nine economists from seventeen countries recently called "a cruel paradox." Because, as a consequence of prevailing subsidization and protection, "in the midst of a surplus of food and excess capacity in agriculture in much of the developed world, there is widespread malnutrition in many countries with serious famine in isolated areas."

Finally, ample evidence exists that the most acrimonious trade disputes among the industrialized economies derive from the levels of protection and subsidies prevailing in agriculture, fisheries and forest products.

Despite these distressful signals emanating from the state of world agriculture and of their recognition by the leaders of the industrialized countries, the communique issued at the conclusion of the last OECD Ministerial Council shows that a process of reform of world agriculture is taking place, but slowly and protractedly.

Among the conclusions, expressed in the arcane language of this last communique, the Uruguay Round is the setting considered more appropriate to arrive at agreements on this matter. Thus, it is hoped that the ministerial mid-term review of the trade negotiations, to be held in Montreal in December 1988, will "add impetus to the negotiating process." In other words, there was agreement that next week's Toronto summit will not seek to arrive at conclusions on the highly controverted issue of world agricultural reform.

This last conclusion coincides with the generalized impression that the Toronto summit will avoid "disruptive issues," such as trade, agriculture, Latin American debt or the U.S. budget deficit. Some of the reasons offered to explain this avoidance of controversy are that the world economy is growing faster and with lower inflation than expected. If lasting, this situation obviously favors the Presidential aspirations of Vice-President George Bush.

In the words of Secretary of the Treasury James Baker, what can be expected from the next summit is that "the leaders of the industrialized countries of the world will recognize the enormous contributions made by the Reagan-Bush Administration to the course of the world's economic policy over the last eight years." Also, Secretary Baker hopes there will be "some recognition that policies that were derided in '81 and '82 as being inappropriate or unrealistic are now the standard. And those are the free market economic policies espoused by Ronald Reagan at his first summit."

Consequently, since neither controversies nor breakthroughs can be expected from the summit, the burden of dealing with the problems of world agriculture has fallen upon the mid-term ministerial review of the Uruguay Round. As expressed in the communique of the OECD Ministerial Council, the objective then will be to agree on "a framework approach." This wording is the result of a compromise between the positions adopted by the delegations of the European Community and of the United States. Originally, the U. S. delegation proposed that the wording should be the approval of a "framework agreement," but the communique mentions only an "approach." In the words of Secretary Baker, "for the United States, a framework means three things: a destination (where we are going), a road map (how we are getting there) and a timetable (when do we arrive)."

As a result of this compromise, the framework will include "short term as well as long term elements." Apparently, the Europeans wanted to focus on present trade difficulties, while the United States insisted in the long-term goal of phasing out all subsidies by the year 2,000. This last position was countered by the European argument that for them subsidies were subject to reductions, instead of subject to elimination. The conclusion was that the framework will include short and long term elements.

The basic issue underlying these negotiations is the "decoupling" of assistance to farmers from prices and production levels, in a way that transforms such assistance into trade-neutral, welfare measures, instead of measures that encourage excess in production. Obviously, among other requirements, this entails an agreement on the phased reduction of trade-distorting policies, with the purpose of allowing market signals to progressively guide resource allocation and trade.

Finally, a crucial question which remains unanswered is if such a framework agreement will recognize the interests of developing countries.

IV. 2. AGRICULTURAL PROTECTIONISM IN THE LEADING CREDITOR NATION (WDW/32/88 - 26 October 1988)

Probably one of the most outstanding aberrations of the present international economy can be found in the fact that one of the countries that exhibits a most persistent trade surplus, which has made it the leading creditor nation (WDW/5/88), exhibits also the most protected agriculture.

A recent World Bank Discussion Paper (No. 22, May 1988), by Delbert A. Fitchett, entitled AGRICULTURAL TRADE PROTECTIONISM IN JAPAN: A SURVEY, concludes that the country credited with undergoing one of the most profound and successful contemporary processes of structural adaptation, in effect, has resisted the erosion of its comparative advantage in traditional sectors. This retrogressive design is pursued by an impressively spiked array of measures "intended to delay, attenuate or otherwise cushion the readjustment in rural resource use patterns."

Agricultural protectionism in the Japanese economy can be traced to the beginning of the century. A shift from net exporter, to rice imports, led farmer groups to assert themselves against other groups, such as manufacturers and merchants, relatively more sensitive to upward pressures on wage goods. In1904, a tariff was imposed on rice imports, initiating the pursuit of what later came to be known as "imperial self-sufficiency."

By the end of the thirties, this goal remained elusive, as illustrated by the structural transformations undergone by the Japanese economy. For instance, from 1900 to 1939, agriculture as a percentage of GNP moved from 29% to 15%; the labor force in agriculture passed from 60% to 42%; and agricultural products went from 30% to 18% of total exports. More to the point, the elusiveness of agricultural self-sufficiency is revealed by the ratio of agricultural imports to agricultural exports, which went from 3.9 in 1900 to 7.7 in 1939.

In the sixties, after the Japanese economy fully recovered, "self-sufficiency" became "food security," which coincided with the government's concern with securing the support of a conservative rural base, found among the small-scale, land-owning peasantry, which emerged after the war as a result of the agrarian reform program.

"Food security" consisted in striving for rural-urban income parity, to mitigate the sectoral adjustments, accentuated by the spectacular transformation of the contemporary Japanese economy.

The agricultural law of 1961 codifies this income objective pursued by the government, by means of measures such as price and trade regimes, "aimed at retarding the transfer of human and land resources out of the agricultural sector."

The success of the non-agricultural economy contrasts sharply with the anachronism symbolized by the highly protected agricultural sector. For instance, there has been a persistent shortfall in agricultural sector productivity growth, which from 1960 to 1979 fell at an annual average of -0.78%, while overall productivity grew at an annual rate of 1.12% during the same period. Another factor which contributed to increase the pressures in favor of a protectionist trade regime to improve farmers incomes.

Apparently, the income-parity objective of farm policies has been achieved, because, during 1984-86, average farm household incomes exceeded average blue-collar incomes by around 30%. However, this figure disguises the fact that, besides the protectionist trade regime, the relative superiority of farm income is also a result of the increasing importance of non-farm employment among farm households. To the point that, for instance, only 15% of the average farm family's net income is obtained by means of agricultural activities.

The instruments used to carry out the income-parity objective consist of different measures of public sector intervention, aimed at generating considerable deviations of domestic producer prices from international market prices. In the case of rice, the government sets the price on a "cost-plus" basis, to increase farm incomes, and manages all foreign trade. Since almost 80% of all the wheat consumed is imported, the government compensates the higher prices at which it purchases locally produced wheat with the low price at which it sells imported wheat.

A Livestock Promotion Corporation supports milk production by means of market intervention and stocking, to maintain prices within a predetermined band. The same agency administers a price support mechanism based on a "price stabilization band" applied to domestic supplies. The program for pigmeat relies primarily on variable import levies, rather than on direct market intervention or direct control over imports.

There is also the Japan Silk and Sugar Price Stabilization Corporation, managing a price support system for domestic producers of beet and cane sugar. Almost one fourth of overall sugar consumption comes from domestic sources, while the remainder is imported in raw form, to be refined locally. The Corporation purchases the product refined from domestic sources and sells it back to the same refineries, usually at lower prices and the same mechanism applies to imports. In these conditions, during the last two decades, sugar beet production has doubled, while sugar cane production has tripled.

Finally, fisheries also receive considerable protection, by means of sheltering the national fleet and the processing plants behind tariffs and quotas. In all, the World Bank report concludes, "the Government operates a tightly articulated system of domestic marketing policies and related border measures which have served to cushion the producers and processors of farm commodities from international market conditions."

The domestic costs of these policies are estimated according to the OECD's concept of Producers' Subsidy Equivalent (PSE), which measures "the financial transfer necessary to leave the commodity producer's revenues unchanged were the trade-distorting measure terminated." According to this criteria, during 1982-85, the annual average resource transfers to agricultural producers in Japan amounted to $19 billion, using an average exchange rate of 240 yen to the U.S. dollar for the same years. These figures are evidently in stark contrast with the $7.5 billion provided by Japan as official development assistance (ODA) to developing countries, a figure only second to the $8.7 billion provided by the United States in the same year.

Also, during the same period, the per capita cost of these policies in Japan was four times higher than those of the European Community's Common Agricultural Policy (CAP), amounting to more than 1% of GNP in Japan and 0.5% in the European Community. No wonder, in 1984, the Japanese had to dedicate "20% of their personal consumption expenditures to the purchase of food, compared to 18% in France and Germany, 15% in the Netherlands and the United Kingdom, 13% in Canada and 11% in the United States."

V. THE INDEBTEDNESS OF DEVELOPING COUNTRIES

V. 1. THE AMOUNT OF WORLD DEBT (WDW/2/1988 - 27 January 1988)

Once again, although this year a bit earlier, the World Bank has published the WORLD DEBT TABLES 1987-88. As it is well known, this publication constitutes one of the most important contributions to the quantification of the analysis of world indebtedness. By contrast with last year, the present edition contains certain remarkable changes, even in the presentation of the data.

The TABLES are issued in two volumes, the first one presents analysis and comments on recent developments in international lending to developing countries, and the second volume contains individual statistical tables, showing the external public and publicly guaranteed debt for the 109 countries that furnish information to the World Bank's Debtor Reporting System (DRS).

The presentation of the data this year is broken down by more geographic groupings, comprising Africa South of the Sahara; East Asia and the Pacific; Europe and the Mediterranean; North Africa and the Middle East; South Asia; and finally, Latin America and the Caribbean. Also, other groupings appear, such as the highly indebted countries (HICs); low-income Africa; low-income Asia; middle income oil importers; and oil exporters.

Here are some of the highlights which appear in Volume One, entitled, ANALYSIS AND SUMMARY TABLES.

1) After adjusting debt stocks for the effect of exchange rate changes, the external debt of developing countries in 1987 grew at between 2 and 2 1/2 percent, or at about the same pace as in 1986. In nominal terms, total debt grew by 6 1/4 percent, from $1,120 to an estimated $1,190 billion.

2) Almost no change appears in the levels of new lending, which has been declining since 1981. For instance, there was a slight increase in disbursements of long-term loans, from $86 billion in 1986, to about $90 billion in 1987. This almost insignificant increase gives ground to the assertion that the decline in new lending "appeared to bottom out in 1986 and was followed by a small rebound in 1987." Although, admittedly, the increase in new money from private sources was due to the rescheduling packages arranged for Argentina and Mexico, as well as by the refinancing for the Republic of Korea. Also, the

increase in official disbursements was due to increases in export credits and other bilateral financing.

3) Net lending flows were slightly higher in 1987, amounting to $26 billion, by contrast with the $25 billion they reached in 1986.

4) Payment of interest is said to have been affected by the rise in world interest rates experienced in 1987, as well as by the payments suspensions unilaterally imposed by some important debtors. The amount of interest paid during 1987 stayed close to the $56 billion paid during 1986, while payments of principal increased to $64 billion in 1987, from $60.8 billion in 1986.

5) These last figures amounted to a rather small reduction in the net transfers made by developing countries to their creditors. During 1987, these negative transfers still amounted to $29 billion, very close to the $30.6 billion transferred in 1986.

6) During the first nine months of 1987, nineteen countries renegotiated their debts, restructuring a total of $103 billion, including $48 billion of previously rescheduled debts.

7) One of the most salient individual events of 1987 is considered the unilateral suspension by Brazil of interest payments to private creditors.

8) Also significant during 1987 was the decision adopted by most international banks, following the lead of Citicorp, of increasing their loan loss provisions, in anticipation of loss or against the possibility of loss resulting from the borrowers' failure to service their debts.

9) Admittedly, one of the main consequences of this provision has been a further hardening of attitudes among commercial banks, which, coupled with several cases of unilateral payments suspension, are viewed as "symptoms of growing frustration and fatigue at the lack of progress in resolving debt problems."

10) A positive note regarding the perspectives for low-income countries, particularly for those of Sub-Saharan Africa, concludes the description.

Finally, after analyzing chronologically the evolution of the issue of indebtedness, four appendixes dedicated to specific subjects are offered: I) striving for solutions in ~~low-income~~ Africa; II) loan loss provisions and the problem debtors; III) debt trends in 1986; and IV) recent developments in debt relief negotiations.

Beyond the presentation of the data, the present volume contains several contrasting differences with the analysis presented last year, which reveal a certain degree of evolution in the treatment of the debt issue by the World Bank.

First of all, last year the Bank considered the issue of indebtedness from the perspective of the international economic system as a whole, viewing its solution as a "common good." In a contrasting manner, this year indebtedness is viewed more as a development issue. Several assertions made throughout the document give ground to this conclusion. For instance, it is recognized that "sustained economic recovery has continued to elude" the debtor countries. Also, resulting from this are "lower personal consumption and increasing social and political problems." Even more serious, for the economic prospects of debtor countries, is considered the fact that "investment activity has collapsed."

Second, it is recalled that the Interim Committee of the International Monetary Fund (IMF), in September 1987, recognized that "a satisfactory resolution of the debt problem is likely to take longer than was expected earlier." This gives ground to the assertion that, in the case of the low-income countries, "the chronic debt problems justify the term 'crisis'." The Bank also recognizes that for middle income debtors, as well, "restored growth remains essential," spelling out what are termed as "the preconditions for restoring growth" in these countries. The first of these preconditions is "policy reform," which is considered "extensive but has not to date resulted in sustained progress toward adjustment." The other two preconditions are adequate financing to foster adjustment and an open and vigorous trade environment, which until now are said to have been absent.

Third, among seventeen "highly indebted countries," appear prominently twelve Latin American and Caribbean countries and it is admitted that a net inflow into all of them of $65 billion in 1978-82 transformed itself into a net outflow of $100 billion in 1983-87. This leads to the forceful assertion that "perhaps the most serious failure of the past five years has been the failure to recognize and address the damage that the dramatic reversal of these flows has done both to the management of debt problems and to the momentum of growth in the world economy."

Fourth, the conclusion is also offered that "while the costs of incomplete adjustment and stalled growth has hitherto been borne largely by the debtors themselves through foregone income and falling living standards, other costs have been growing --lost demand for the world economy, potentially dangerous political shifts, and a rising threat of economic confrontation." In such terms, the Bank admits that "growth in the debtor countries remains the key."

Finally, as further evidence of the relatively more developmental stance adopted this year by the World Bank, it can be mentioned that the document also contains a brief description of different "debt relief proposals," which have been discussed particularly in congressional and academic circles in the United States. This is obviously a recognition that there is a need to search and to identify different alternatives. Thus, the conclusion seems to be sufficiently warranted that, this year, the World Bank views indebtedness as a development issue, rather than as it would be viewed by a "debt management institution."

V. 2. <u>ASSISTANT SECRETARY MULFORD ON INTERNATIONAL DEBT</u>
(WDW/4/88 - 10 February 1988)

Assistant Secretary of the U.S. Treasury for International Affairs, David C. Mulford, has "gone to the Hill," to testify before two Congressional Subcommittees on the subject of international debt. Mr. Mulford is considered the author of the Treasury's "Program for Sustained Growth," better known in international financial circles as "the Baker Plan." His remarks on international indebtedness are the latest, most authoritative statement on the issue made by a high level spokesman of the U.S. Government.

Mr. Mulford opened his statement by "strongly reaffirming the Treasury Department's support" for the Baker Plan, explaining that it is considered "the only viable and widely acceptable approach to international debt problems." He also reasserted what he called "four fundamental principles," on which the Treasury's debt strategy is based: 1) economic growth will ease the debt burden over time; 2) market-oriented reforms are needed in debtor countries to achieve such growth; 3) new debt and equity financing, as well as the return of flight capital, are also necessary to support such reforms; 4) the case-by-case approach should be used "to address the individual needs of each debtor country." These basic principles are said "to remain as important and valid today as when initially proposed."

Mr. Mulford asserts that "considerable progress" has been made under the prevailing debt strategy. To substantiate this assertion he mentions, among other examples, the "substantial efforts" made by debtor nations "to restructure their economies along more market-oriented lines;" GDP growth is said to have "improved substantially;" export earnings are said to have risen "sharply last year, and imports have also increased;" capital flight is seen as "reversed in several countries;" and interest to export ratios "are expected to stay around 26 percent this year, compared to an average 30 percent in 1982-86." All in all, "the most important change during the past two years" is found in "debtor attitudes," since these countries are said to be "increasingly focusing on the importance of market-led growth, and adopting the reforms necessary to achieve it." Several examples are then offered by Mr. Mulford to illustrate this assertion, such as Mexico's "trade liberalization, tax reform, privatization efforts, and market-oriented pricing policies," which are said to have "helped to restore confidence and encourage the return of substantial amounts of flight capital." Ecuador is said to have "adjusted well to two shocks, lower oil prices and a devastating earthquake." While Colombia is considered "the most successful adjuster in Latin America," with 5 percent growth last year and succeeding in "raising $1 billion from commercial banks without entering into a rescheduling agreement or Fund program."

Nonetheless, Mr. Mulford also recognizes that "serious problems remain," because: 1) "a number of debtor countries have failed to follow through on needed structural changes;" 2) "reductions in commodity prices and export earnings in 1985-86 have worsened debt-to-export ratios;" while 3) "protectionist pressures in both industrial and developing countries" are seen as "matters of serious concern."

"To reinforce the debt strategy," Mr. Mulford recalls the proposals made by Secretary Baker, at the last annual meetings of the Bank and the Fund. First, the Administration will seek authorization and appropriations for U.S. participation in a World Bank General Capital increase (GCI), in fiscal year 1989. Second, the creation of a new IMF External Contingency Facility (ECF) will also be supported, "to help cushion the adverse effects . . . of unforeseen external developments," but on the condition that this new facility be "financed from the Fund's current financial resources." Third, lending policies by the IMF should entail "longer term programs in order to increase the emphasis on structural policies for growth and stability." Finally, emphasis is placed on "the importance of developing a variety of market-driven financial instruments to help meet the diverse interests of both debtor nations and the banking community in devising new financing packages." This so-called "menu approach" comprises several items, such as trade and project loans, new money bonds, notes or bonds convertible into local equity, exit bonds, debt/equity swaps, donation of debt paper to charitable organizations for social and environmental use in debtor countries, limited voluntary interest capitalization, and general balance of payments loans. It is within the context of these alternatives that the recent Mexican debt exchange offer is considered "an example of an additional possible menu item with applicability in a limited number of circumstances."

Commenting on the recent actions by commercial banks to increase their reserves, Mr. Mulford considers them positive for two main reasons: 1) this decision is said to have "opened the way for further development of the menu approach through greater creativity on the part of commercial banks in devising instruments for future money packages;" and 2) the enhanced position of the banks "will enable them to be more demanding in terms of debtor country support for the adjustment process."

A description of the latest Mexican debt exchange offer is accompanied by an explanation of the Treasury's participation in the proposal. Admittedly, this operation "could have been arranged without any special effort by the Treasury." But Mr. Mulford reveals that "Mexican officials sought Treasury's involvement" because it was difficult to put together a package of Treasury notes "to match the maturing amount of Mexican bonds." Another difficulty consisted in predicting the "amount of Treasury Securities needed to collateralize the Mexican bonds prior to acceptance of bids."

The debt conversion offer is said to have been "possible because of the relatively high level of (Mexico's) international reserves." This leads to the reminder that "Treasury's participation in future proposals will be considered on a case-by-case basis," with the specific warning that "no commitment has been made to engage in similar transactions."

Finally, Mr. Mulford addresses several issues related to accounting and regulatory aspects of the Mexican bond swap program and recalls that domestic policy reforms still are "essential" for the success of the debt strategy.

To conclude his remarks, Mr. Mulford raises two important points. First, he emphasizes that "there are no real 'overnight' solutions to debt difficulties." And second, on the creation of an "international debt facility to purchase at a discount and securitize or swap sovereign LDC debt," he emphatically states that this continues being "unacceptable to the Administration." The reasons for the rejection of this alternative are spelled out: 1) "its creation would shift the risk on LDC loans from commercial banks to the public sector;" 2) it would "represent a move away from the case-by-case approach, which isn't feasible;" 3) "the consolidation of debt claims in a large international forum is almost certain to politicize the development process, distracting debtor and creditor attention from the difficult but fundamental economic adjustment issues;" 4) "by raising expectations of a bail-out, the creation of such a facility would weaken the resolve of the debtors to undertake necessary reforms and encourage unilateral actions to maximize debt forgiveness;" 5) finally, there is "little interest among the key industrial nations in allocating funds for such a facility."

Having thoroughly dismissed the creation of an international debt facility, Mr. Mulford reminds that "resolving debt difficulties will take time," that solutions "must be founded on economic reforms" and that all this "must be buttressed by modest new financing essential to meet the debtors' immediate needs to support reform and to generate growth." These elements are considered "the essence of the strengthened debt strategy."

V. 3. UPDATE ON THE DEBT SAGA
(WDW/8/88 - 9 March 1988)

Two recently made statements have led some to the conclusion that "debt relief" is on the point of becoming acceptable. The fact that these statements were made, at a conference held in Washington under the sponsorship of the Overseas Development Council (ODC), by none other than the Managing Director of the International Monetary Fund (IMF) and by the Chairman and Chief Executive Officer (CEO) of the American Express Company, obviously, gives some ground to a certain optimism. Nonetheless, before jumping to any kind of conclusion, it is better to describe these proposals, as well as the context in which they were made.

The Managing Director of the IMF, Mr. Michel Camdessus, dealt with the issue of indebtedness in a presentation entitled "Stimulating Global Growth: The IMF's Perspective." Warning that the Fund and the World Bank "cannot assume the financing task alone," Mr. Camdessus emphatically asserted that "first and foremost there is a need for the banks to do more." Thus, "the importance of building on the development of new financing instruments and innovative approaches, freely negotiated between debtors and creditors." In conclusion, the IMF "could only welcome" --and this deserves full quotation-- "imaginative schemes that are market based --like the current Mexican scheme, but also any other proposal that would be market based and would share in a mutually-agreed fashion between debtors and creditors the discount on debt and the benefits of adjustment."

Evidently, it is far-fetched to interpret this statement, about the need to share the discount on the debt, as an endorsement of "debt relief." Anyway, as if there were any doubts about the IMF's position, Mr. Camdessus forcefully dispelled them in another speech on "Debt: Strategy for the Future," given in Zurich on March 8. He said, "we remain on the right road; the basic elements of our strategy --better policies, a favorable external environment, adequate levels of external financing, and a case-by-case approach-- continue to be valid; and we should stick to this strategy."

By contrast, the proposal made by the American Express CEO is more sweeping. Avowedly, Mr. Robinson's objective is "to shift the dialogue and the focus to the comprehensive level," for several reasons. First, he considers that "the current strategy of case-by-case negotiations" has been "a good strategy for its time." Second, he also claims that this strategy "has not brought with it adequate resources to support sustained growth in LDC economies and the consequent gain in living standards." Third, even admitting that "the case-by-case approach has bought time," Mr. Robinson quoted the World Bank to support the assertion that "the participants in LDC negotiations are suffering from 'debt fatigue'." Consequently, based on these premises, Mr. Robinson believes that "the time has come to develop new approaches that are comprehensive."

Moreover, the American Express CEO went farther in his criticism of the Baker Plan, because he found it lacking in: 1) "mechanisms to encourage adequate new lending and investment;" 2) "adequate incentives for LDCs to adopt market-oriented policies;" and 3) "the means to assist these countries during a difficult adjustment period when both debt service and growth have to be accommodated."

Thus, Mr. Robinson called for what he termed "a more comprehensive approach," by means of the creation of an "Institute of International Debt and Development (I2-D2)," whose main features briefly follow.

First, it would be a "joint venture of the IMF and the World Bank," but its board of directors would include, besides the representatives of these institutions, creditor and debtor governments, as well as commercial and central banks.

Second, major developed country governments will provide the initial capital, estimated at about $12.5 billion.

Third, the purpose of the Institute is described as to negotiate on a case-by-case basis with the debtor governments the implementation of economic and financial policies for growth, open markets and credit-worthiness. The Institute will also negotiate with creditor banks the purchase of their LDC loans at a discount in exchange for high quality obligations, in the form of floating rate perpetual bonds and preferred stock.

Fourth, because debt would be purchased from the banks at a discount from face value, the Institute's debt servicing needs would be less than present debt service requirements, enabling it to provide "meaningful debt concessions to the LDCs during the adjustment period."

Fifth, a feature described as key and powerful consists in the subordination of the debt bought from the banks to all new debt issued. This means that "new loans would have a prior claim on resources over debt purchased."

Sixth, on the program's dimensions, it could cover all the debt owed by the Baker Plan's seventeen countries, or around $250 billion. Supposing that all of this debt is acquired at 60% of its face value, only $150 billion in securities would be required. This amount is arbitrarily split into $125 billion in perpetual bonds and $25 billion in preferred stock, thus, only $12.5 billion in equity capital would need to be paid or called among the sponsoring creditor governments.

To conclude, Mr. Robinson declared that "it is time to expand our vision to the interrelationship between trade and debt, growth and national security, prosperity and peace."

To appreciate the context in which was made this comprehensive proposal for debt relief, it should be recalled that it comes just immediately after the Assistant Secretary of the U.S. Treasury for International Affairs, Mr. David Mulford, made a forceful statement supporting the Baker Plan (WDW/4/88).

Even so, the response from the Treasury Department this time came from the Secretary himself and did not make itself wait. Mr. James Baker 3rd. was quoted as declaring before Congress that anybody can solve the LDC debt problem by putting it on taxpayers. He also added that a Marshall Plan to solve the LDC debt problem would be a great idea, but the money is not available.

Consequently, although it is important that a representative from the commercial banks sponsors a proposal for "debt relief," as long as the creditor governments do not support it, such proposal sounds more as posturing by one of the active participants in the debt saga.

V. 4. <u>THE BANKERS' VIEWPOINT</u> (WDW/11/88 - 27 April 1988)

As it has become traditional, with the spring meetings of the Fund and the World Bank, the Managing Director of the Institute of International Finance (IIF), Mr. Horst Schulmann, issues a letter addressed to the Chairmen of the Interim and the Development Committees. This letter contains the viewpoint of the IIF's Board of Directors, which represents around 200 commercial lending institutions from all over the world. The purpose of this year's letter, clearly stated from the beginning, is "to summarize the

IIF's) views on the measures necessary to make further progress in the resolution of the payments problems of the highly-indebted, middle-income countries."

The world financial system is seen as undergoing "increased strain," as revealed by "marked disturbances in financial and foreign exchange markets and uncertainties about growth prospects in industrial countries, while high unemployment and structural imbalances continue to foster pressures for protection." Furthermore, "the events of the last quarter of 1987" are mentioned as evidence of "how closer integration of the world economy has increased the costs of faulty policies." Without sparing criticism, the Institute concludes that "despite this, governments have failed to respond vigorously," while "the best that can be said about the current policies in industrial countries is that most of them are pointed in the right direction." In this "environment of uncertainty," the Institute closes its remarks on the state of the world economy by saying that "activity is slowed, interest and exchange rates are volatile, and disruptions can be violent."

So much for the world economy. On the debt problem, which admittedly constitutes the IIF's central concern, recent developments are characterized as "mixed." On "the favorable side," the IIF finds that "interest rates are down again from the levels reached last October," while "many primary product prices" are said to "have improved." Also, "where appropriate exchange rate policies are in place," the Institute recognizes that "developing countries' exports of manufactures have produced sharp improvements in the trade balances." Finally, to conclude this positive side of the balance, the IIF considers that "the IMF Enhanced Structural Adjustment Facility provides hope for increased financing and more effective adjustment efforts among the low-income countries."

Nonetheless, avowedly, "banks are chiefly interested in middle-income countries." In this regard, for the Institute it is positive that "some restructuring countries have improved their adjustment policies." It also asserts that "if the cost of debt servicing is measured by the ratio of interest payments to exports of goods and services, debt management has become easier for most middle-income countries over the past five years, partly because both interest rates and the spreads have declined."

However, in what almost immediately became the most quoted assertion drawn from this year's letter, the Institute concludes that "the dominant impressions on debt management are of lack of leadership and increasing strains on the process." This judgment rests on the perception that "creditor governments have not done enough in bilateral relations to provide more official financing, to open their economies, or to improve the regulatory and tax regimes for private lenders and investors." These same governments also are said to "have failed to make effective use of the international financial institutions."

The International Monetary Fund also comes under criticism because it has become "a substantial taker of money from the developing countries." By contrast, some of the comments on the World Bank are relatively more positive. For instance, it is said that "despite delays in increasing its capital and the effect of the decline of the U.S. dollar on its loan limits, the World Bank has expanded its commitments." Nonetheless, the Bank is said to have "only been partially successful in obtaining policy improvements in debtor countries," since "its net lending has expanded less than envisaged as a result of rapidly growing repayment obligations." The Institute also suggests that the World Bank should be "more innovative in its approach to the debt problem," and that it "should do more to facilitate new money packages through credit enhancements."

Concerning the commercial lenders, allegedly, "because of inadequate support from other lenders, banks have encountered growing strains in the concerted lending process." But even recognizing that there are "increasing difficulties in agreeing new loans and gaining widespread participation," a complaint is expressed because "banks have been scarred by debtors' lack of persistence with corrective programs and disappointed with the slow pace of the kind of structural reforms required by the Baker plan."

To counter the criticisms derived from the "declining share of bank lending in the overall flow of resources to developing countries," the Institute demands that this should be "seen in perspective." For instance, "the strong expansion of bank lending" of the 1970s is said to have "marked an aberration from historical trends which could not be expected to continue." For the IIF, "the subsequent reduction in bank flows, particularly to troubled debtor countries, represents a return to earlier levels." Hence, what is seen as "the real problem is that direct investment has not recovered and official lending has not picked up the slack."

Turning towards the solutions, the IIF's letter recalls the "banks interest in moving away from general purpose loans for financing balance of payments gaps and in replacing them with transactional and investment finance, debt-equity swaps and other options," although it is admitted that "progress in the past twelve months has been uneven and generally low." Also, as it could be anticipated, skepticism is expressed "about the valuation of existing bank claims in secondary markets." But, admittedly, "bankers live with reality and see virtues in voluntary arrangements that permit lenders to withdraw at a price," with the Mexican bond issue of March 1988 termed "a useful experiment."

Despite the recognition that "progress in easing the debt problem has been far from satisfactory," it is said that "banks at this point remain unconvinced that government-supported schemes for generalized 'debt relief' are the answer." Thus, the letter reiterates the "support of the cooperative case-by-case approach to the debt problem."

To conclude the IIF makes a proposal for an allocation of SDRs, to be distributed according to IMF members' ~~quotas. The~~ advantage of this proposal is that it entails "benefits for all participants." Particularly because "it would strengthen the financial arrangements to maintain orderly exchange markets and ease the financing problems of both surplus and deficit countries." Also, "by providing highly indebted, middle-income countries with increased reserves, they would be able to collateralize new borrowing from banks or to enhance debt conversions." A detailed description of the proposal for an SDR allocation and of its "economic implications" appears as an appendix to the letter.

The IIF's closing remarks are not encouraging. The letter ends saying that "the present situation is far from satisfactory; there is more uncertainty and greater risk; major international financial institutions appear to be moving sideways rather than forward. In short, leadership is required."

V. 5. <u>A FRESH LOOK AT LDC INDEBTEDNESS</u> (WDW/12/88 - 4 May 1988)

One of the better informed practitioners in the issue of LDC indebtedness, the President of the Federal Reserve Bank of New York, Mr. Gerald Corrigan, made a statement at the 66th. annual meeting of the Bankers' Association for Foreign Trade, held in Boca Raton, Florida, on April 25, 1988. The statement dealt with the question of "where we have been and where we are going in the continuing effort to manage and ultimately resolve the debt problem." This statement is illustrative of a fresh perspective on the issue.

Mr. Corrigan begins asserting that in these matters "far more has been achieved than is widely recognized," and he lists what he sees as the main "accomplishments."

First, cooperative efforts by debtors, creditors, central banks, governments and multilateral institutions are credited with the hardly negligible achievement of averting "financial and economic calamity."

Second, it is recognized that "debtor countries have made some very important strides in improving their economic policies and their performance against very strong countervailing forces."

To illustrate this point the case of what are called "eight troubled debtors" --Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, the Philippines and Venezuela-- is depicted in the following terms. These countries are said to have undergone "a significant improvement in aggregate trade and current account positions despite the fact that virtually all have experienced devastating setbacks in the terms of trade." Growth is said to have "reemerged even if at slow and sporadic rates." What is considered as "the key ratio of external interest payments to exports" is said to be "falling in virtually every country." While in the adoption of measures to move toward "more open and more competitive economies," these eight countries are said to have taken "important but not yet decisive steps." Finally, considering "the economic environment of the past six years," characterized as "one in which cyclical forces would be expected to swell public sector deficits," it is said that "some debtor countries have made important strides in reducing public sector deficits as a percentage of GDP."

Evidently, even when there can be disagreements with some of these assertions, it has to be admitted that they sound different to those habitually heard expressions of "debtor-bashing," by which the latter are admonished to first put their houses in order.

President Corrigan also considers, in third place, that "the scope of the overall debt restructuring effort has been remarkable."

Fourth, "the commercial bank new money process" is said to have also worked "reasonably well."

Finally, President Corrigan points out that "the past six years have witnessed a dramatic reduction in bank exposure to the troubled LDCs." This deserves to be fully quoted, "for any cross section of the very largest U.S. banks, exposure to the Baker 15 relative to primary capital in 1982 was in the range of 225 to 250 percent." Then, as a reflection of what is considered "the enormous growth in primary capital" among these same banks, by the end of 1987, "these ratios were in the range of 80 to 90 percent." Obviously, current exposures are still considered "too high," but they are also said to be "still declining as capital grows and as individual banks utilize various bilateral and voluntary techniques to reduce exposure."

This list of "achievements" concludes with the rarely found recognition that "reductions in bank exposures have been aided by limited but not unimportant amounts of outright debt repayments as, for example, in the case of Colombia and Venezuela and on the part of private debtors in many countries."

From this list, Mr. Corrigan emphasizes that "a great deal has been achieved on many fronts over the past six years." He warns against viewing this as "muddling through," because "time has been bought but it has not been wasted in that ~~we are closer~~ to lasting solutions now than we were a year, two years, or six years ago even if it remains true that the process will still take time--a lot of time."

In this sense, Mr. Corrigan recalls the need to "be realistic in recognizing that from the perspective of the debtor countries that progress has been exacted at a high cost in both political and economic terms."

Remaining problems are also listed and the following are briefly mentioned: 1) inflation performance, especially in the major debtors, is called "a major disappointment;" 2) levels of debt relative to GDP or to exports "have not come down and in most cases have actually increased;" 3) there remain "major structural impediments to more open and more efficient economies;" 4) levels of frustration and fatigue are found to be "high;" 5) there is a "need for greater adaptability in the approaches of the multinational institutions;" and 5) in what is termed "an ironic and worrisome way, the new money commercial bank financing process has been weakened in part because bank exposures have been reduced so dramatically."

Mr. Corrigan's evaluation of "the overall situation" is that "we are at something of a crossroad in that we face the crucial question of how to best sustain the progress of the past while dealing with shortcomings which have emerged during the past several years."

Focusing on the different alternatives, Mr. Corrigan rejects any "sweeping and generalized approach that would incorporate --one way or another-- a program of debt relief, debt forgiveness and/or the shifting of commercial bank debt to the official sector." For instance, "the outright shifting of even a part of the commercial bank debt to the official sector" is considered "a political non-starter." Also, "anything approaching a 'forced' write down of even part of the debt" is said "to run clear risks of inevitably and fatally crushing the prospects for fresh money financing." Finally, "even the specter of some generalized form of debt relief" is said "to carry with it the ~~illusion~~ that the burden of policy adjustment and adaptation is lessened or removed."

Having dismissed these comprehensive alternatives, Mr. Corrigan proposes his own solution. He calls it "a package deal," constituted by the following prerequisites: first, growth in the debtor countries must remain "in the five percent range;" second, LDCs should maintain "businesslike relationships with their creditors;" third, there must be "a reasonably stable and predictable flow of appropriate amounts of official and commercial bank credit to the LDCs;" fourth, the multilateral financial institutions must be "strong and well-funded;" and fifth, among private bank creditors there must exist "an appropriate degree of solidarity and commonality of purpose," particularly "among major bank creditors." That this set of "prerequisites" constitutes a package deal means that "success in any one or two or four is not good enough," because "true and lasting success will be found only if we have progress on all five fronts."

Mr. Corrigan closes his remarks describing some of the steps required from different participants. For instance, the strong conviction is expressed that "the only real solution to the debt problem is for the (debtor) countries to grow out of the problem over time." Regarding the multilateral financial institutions, the general capital increase for the World Bank is "much needed," while the IMF's areas of greater priority are said to be "greater flexibility and a longer perspective." As for commercial bank financing, Mr. Corrigan considers that "the one problem we do not need is to have the debt problem again take on the characteristics of a debt crisis because of a crisis among the creditors." To avoid this, he demands "a strong reaffirmation of the commitment of the creditor banks to the bigger picture," as well as that decision-making among the banks be "expedited and driven more by policy consideration and less by legalities and technicalities." Finally, this entails finding a solution "to the so-called 'free-rider' problem in which an increasingly large number of banks refuse to participate in the new money lending but get the benefit of the process in the form of interest payments on existing loans."

The least that can be said about these remarks is that they deal with the debt problem in a non-traditional manner.

V. 6. MR. CAMDESSUS ON LATIN AMERICAN INDEBTEDNESS
(WDW/14/88 - 18 May 1988)

The Managing Director of the International Monetary Fund (IMF), Mr. Michel Camdessus, in a seminar on "Latin America in the World Economy," held in Caracas on May 2, 1988 under the sponsorship of the Aspen Institute-Italia and the Latin American Economic System (SELA), addressed the issue of Latin American indebtedness. As can be seen in the summary that follows, Mr. Camdessus' remarks were not very encouraging for the future of the world's largest debtors.

The Managing Director dealt with "the challenges facing Latin America and the international community in its relations with Latin America," by offering answers to the following questions: "what is the situation? what is to be done? and what are we doing?"

On the current situation, Mr Camdessus points out that "since the onset of the debt crisis there has been an improvement on the external current account of Latin America and the Caribbean of 4 1/2 percent of GDP, despite a deterioration in the region's terms of trade equivalent to some 2 percent of GDP." This is considered "a creditable result by any standard." Even so, it is also admitted that "many countries are little closer to regaining voluntary financing," while economic growth is said to be "slow to recover."

Based on these assertions, Mr Camdessus raises the very central question of "why has the pay-off been so modest?" He finds the three following answers. First, policy implementation is said to have been "uneven." Second, "internal adjustment has not matched external adjustment, so that the inevitable cuts in imports from unsustainable levels before the crisis have had perceptible effects on investment and output." Finally, "despite an appreciable growth in volume terms," it is recognized that "exports have stagnated in value terms as prices have weakened."

So much for the explanation. From thereon, Mr. Camdessus asserts that different perceptions prevailing among debtors and creditors "feed one another," in what amounts to "the makings of a vicious circle." To break away from it, Mr. Camdessus proposes "a new realism," characterized by the warning that "one should not expect any miracles."

For instance, it is "unrealistic" to expect "the international environment to turn substantially for the better in the foreseeable future." Also, any "generalized scheme of debt forgiveness to strengthen the indebted countries' external balance sheets" is said to face "no readiness by governments of the major creditor countries to entertain such an approach." Thus, "the only initiatives from which there can now come some relief," in the Managing Director's opinion are "growth-oriented adjustment programs and appropriate financing."

In what constitutes the speech's core, there is an attempt to analyze the responsibilities of each one of the main participants in the debt saga. Mr. Camdessus begins by saying that "the urgency of action lies first and foremost, of course, with the indebted countries themselves." These countries are said to "need to be more steadfast in their efforts to deal with their imbalances and structural weaknesses." This is considered not only "the key to stronger performance," but also "the essential catalyst for other elements of a more concerted collaborative approach."

Furthermore, Mr. Camdessus finds that there exists "a clear movement toward a basic consensus on what has to be done in the indebted countries to overcome the debt crisis." He describes "the essence of this consensus" as the recognition that "there are certain imperatives that countries cannot ignore." The list of these "imperatives" comprises, first, "more savings will have to be mobilized domestically to finance a higher level of productive investment," adding that "realistically, the principal instrument here has to be fiscal policy." Second, "efforts to guard against and to reverse capital flight continue to be crucial." Third, "more efficient use needs to be made of existing resources." Finally, there is "an urgent need to strengthen the region's outward orientation."

Mr. Camdessus himself candidly admits that this is "a familiar litany," warning that "any of it will be easy." Even so, he dismisses as "an illusion to expect the necessary restructuring of resources to be achieved without consequences for the distribution of income and without transitory losses of output in some sectors." All this by way of contrast with what is termed the "greater illusion" of looking for "a resumption of sustainable growth without adjustment."

On the basis of this assertion, Mr. Camdessus admonishes indebted governments that they "must not allow narrow time perspectives and the pressures of sectional interests to blind them to the wider possibilities which, through this effort, growth offers." Consequently, governments are urged to "summon up the courage and determination to embark on stronger programs and to hold unswervingly to them."

Having defined extensively the responsibilities of the debtors as the first and foremost, Mr. Camdessus proceeds to outline the responsibilities of other participants. Concerning the IMF, its role is described as consisting of three elements: first, "helping debt-burdened countries to formulate effective programs of adjustment oriented to growth;" second, "making available its own resources to support such programs;" and third, "helping to mobilize financing from other sources."

The Fund's involvement in Latin America and the Caribbean is described as "particularly extensive," since in the last five years 28 of the 32 member countries have "availed themselves of the Fund's financial assistance."

Also, the following weaknesses in the Fund's performance are recognized: first, "resources for supporting the poorest countries were notoriously inadequate;" second, "too often in the past, sound programs have been negated by developments over which governments have had no control;" and third, there have been difficulties in "addressing payments imbalances of the size that have developed with annual or 18-month programs."

To correct some of these deficiencies, three initiatives have been taken within the IMF: first, the opening of a new lending window for the poorest member countries, called Enhanced Structural Adjustment Facility (ESAF); second, the Extended Fund Facility (EFF) will be modified to provide a longer-term horizon for adjustment; and third, a contingency financing mechanism will be created.

Regarding the responsibilities of other participants, Mr. Camdessus emphasizes three contrastingly brief points. The major industrial countries are asked, first, "to implement growth-oriented adjustment policies;" second, to implement liberal trade and agricultural policies, as well as to resist the recourse to protectionism; and third, "creditors need to demonstrate a greater readiness to provide adequate financial support expeditiously to countries undertaking strong programs of adjustment."

Certainly, the suggestions for the other participants in the debt problem are not as extensive and detailed, nor do they seem as "imperative" as the specific recommendations addressed to the debtors, a reason for which the speech has been considered rather unbalanced. Even more so, when it is contrasted with other recent comments made on the issue of international indebtedness, as those recently made by the President of the Federal Reserve Bank of New York (WDW/12/88).

V. 7. THE BANKERS' CONCERNS
(WDW/30/88 --12 October 1988)

This year, a second letter has been addressed by the Managing Director of the Institute for International Finance (IIF), Mr. Horst Schulmann, to the Chairmen of the Interim and the Development Committees. Usually, such a letter is issued only once a year, for the Spring meetings of these bodies (WDW/11/88), not for the annual meetings, held in September. Even so, without much explanation, the IIF's authorities apparently have deemed necessary to issue a second letter, avowedly, "to summarize its views on the evolution of the debt problem and some of the principal issues facing the international financial community in both the short and medium term."

The letter describes, first, the bankers' concerns about the world economy and about the adjustment efforts of highly indebted, middle-income countries; second, it examines "some of the factors affecting bank lending;" and it concludes with the presentation of some suggestions about how the situation can be improved.

On the world economy, the Institute's opinion is mixed. On the positive side appear listed, first, that "economic growth in the industrial countries has turned out to be stronger than expected;" second, that "there has been more stability in international financial markets;" and third, that "there has been some reduction in the current account imbalances among the largest industrial countries."

In the developing countries, the Institute finds that in Asia most countries "have strengthened their payments positions and maintained market access while continuing to grow robustly." Also, among "the highly indebted, middle-income countries," the Institute finds "there has been progress, too." It considers "most encouraging," that "efforts to strengthen payments positions are succeeding." The Institute notes, as well, that "the key ratio of interest payments due to export earnings fell sharply in 1987, and interest payments due relative to GNP have fallen every year since 1984."

Nonetheless, amidst these "welcome developments," it is pointed out that "uncertainties abound." Among them the Institute finds the U.S. fiscal deficit, which remains "unresolved." Current account imbalances, which "still are unsustainably large." Inflation, which has "begun to accelerate again." The threat of recession, "while postponed, must be ~~taken into~~ account." The domestic problems of the "troubled debtor countries," which cannot be minimized, because "while sustained policy corrections are required, governments appear unwilling to tackle the political difficulties that are inhibiting effective action." A major risk is found in "sharply rising world interest rates," recalling that every percentage point rise in LIBOR adds $5 billion to the annual interest bill of the highly indebted, middle-income countries. To prove the last point, it is also brought out that, since last April, "central bank action has led to a rise in 6-month LIBOR from about 7 1/4 to nearly 8 3/4 percent, thus adding, on a full-year basis, $7.5 billion to the debt service requirements."

Moving ahead, to the factors that are affecting bank lending, the Institute challenges an estimate made by the World Bank about the annual financing requirements of highly indebted, middle-income countries. Such estimates are criticized because they assign to "commercial banks the role of residual lenders." They project that in 1988-90, to sustain an economic growth rate of 4-5%, without any rise in interest rates, the banks would have "to provide $6-9 billion per year."

These calculations, for the Institute, "demonstrate the need for larger contributions from other creditors," considering "unrealistic to expect that banks will provide such amounts," given the recent factors said to be affecting bank lending. Among these factors, the Institute mentions: 1) by contrast with what happened in the 1970s, "there is little scope for commercial banks to recycle current account surpluses to developing countries as a group." 2) Banks need "to continue to improve their capital base." 3) There is "reduced cohesion within the banking community," which has decreased "the potential benefit from a strategy of concerted lending," because of factors such as the depreciation of the dollar, which has reduced greatly the exposure of banks outside the United States and Canada, as well as because of divergent regulatory requirements. 4) "International lending is losing its attractiveness because of the increased incidence of arrearages," while "calls for generalized debt forgiveness also have a chilling effect."

The main consequence of these factors is "that the demand for bank financing from developing countries exceeds the capacity and willingness of banks to supply it." Therefore, the Institute considers that "the crucial question is how to make bank lending more attractive." This leads straight into the listing of certain suggestions for the improvement of the present situation.

First of all, debt relief schemes, "which involve the involuntary participation of private creditors," are outrightly dismissed, because "they do not provide a solution." By contrast, "the acceptable way" for commercial banks is identified as "voluntary, market-oriented debt conversion schemes." Those considered "most satisfactory" are debt-for-equity conversions, as well as the debt exchange mechanism built into the recent Mexican scheme. Nonetheless, these mechanisms are said to be insufficient, unless they are accompanied by "credit enhancement of interest payments on the new asset either by creditor governments or through the multilateral institutions."

Another requirement, for "the satisfactory resolution of the debt problem," consists in the recognition by creditor Governments, multilateral institutions and debtor countries of "the growing strains which are limiting the banking community's ability to raise large amounts of new money for highly indebted developing countries." For the Institute, this means that "debtor countries will have to do more to mobilize domestic savings and that creditor governments and multilateral institutions will have to increase their financial commitments substantially."

In this sense, it is asserted, somewhat bluntly, that "increasing the financial commitment should start with the World Bank," while "the declining trend in IMF lending needs to be reversed." As far as creditor governments are concerned, the Institute suggests they "have to expand the scope of bilateral credits being made available through the export credit agencies and continue to take a flexible approach to rescheduling through the Paris Club." Finally, highly indebted developing countries are requested "to double their efforts."

Meanwhile, the banks are said "to have yet again demonstrated their resolve to support the cooperative approach by their contribution to the new financing package for Brazil." Nonetheless, the banks are seen as "straining at the limits of what is achievable and acceptable given their fiduciary responsibilities to engage in bankable business." Therefore, "official creditors will need to play a larger part," while developing countries should be "prepared to service their debts and commit to meaningful structural adjustment." If these conditions are met, the banks "stand ready to cooperate with other creditors and will continue to seek innovative new ways to provide new financing."

In these terms, the IIF'sletter makes almost inevitable the conclusion that solutions to international indebtedness, as beauty, lie in the eyes of the beholder.

VI. ADJUSTMENT AND GROWTH

VI. 1. THE LONG ROAD TO ADJUSTMENT (WDW/3/88 - 3 February 1988)

A recent speech by Mr. Michel Camdessus, Managing Director of the International Monetary Fund (IMF), in Singapore, on January 20, 1988, has been picked-up by THE NEW YORK TIMES to illustrate how the "I.M.F. Is Trying To Become More Flexible." The Fund is described as trying "to design new lending conditions that are less harsh and create programs to cushion borrowers against adverse turns in the global economic climate." It is thus of some interest to try to find out if Mr. Camdessus' remarks give ground to this assertion.

A rather pessimistic characterization of "world economic fundamentals" introduces the question of how the Fund can "do more and do better?"

The "world economic climate" is characterized as "uncertain and probably unpropitious," despite the recognition of positive signs, such as a stronger performance of economic activity during the second half of 1987 and the fact that the effects of the stock market crash "are now seen as less adverse than many observers initially thought."

These relatively positive indicators are "clouded" because of "the very large external current account imbalances in the three largest countries that have accompanied the upswing of the past few years have made its foundations increasingly fragile." Furthermore, these imbalances are said to have been "slow to respond" to the "mix and thrust of policies" adopted by the major industrial countries. Even so, "imbalances of the current order" are considered unable to "preclude the possibility that growth could be reasonably well maintained in the short run." In support of this relatively modest and cautious optimism, it is recalled that the latest projections made by the Fund suggest "a rate of growth of GNP in the industrial countries of 2 1/2-2 3/4 percent in 1988-89, as against an estimated 3 percent last year."

Against the background furnished by these "fundamentals," Mr. Camdessus describes the role of the Fund as "seeking to ease the path of economic adjustment through the provision of financial assistance." In his own terms, the performance of this task is grounded in a "basic consideration: the orderly pursuit ... of a program of economic adjustment to restore viability to the balance of payments."

How is "adjustment" conceptualized? First of all, it is said to be "not a creation of the Fund." Neither, "is a country's willingness to undertake an adjustment program a concession to the Fund."

Second, a complaint is expressed because "in some quarters 'adjustment' has become an emotionally-charged term." This is considered "unfortunate," because adjustment is said to be "inevitable for any country whose external position has become unsustainable, or would be unsustainable but for the undue compression of the rate of economic activity."

Third, it is recognized that "there is much concern -rightly- about the transitional costs of adjustment, particularly for the poorest members of society." Although, immediately, it is added that "there is at times too little appreciation that failure to take steps to adjust when adjustment is necessary is often the most impoverishing approach of all."

Fourth, it is also admitted that adjustment is "never easy," and admittedly, "in the exceptionally adverse global economic environment of recent years it has been particularly difficult."

In these conditions, the Fund is seen as confronting "three realities in the performance of its basic mission, defined as "to help promote and sustain the implementation of appropriately strong programs of economic policy reform."

The first of these "realities" concerns "the nature of the task facing many heavily indebted countries," with two considerations deemed appropriate. On one side appears "the sheer magnitude of the imbalances that have accumulated over the years," and on the other, "the greater emphasis that must, of necessity, be given to structural reforms to address these imbalances while promoting growth." On this basis, Mr. Camdessus proposes that "longer periods must often be envisaged now for adjustment," as well as that larger amounts of assistance be made available.

Another "reality" consists of a recognition that there exists "a growing sense of adjustment fatigue in many countries, coupled with an increased vulnerability to adverse external developments."

Two phenomena appear as reflection of this "fatigue." First, "an increase in the number of adjustment programs that have been undermined by factors outside the countries' control." And second, in its turn, this has led to the fact that "some governments have been less willing to take or follow through on the policy action that is often needed to strengthen an economy, but which could be politically costly if its yield turned out --for whatever reasons-- to be small."

Finally, the last "reality" is termed "a vicious circle," because governments approach the Fund with some delay, when the terms of a program can only be more rigorous. This is said to "foster the impression that an approach to the Fund entails 'harsh' conditionality --which, in turn, can only serve to deter members from seeking the Fund's financial, technical and moral support in timely fashion." To brake away from this circle, Mr. Camdessus advises that governments should "adopt corrective measures at an earlier stage," and that they should "explain to their citizens that such measures stem from the country's own imperatives and its own initiative, not from the imposition of an external agency." But Mr. Camdessus also suggests that "the Fund must ask itself whether there are not steps that it, too, could take --while remaining a prudent institution-- to facilitate earlier recourse to its support." Hence, he concludes by posing the very important question, if there are also "changes that could reasonably be made in the implementation of conditionality?"

These three "realities" are said to be presently undergoing "close review by the Fund's Executive Board," with the purpose of arriving at modifications in lending instruments, as well as in the design of adjustment programs and in the implementation of conditionality.

Mr. Camdessus also raises "two additional matters" that need to be confronted. First, he proposes that Fund quotas "be increased substantially under the Ninth General Review." Second, he also requests from the commercial banks to perform their part, because "it is simply not reasonable to expect the Fund to compensate for shortfalls in financing from other sources."

This very brief description of the recent remarks by the IMF's Managing Director, certainly, supports the assertion that changes are taking place in the institution. First of all, some of the suggestions proposed by the Group of Twenty Four developing countries (G-24) apparently are being considered and taken into consideration by the Fund's Executive Board. Second, the readiness of the staff to follow enthusiastically in the implementation of these changes should not be taken for granted. Although, in this regard, Mr. Camdessus' persuasive powers should not be underestimated, as demonstrated by the recent increase in the resources of the Extended Structural Adjustment Facility, completed without the participation of the United States and in spite of considerable skepticism on the part of most of the Fund's staff.

Finally, a reaction against Mr. Camdessus' remarks was registered almost immediately. It came, of all places, in the form of an assertion made by a spokesman of the Treasury Department in the sense that, given the support already granted by the present Administration to the World Bank's capital increase, as well as because of the fact that present IMF resources are considered ample, the United States is firmly opposed to boosting these last at the present time.

VI. 2. RESOURCE FLOWS TO THE HIGHLY INDEBTED COUNTRIES (HICs) (WDW/13/88 -- 11 May 1988)

As background to the first item that appeared in the agenda of the Development Committee's last meeting, held in Washington, on April 15, 1988, a document was presented on the adequacy of resource flows to developing countries. Since this document is still of restricted distribution, readers of this WEEKLY DISPATCH are requested to refrain from publishing, quoting or citing the whole or part of the summary that follows.

Three groups of countries are analyzed: first, Sub-Saharan Africa; second, Low-income Asia; and third, Highly Indebted Countries (HICs). This last group includes twelve Latin American and Caribbean countries --Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Jamaica, Mexico, Peru, Uruguay and Venezuela-- as well as five others --Cote d'Ivoire, Morocco, Nigeria, Philippines and Yugoslavia. For obvious reasons, here will be mentioned only some of the highlights about the HICs.

An evaluation of the historical net flows and net transfers of external finance to all developing countries, during the present decade, reveals the existence of a precipitous decline in the overall volume of resources, with development assistance remaining constant in real terms while private flows from commercial banks declined dramatically. For instance, from 1977 to 1982, the net transfer of resources to all developing countries, through long-term lending, amounted to a positive $140 billion. By contrast, in the following five years the equivalent amounted to a negative net transfer of $75 billion.

For the HICs, from 1978 to 1982, a net positive resource transfer of $65 billion becomes, from 1983 to 1987, a net negative resource transfer of $106 billion, or the equivalent of 2.8 percent of their aggregate GDP for the same period.

A breakdown of the different components of resource flows to developing countries makes evident that the most dramatic reversal during the eighties took the form of a steep and abrupt decline in private bank lending, which accounted for the major portion of the change in the volume of these flows. Thus, in 1986, official development finance from multilateral and bilateral sources represented 70 percent of the net flows to developing countries, or almost twice the proportion it represented in 1980. Also, multilateral sources presently constitute about 25 percent of the aggregate net flows to developing countries, up from 10 percent in 1980. Among these last, one of the most remarkable is the case of the International Monetary Fund (IMF). In 1987, net purchases from the Fund amounted to negative $5.5 billion (in current dollars) and net transfers after excluding charges were negative $8.1 billion.

The boom in export credits, that lasted until 1982, almost disappeared on a net basis, accounting in 1986 for only 2 percent of the net flows to developing countries, compared to 14 percent in 1980. In the same terms, the role of private foreign investment has been minor, with these flows remaining unchanged throughout the eighties.

The volume of net flows to the HICs has declined radically, from $49 billion in 1981 to a yearly average of $7 billion from 1985 to 1987. For these countries, the only source that has increased during this decade are the net flows from multilateral institutions, which experienced an increase of 35 percent during the 1981-86 period. Nonetheless, the volume of net transfers has undergone a pronounced turnaround, from a positive $23 billion in 1981 to a negative yearly average of $24 billion during the last three years.

This dramatic reduction in the HICs access to commercial lending has entailed impressive sacrifices. For instance, gross domestic savings in 1986 represented 22 percent of GDP and gross domestic investment accounted for 19 percent of GDP, generating a positive resource balance of 3 percent of GDP. By stark contrast, five years before, the resource balance amounted to a negative 2.5 percent of GDP.

The HICs record in the achievement of trade surpluses is also outstanding. The cumulative trade surplus generated by these countries during the last five years amounted to $160 billion, or a yearly average of $32 billion. Current account deficits were more than halved, from a yearly average of $40 billion in 1981-82, or 3.2 percent of GDP, to almost $16 billion in 1986, or 1.7 percent of GDP. Meanwhile, during the same period, export volume registered an average yearly increase of 1.4 percent. Also, the volume of imports has been constantly reduced since 1983, reaching a level of 40 percent below that registered in 1980, or a yearly decline of 8 percent.

The investment ratio has fallen from 25-28 percent in the early 1980s to 17-18 percent in 1986-87, with the rate of investment declining by an average of 5 percent annually. Consequently, net investment has fallen by more than half, from 16 percent of GNP to about 7 percent. ~~Public~~ sector deficits have also been significantly reduced. In 1986, government budget deficits as a proportion of GDP amounted to 0.7 percent, down from 5.6 percent in 1982. To concludethat, as a whole, presently per capita incomes are one seventh lower of what they were at the beginning of the decade.

The consequences of this severe import compression and economic stagnation have also affected the industrialized countries. For instance, while exports from the United States to the rest of the world were on the rise, U.S. exports to Latin America have fallen by 26 percent in the last five years, from $42 billion in 1981 to $31 billion in 1986. In this same period, the imports of the four largest debtors --Brazil, Mexico, Argentina and Venezuela-- have fallen between one third and one half.

Regarding the HICs medium-term outlook, it is estimated that these countries require at least $11-12 billion of annual long-term borrowing in order to achieve, by 1992, a modest growth in per capita consumption of an average of 2 percent. Less than half of this amount could be available from official bilateral and multilateral sources, but the residual gap of an annual average of $6-7 billion would have to come from private commercial sources.

Based on these projections, the concluding proposal is that negative net transfers from the HICs have to be reversed, in a way that maximizes their growth potential and by means of options that are mutually acceptable to both creditors and debtors. Otherwise, these countries will confront severe payments difficulties, which in its turn would have an unfavorable impact on their growth and would transform their indebtedness, in the nineties, into an even more critical issue than it has been in the eighties.

VI. 3. WORLD DEVELOPMENT, ACCORDING TO THE WORLD BANK (WDW/21/88 - 6 July 1988)

This year, the first part of the World Bank's WORLD DEVELOPMENT REPORT is dedicated to explore "policy options for global adjustment." It addresses three basic issues: 1) the external imbalances among leading industrial economies; 2) the need for policy reforms in developing countries; and 3) the reduction of the net resource transfer from developing countries to the rest of the world.

After reviewing recent economic developments in the evolution of the leading industrial economies, the REPORT focuses on the prospects of stabilization for the dollar. On one side, it points to the risks entailed by a further depreciation of the dollar, in the form of inflationary pressures in the United States, as well as by a corresponding rise in interest rates. But if, despite these trends, investors become reluctant to hold dollar denominated assets, this can provoke instability in financial markets. On the other side, the stability of the dollar can require continued currency intervention, which in its turn might result in unwanted monetary expansion, with tighter credit and rising interest rates in response increasing the risk of domestic recession and another disruption in the stock market.

Within these two unwanted alternatives, concerted policy action by the main industrial countries is described as "the only way to reduce payment imbalances to sustainable levels, avoid a recession in the United States, and set the stage for steady growth worldwide during the next decade."

Probably of more interest is the section dedicated to describing the situation of "developing countries in the world economy," where some innovative points are made on issues such as external trade and the debt overhang.

On commodity prices, despite a slight improvement in 1987, by the end of the year they were "still some 32 percent below the average for 1980-1984." And where this decline was not compensated by increases in volume growth, as in Latin America and South Asia, the purchasing power of commodities also declined.

Exports of manufactures from developing countries have been declining as well, in value and in volume. Again, the decline has been more pronounced in Latin America and in Sub-Saharan Africa. Although, admittedly, "even the best performers experienced a decline in the growth of exports of manufactures," with the purchasing power of total exports reflecting this, particularly in Latin America where it fell by 26 percent.

What is termed "the other main external determinant of the economic performance of developing countries" is the cost and availability of external finance, upon which, the debt crisis is having "a profound impact." In this regard, "one of the most urgent tasks facing the international community" is described as "to find ways of reducing the drag exerted by the continuing debt overhang on economic growth in the developing world."

Even so, the cost and availability of external finance has deteriorated, with voluntary lending coming to a virtual standstill after 1982 and the United States making a bigger claim on world savings, due to the rapid deterioration in the U.S. savings-investment balance.

Some of the implications of all this are spelled out, in the form of the reversal of net resource transfers to developing countries. This shift in resource transfers is said to be "especially pronounced" for the highly indebted, middle-income countries, for whom a $61 billion net gain in 1978-82, in the next five years, became a net loss of $93 billion --or more than 2 percent of their aggregate GDP. Furthermore, this "drain of resources forced many countries to undertake rigorous domestic adjustments," by which an average trade surplus of only $2 billion in 1982 turned into an average annual trade surplus of $32 billion during 1983-87.

Nonetheless, the debt overhang persists, "as an obstacle to growth in the debtor countries and a threat to the world economy." Thus, the outstanding long-term debt of developing countries has continued to increase; poverty is on the rise; and negotiations between creditors and debtors have gradually become more confrontational. Finally, the danger of future defaults and moratoria "remains a potential threat to the stability of the international financial system," with import compression in the highly indebted countries "hampering the export growth of the industrial countries --especially the United States." As an example, from 1980 to 1986, "the U.S. trade balance with Latin America turned from a surplus of around $2 billion to a deficit of $13 billion." From this, the conclusion is derived that "as long as debt service continues to absorb a large part of the debtors' export revenues, their imports will not revive and global economic growth will suffer."

These considerations lead to the proposition that "a comprehensive framework" is needed to deal with the debt overhang. Two objectives are singled out as central to this framework: first, "to enable debtor countries to allocate more resources to investment and consumption" and second, "to strengthen their creditworthiness, thus eventually permitting a resumption of voluntary commercial lending."

It is also proposed that this "comprehensive framework" should contain two elements: first, "the debtors need to grow faster and export more" and second, "the cost of debt service must fall." All this leads to a description of what are called "the right policies in both industrial and developing countries."

First of all, under the heading of "structural adjustment," it is asserted that "the key to faster growth and better export performance is the more efficient use of domestic resources in both the public and private sectors" of debtor countries.

Second, there have to be "new external capital inflows," to finance new productive capacity to provide support for policy reform and growth.

Third, "a better trading environment" means favorable prices for developing country exports and unimpeded access to growing markets in industrial countries, as well as the reversal of the trend of rising protectionism. Fourth, lower interest rates are required because "long-term solvency depends directly on the cost of debt." Accordingly, it is recalled that for the highly indebted, middle-income countries, every percentage point decrease in the cost of debt service would lower their interest burden by an estimated $5 billion and reduce their debt-service ratio by about 4 percentage points. Thus, "a return to low and stable interest rates would significantly improve the prospect of a gradual release from the debt overhang." Finally, "to alter the profile of debt service," some degree of debt restructuring and of debt relief will be needed, although this will have to vary from country to country and over time.

In sum, concludes the REPORT, "progress is needed simultaneously on many fronts. Measures to improve the international outlook, domestic policy reform, new money and creative debt-restructuring approaches are all necessary. The right mix of ingredients will vary from case to case."

Finally, on the basis of these assertions, the REPORT describes the outlook for the world economy until 1995. It depicts two scenarios, based on the policy changes that have to be adopted by both developed and developing countries. The "high case scenario" assumes that if such policy changes are implemented, the industrial countries can achieve annual growth in per capita GDP, for the period 1987-1995, of an average of 2.6 percent. In this scenario, developing countries could average a real per capita GDP annual growth of 3.6 percent. By contrast, the "base scenario" assumes that these policy changes are not implemented and the same projections drop to 1.8 percent for the industrial countries and to 2.2 percent for the developing countries.

These are, very briefly summarized, some of the main highlights offered this year by the World Bank's vision of world development. Probably, the most outstanding trait of this first part of this year's REPORT is the central role ascribed to the debt overhang and the forward-looking manner in which are described different measures to overcome it.

VI. 4. PUBLIC FINANCE AND DEVELOPMENT
(WDW/22/88 - 13 July 1988)

As usual, the second part of the World Bank's WORLD DEVELOPMENT REPORT is dedicated to a specific subject. In 1986, it was agricultural protectionism and in 1987, the role of foreign trade in industrialization.

This year's subject is public finance policies and development, addressed according to the following outline: the role of public finance in development; fiscal policy for stabilization and adjustment; reforming tax systems; improving the allocation of public spending; spending priorities and revenue options in selected sectors; financing local government; strengthening public finance through reform of state-owned enterprises; and directions for reform.

These headings illustrate the depth and breadth of the analysis presented in the REPORT on this relevant and controverted issue. What follows is only a brief description, which necessarily sacrifices the REPORT's richness.

The role of government is considered essential, directly and indirectly, for the allocation of resources. When they provide defense and social infrastructure, governments are said to act directly, as when they supply power and telephone services, or when they produce industrial and agricultural goods. The indirect influence of governments is found in subsidies and taxes, as well as in regulatory tools, such as price controls and quantitative restrictions.

Certain factors are held responsible for complicating "any analysis of public finance policies." First, the dividing line between public and private is considered "unclear." Second, governments are not "monolithic entities, but consist of many agencies with varying degrees of autonomy." And third, accurate data on public finance in developing countries is said to be lacking.

To illustrate the rapid growth of the economic role of governments, the REPORT describes how the share of government spending in GNP has been increasing in industrialized countries, since 1880, from 10 percent to an average of 47 percent in 1985. In developing countries, since 1940, this share has also risen, from 19 percent of GNP in 1972 to 26 percent in 1985.

Some general conclusions are drawn from this anlysis of the evolution of public expenditure. First, the share of central government expenditures in GNP is still smaller in developing than in developed countries. Second, the public sector tends to play a greater role as an investor in developing countries. Third, in most developing countries state owned enterprises (SOEs) account for important shares both of total public spending and of GDP. Fourth, state and local governments have a smaller role in developing countries than in the industrial world.

Parallel to this expansion in the role and the size of public sectors, there has been a redefinition of the views about this role. Two mutually exclusive viewpoints are said to exist. On one side, the "private interest" emphasizes the potential for failure and cautions against viewing government "as the impartial guardian of the public interest." On the other side, the "public interest" stresses the potential benefits of government intervention, "when it is effectively deployed to correct market failures."

The World Bank, instead of choosing between these alternatives, says it is more fruitful "to consider the public and the private views ~~as contributing~~ complementary perspectives," in what is characterized as "a pragmatic approach to public policy."

The purpose of this "pragmatic approach" is described as "to draw strengths of both the public interest and private interest" viewpoints, by means of: 1) considering the benefits and costs of governmental involvement; 2) asking which groups are likely to receive the benefits and which to bear the costs; 3) recognizing the institutional and political constraints that are likely to be encountered in implementing a particular policy; and 4) searching for ways to ensure that the public sector operates efficiently within these constraints.

From these considerations the conclusion is derived that "what matters is the quality of government, more than its size as such." Quality is defined according to the five following criteria: 1) prudent fiscal policies, by bringing expenditures more closely in line with revenues; 2) efficient revenue mobilization, by raising additional revenues in the most cost-effective way and to cut spending in the least damaging way; 3) to set priorities for public expenditures, in order to improve the effectiveness of the public sector in supporting long-term growth and poverty alleviation; 4) an appropriate structure of government, by improving the effectiveness of its constituent parts, as well as the relations between these parts; and finally, 5) a good administration.

The chapter on fiscal policy for stabilization and adjustment deals with "one of the most important aspects," defined as "the management of the public sector's deficit." Given the impressive growth of deficits during the previous decades, by contrast, the eighties are characterized by the equally impressive reduction of these deficits. The challenge, admittedly still insufficiently confronted, is described as to contain the deficits without further falling into recession.

The REPORT clearly distinguishes between stabilization and structural adjustment. The first one is described as the short-term treatment of problems that have to be dealt with urgently, while the latter is understood as addressing the obstacles encountered by long-term growth. This chapter also contains sections dedicated to the fiscal dimension of the external debt crisis, as well as the fiscal management of commodity export cycles.

On the revenue side, the reform of tax systems is required, since most of them could be restructured to increase yield, reduce distortions and minimize the burden on the poor. On the spending side, given the high costs of raising revenues, it is considered vital to set priorities according to what governments and markets do best. Also, to improve the efficiency of public spending the reform of "fiscal planning" is required, which involves the formulation of "a phased investment program, projecting current spending needs, and assessing revenue availability and borrowing requirements," for a five year period and in the context of a consistent macroeconomic framework. In these terms, the annual budget becomes "a comprehensive one-year slice" of the medium-term plan.

Finally, concerning local governments, decentralization is viewed as an instrument for the increase in public accountability and responsiveness to local preferences. Also, the reform of state-owned enterprises is mentioned as one of the essential features of the broader fiscal reforms required.

To conclude, the REPORT outlines the directions in which the reform of fiscal policies should move: 1) the adoption of prudent fiscal policies; 2) the reduction of the costs of increasing revenues; 3) the increase in the efficiency and effectiveness of public spending; 4) the strengthening of the autonomy and accountability of decentralized public entities; and 5) the design of public finance policies consistent with poverty alleviation goals. These constitute the elements of the comprehensive approach to public finance sponsored by the World Bank. Evidently, the most salient trait of this proposal resides in its pragmatic, as opposed to its ideological, orientation.

VII. MULTILATERAL FINANCIAL INSTITUTIONS

VII. 1. THE WORLD ECONOMY, ACCORDING TO THE IMF
(WDW/9/88 - 13 April 1988)

With the spring meetings of the Group of Twenty Four, as well as of the Interim and the Development Committees, the International Monetary Fund (IMF) issues the WORLD ECONOMIC OUTLOOK, on the state and perspectives of the world economy.

This year, the world economic setting for this annual ritual has been considered, by Peter Kilborn of THE NEW YORK TIMES, as "unusually calm." The world economy is expanding at an annual rate of 3 percent, inflation in the main industrialized countries remains low, and the dollar is experiencing a period of stability. Even "some of the acrimony between developing countries and their Western lenders" is said to have "subsided." Last but not least, the Reagan Administration is "not inclined to do anything that would rock the boat in a Presidential election year."

In this setting, the Fund views the world economy as "continuing to expand at a moderate pace," while the persistence of large fiscal and external imbalances "clouds the international economic outlook." As "positive developments," the Fund considers that the Federal budget deficit of the United States has fallen "substantially," since it was reduced by the equivalent of around 2 percent of GNP, during fiscal year 1987. Also, on the positive side, the Fund considers that as a consequence of the steps to encourage the expansion of domestic demand, basically in Japan and West Germany, the real trade balances of the major industrialized countries are said to have undergone significant adjustments in the desired direction. Finally, it is also considered positive that the growth rate of industrialized countries attained 3 percent, while inflation remained low. For the developing countries, the continuation of adjustment efforts, coupled with a recent recovery in the terms of trade, are considered positive because of what the Fund calls "the first significant fall in debt-export ratios since the onset of the debt crisis."

Nonetheless, the following "worrisome developments" are also recognized: 1) a remaining concern is said to prevail in markets because of the persistence of major financial imbalances among industrial countries; 2) these disequilibria also reflect themselves in the recurrent unstable conditions in foreign exchange markets; and 3) "a major source of concern" are the difficulties experienced by developing countries to restore credit worthiness and re-establish the momentum of the development effort, since rates of economic growth are said to "have remained low and investment has not revived." Furthermore, other negative signs are found because adjustment efforts are said to be "flagging" and inflation is said to have "accelerated sharply," while fiscal deficits "remain high."

The IMF offers projections for 1988 and 1989, in the form of scenarios, envisaging a continuation of moderate growth with low inflation in the industrial countries. Payments imbalances are projected to diminish, although deficits and surpluses will remain close to 3 percent of GNP in the three largest industrialized countries. In developing countries, the Fund sees prospects for some recovery of growth, if the benefits of "recent increases in commodity prices are felt more strongly." Nonetheless, it is admitted that "external financial pressures in developing countries will probably remain severe," with borrowing expected "to remain low," while debt ratios will continue to decline.

It is interesting to describe briefly, before mentioning the policy challenges posed by these perspectives, the different medium-term scenarios that were drawn to arrive at these projections. The first is called "the reference scenario." It is based on the assumptions that policies will remain unchanged, constant real exchange rates, and the absence of financial market disturbances, in particular of major changes in interest rates and stock prices. The second is called "the financial tensions scenario." It explores the possible consequences of retaining present policies and of market reactions, if economic agents perceive the resulting financial imbalances to be unsustainable. The Fund characterizes this scenario as "somewhat speculative," since admittedly, "conventional techniques for making economic projections do not permit confident judgments about how and when an unsustainable trend will eventually be reversed." Finally, a "policy adjustment scenario" explores different implications of the policy actions suggested to relieve the tensions perceived as looming in the medium-term.

Some of the policy issues that have to be confronted to avoid these tensions are spelled out. The "principal policy issue" for the industrialized economies is found in the reduction of the fiscal and current account imbalances. This is considered the major threat to "the sustainability of stable expansion." Consequently, the policy challenge is defined as reducing these large imbalances, while preserving the progress made in other areas, such as "lowering inflation, reducing fiscal deficits, tackling structural rigidities, and sustaining growth."

Other issues among industrial countries are seen as "not yet fully resolved," such as the role of exchange rates in the adjustment process; burden-sharing of adjustment among deficit and surplus countries; as well as the degree of emphasis to be given to macroeconomic relative to structural measures in supporting non-inflationary growth, while bringing about the required distribution of demand between domestic and external actors.

A separate section deals with the matter of growth and debt in developing countries. On the positive side are the efforts made by developing countries to improve their external situation, which are said to have resulted in "a dramatic strengthening of their current accounts." Moreover, it is admitted that "the specter of widespread defaults and breakdown of relations between debtor and creditor countries has thereby been avoided."

Nonetheless, several facts are found on the "disappointing side." First of all, it is recognized that the size of developing country debt relative to exports remains considerably higher than at the onset of the debt crisis.

This assertion is followed by an admission that deserves to be quoted separately. The size of the debt is said to be such, because "adverse terms of trade movements have repeatedly offset much of the strengthening of exports in volume terms." Also, in developing countries, "although growth has recovered somewhat in recent years, it has nevertheless remained low by historical standards, and has been vulnerable to adverse developments in the external environment." Even so, the maintenance of a favorable external environment is in itself insufficient to permit a resumption of growth. Because in those countries where investment rates have fallen sharply, it will be necessary both "to reverse the previous declines in the volume of investment and to improve the efficiency of investment." And in the absence of "additional foreign financing this will require that a larger share of domestic output be allocated to investment, concurrently with an enhancement of incentives to raise investment efficiency." In these terms, the policy challenge for developing countries is defined as "how to revive growth in an environment of uncertainty regarding world economic prospects and continuing debt problems."

The report concludes with a list of key issues suggested as "topics of discussion" to the Fund's Board of Directors. These topics are: 1) the realism of the projections; 2) what are the most appropriate policies for external adjustment; 3) how to revive growth in developing countries; 4) the management of the debt situation; and finally, 5) the international monetary system and the role of the Fund.

VII. 2. THE IMF-WORLD BANK SPRING MEETINGS
(WDW/10/88 - 20 April 1988)

It is not easy to try to pierce through the very dry rhetoric generated by the different meetings that every spring take place within the framework of the Washington-based, world-wide, financial institutions. For one thing, several meetings take place during a week and each one of them solemnly produces a "communique," phrased in terms which basically play-down contrasting positions about dominant world economic issues. Hardly ever, in the texts made known to the public, differences on these matters appear openly. The image projected by these communiques is of consensus and sometimes even of harmony and cordiality. Obviously, each meeting caters to the interests of different constituencies.

Only relatively extreme circumstances seem to be capable of altering this apparent atmosphere of civility and formality. As it was the case when the news of the U.S. trade deficit shattered the relative calm projected in the communique issued, just a few hours before, at the conclusion of the meeting of the Group of Seven industrial countries. Thus, the markets plunged, while the Ministers shivered, when it was learned that in February the trade deficit of the United States had increased to $13.8 billion, up from $12.4 billion in January.

The week started with the meetings of the deputies of what is officially known as the Intergovernmental Group of Twenty Four on International Monetary Affairs, better known by the shorter G-24. This year, the communique issued at the end of the ministerial meeting of the G-24, which followed after two days of meetings by the deputies, still was the lengthiest of all those issued during the week. But contrary to the previous two years, instead of adding a statement on immediate action, only a "summary of recommendations" was issued, as an introductory statement to the press conference offered by the Chairman of the G-24, the Minister of Finance from Brazil.

On the present circumstances and perspectives, the G-24 emphasized in its communique that "without increased growth in industrial countries, an opening of their markets, as well as a substantial increase in financial flows to developing countries, there cannot be improvement in the growth rates or external positions of developing countries, regardless of the strength of their adjustment measures." Furthermore, the G-24 emphasized that "there is no way out of the debt problem without a reversal of the negative transfer of resources and a reduction in the debt overhang."

As expected, by stark contrast, the communiques of the Group of Seven and of the Group of Ten industrialized countries address the same circumstances in relatively different terms. For instance, the Group of Ten "underlined the continuing validity of the present debt strategy, built on an appropriate mix of adjustment and financing." Also, the most lengthy section of the communique issued by the Interim Committee of the Boards of Governors on the International Monetary System, ~~better known~~ only as Interim Committee, addressed the same issue in similar terms. It asserted "the importance of continuing the case-by-case approach to debt problems," noting that "this was the only way in which adjustment programs and financing flows could be tailored to individual country circumstances." Moreover, the Interim Committee stated that "to marshall continued support for their adjustment efforts, debtor countries must be able to demonstrate that their policies yield positive results."

Somewhat contrasting was the wording used by what is officially known as the Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries. In attention to its more lengthy official name, the press communique issued by what is known as the Development Committee stated that its members agreed that "an enlarged volume of financial flows to the developing countries was required to meet the needs for economic growth, poverty alleviation, environmental conservation, structural adjustment and the resolution of debt difficulties." Furthermore, the "problem of debt in the heavily indebted middle-income countries," was discussed "in the context of the transfer of resources and the need for achieving sustained growth through adjustment programs." In such a context, the Development Committee "reaffirmed its support for the case-by-case market-oriented strategy," recognizing that "strong economic programs were essential" and also admitting that "resource constraints remained a major problem."

Evidently, this very brief description only touches upon some of the most important issues addressed by the different meetings. Other matters which appeared prominently were, for instance, the economic situation and prospects. In this regard, the Interim Committee "noted that economic activity appeared to have been relatively well sustained in industrial countries in spite of the decline in stock markets in October. Also, inflation remained low, and progress was being made in reducing payments imbalances." Contrasting the situation of 1986 with that of 1987, the Interim Committee noted that "the ratio of debt to exports had declined in a number of developing countries, and export earnings had recovered in response to the ~~strengthening~~ of commodity prices and improved competitiveness." As for the prospects in industrial countries, they were seen as "a continuation of steady, moderate economic growth." Nonetheless, the Committee admitted that "important challenges still lay ahead." For instance, in the industrial countries "payments imbalances continued to be large, and unemployment, especially in Europe, remained high." In the developing world, the Interim Committee recognized that "progress in restoring the momentum of investment and output growth had been inadequate, and the burden of external indebtedness remained a major source of concern."

To conclude, probably the most adequate terms to characterize briefly the bottom line of all these discussions and statements were those used by Hobart Rowen in THE WASHINGTON POST. He said that during this last "upbeat week," apparently "all was sweetness and light," and that "harmony, not confrontation, was the byword." According to Rowen, the explanation for this relatively happy state of affairs might be found in the fact that, in this election year, America's allies "don't want to give the current Republican administration any additional problems; they would rather see George Bush win the election than any contesting Democrat, likely to be more protectionist minded."

VII. 3. <u>THE WORLD BANK'S RESEARCH PROGRAM</u>
(WDW/17/88 - 8 June 1988)

A memorandum from President Conable to the Executive Directors indicates that one of the premises underlying the recent internal reorganization of the World Bank is to preserve its role of "intellectual leader in the field of development." This year's review of the social and economic research supported by the Bank is thus "a transitional report," since it describes not only the performance in 1987, but also looks forward into the new directions for research activities in the coming years.

During fiscal year 1987, the World Bank devoted $23.3 million to economic and social research. Of this amount, $19.3 million was for 82 years of staff time dedicated to research, while the balance of $4.0 million was for support activities, such as consultants, travel, computer time, and research assistance. These figures differ only slightly from those of the previous fiscal year and they represent 3.1 percent of overall administrative expenses.

The research projects financed can be broken down into centrally approved, or those that the central research administration approves for funding from the Research Support Budget and departmentally approved, or those undertaken by the different departments with their own resources. This reveals that there is no single, comprehensive source of information and coordination of Bank research. Apparently, only preliminary steps have been taken to establish an information system to provide an inventory of ongoing research activities.

This dualism can be better appreciated by noting that, during 1987, centrally approved projects accounted for $7.4 million, or 32 years of staff time and all the resources distributed through the Research Support Budget. By contrast, departmentally approved research projects accounted for $11.9 million, or the equivalent of 50 staff years, with their share increasing to 51 percent in 1987, up from 42 percent in 1983.

Important changes are also found in the distribution by subject of all research projects. In 1987, macroeconomic and international issues rose to 58 percent of the total, up from 48 percent in 1986, while the share of sectoral research fell from 52 percent in 1986 to 41 percent in 1987. Of the $9.7 million devoted to sectoral research, 40 percent went to agricultural and rural development and 37 percent to population and human resources. The $11.4 million for centrally approved projects was distributed as follows: more than half, or $6.1 million for global or cross-regional research, of which $3.2 million went to comparative studies, while $5.3 million was for research in individual countries or regions, with more than two-thirds, or $3.6 million, for studies on Sub-Saharan Africa.

In 1987, the number of projects centrally funded decreased to 55, from 64 in 1986 and 70 in 1985. The distribution of these funds is skewed towards very large projects, such as four comparative studies, costing $2.5 million each, as well as 47 small projects costing less than $50,000 each. Finally, the participation of regional staff in research declined from 9 percent in 1980 to 6 percent in 1987.

Briefly, the following trends appear in the recent evolution of research spending at the World Bank: 1) the share of departmentally approved research is increasing; 2) macroeconomic and international issues are becoming dominant subjects; 3) there is a trend towards the funding of very large or very small projects; and 4) the staff dedicated to regional affairs is only scarcely involved in research activities.

The subject distribution of new and ongoing projects reveals the substantive agenda of World Bank research. Of the 24 new projects approved during 1987, fifteen deal with government intervention in the economy, as well as with the role of institutional arrangements on the impact of policy measures. Three other new projects deal with the international economic environment and three more deal with the way macroeconomic issues affect growth. The remaining new projects deal with subjects such as poverty, employment of women and training and technical education.

Ongoing research projects were dominated by four comparative studies, which account for about two thirds of the whole Research Support Budget for 1987, as well as for three years of staff time.

The subjects covered by these large comparative studies are: 1) the timing and sequencing of trade liberalization in 18 countries; 2) agricultural pricing in 18 countries; 3) poverty, equity and growth in 21 countries; and 4) macroeconomic policies, crises and long-term growth in 17 countries.

The results of these research efforts were disseminated by means of three publications: The World Bank Research Observer, started in 1986; The World Bank Economic Review, issued three times a year; and finally, a quarterly newsletter, Research News.

Looking to the future, the Wold Bank recognizes the following basic objectives for its research activities: 1) to broaden the understanding of the development process; 2) to strengthen the intellectual foundations of Bank policies and project design; and 3) to assist indigenous research capacity in developing countries.

The main challenge confronted by these objectives is described as assuring that research outputs are available, useful and used by the Bank's operations staff, overcoming the tensions and distance that usually prevail between researchers and operations staff. For this purpose, a new and more adequate internal structure is headed by a Research and Publications Council, under the chairmanship of the Senior Vice-President for Policy, Planning and Research, Mr. David Hopper, to set priorities and establish financial guidelines, as well as to appoint the participants in two other committees. First, a Research Committee functions under the chairmanship of the Bank's Chief Economist, Mr. Stanley Fischer, to apply the Council's guidelines and to evaluate past efforts, as well as to exercise control over funding applications. The other is the editorial committee, dedicated to disseminating the results of research activities.

Finally, the highest research priorities for the future include four basic subjects: 1) economic adjustment with growth; 2) the debt problem in highly indebted countries; 3) the development of Sub-Saharan Africa; and 4) poverty alleviation. Additionally, three other areas are considered new priorities: 1) women in development; 2) the environment; and 3) the private sector.

VII. 4. <u>THE WORLD ECONOMY, ACCORDING TO THE IMF'S EXECUTIVE BOARD</u> (WDW/26/88 - 14 September 1988)

Every year, prior to the annual meetings of the Board of Governors, the Fund's Executive Board releases its annual report. This year, it contains two chapters, as well as several appendixes, with the first dedicated to an overview of developments in the world economy and the second to a description of the Fund's policies and activities.

By contrast to the better known WORLD ECONOMIC OUTLOOK (WDW/31/88), which is released during the annual meetings, the ANNUAL REPORT reflects the viewpoints of the member governments represented in the Executive Board, instead of the staff's opinions. Also, while the REPORT looks backward to IMF's performance during the previous financial year--ending in April--the OUTLOOK offers the staff's viewpoint on the perspectives of the world economy.

Probably because it reflects the positions of the member governments, the REPORT circumscribes itself to a description of the contrasting signs which characterize the functioning of the different segments of the world economy. This avoidance of drawing an overall balance, constitutes the REPORT's most salient characteristic. Thus, it is only recognized that "global economic developments in the period under review were somewhat mixed."

The first chapter on the world economy is divided in two parts. The first part deals with domestic policies and touches upon the policy setting, domestic activity, and inflation in industrial and developing countries. The second part deals with international trade and payments, focusing on world trade, international capital markets, international liquidity, as well as exchange rates, balance of payments developments in industrial and developing countries, and concludes by dealing specifically with the issue of financing and debt.

In the industrial countries the REPORT finds "relatively buoyant activity," which manifested itself in an steady expansion of real output, amidst a low rate of inflation, of 3%, and a decrease in real terms of large external imbalances. This is associated with an expansion of world trade of more than 5% in volume, which allowed for what are seen as "important policy achievements," such as the reduction in the U.S. fiscal deficit, of 2% of GNP, as well as the adoption by Japan and West Germany of measures to stimulate their economies.

By stark contrast, recent economic trends in the developing world are seen as "more mixed." On the positive side, many developing countries are said to have experienced "vigorous export growth," with the result that "debt-to-export ratios declined significantly." Also, in 1987, current accounts were approximately balanced, compared with the deficit, in 1986, of $41 billion.

On the negative side, the average growth rate in developing countries fell from 4.2% in 1986 to 3.4% in 1987, which is attributed partly to a deceleration in the growth of "some of the larger non-fuel exporting countries." Somewhere else, it is recalled that real non-oil commodity prices, at the end of 1987, were 30% lower than in 1980. Moreover, among the group of sub-Saharan African countries, the rise in output remained below the rate of population growth, "a trend that continued the steady erosion of living standards these countries have experienced in almost every year since 1980." Finally, it is considered worrisome that inflationary pressures intensified sharply, in part because of the "effects of currency depreciations in combination with relatively lax financial policies."

Illustratively, the chapter concludes with an analysis of the debt situation in developing countries. Little change is found, in 1987, regarding their "underlying financing position," although admittedly "overall developments masked the very different situations of specific groups of developing countries." Among these, in 1987, the fuel exporters and the exporters of manufactures are said to have adjusted their current account positions. By contrast, in the rest of the developing countries "there was little change in the tight external financing position that they had faced in 1986." Thus, their aggregate current account deficit widened to $21 billion; reserve cover remained at only 13 weeks of imports; and net external borrowing remained at $19 billion, barely higher than the depressed level of 1986.

The stability of official financial flows to developing countries is considered "striking," because official flows to capital importing countries, in 1980-85, were in the range of $27-33 billion annually, while in 1986-87, average disbursements rose to more than $36 billion.

Nonetheless, the same degrees of stability have not characterized credit from the Fund, since net flows averaged $1 billion annually in 1978-80, they rose to an annual average of more than $7 billion in 1981-84, and reversed themselves in 1985-87, a period during which developing countries made net repayments averaging $3 billion annually. The explanation for these changes in Fund borrowing is found in the revolving nature of its resources, as well as in the efforts of many countries to reduce their financing requirements.

By contrast, non-official lending to what are called the capital importing countries rose in 1987 to $9 billion, from a negligible level in 1986. Although this "was entirely the result of increased disbursements under concerted financing arrangements," of which $4.4 billion went to Mexico and $1.2 billion to Argentina. Meanwhile, spontaneous net lending remained negative. By contrast with the average $12 billion of excess in repayments over inflows, during the 1983-86 period, net repayments to private creditors by countries with recent debt-servicing problems declined to $3 billion. Even so, "little evidence" is found that "a substantial reversal of the negative resource flow is likely to occur in the near future."

Still, in 1987, the total dollar value of the outstanding debt of developing countries rose by 10.4%, to $1,217 billion, equivalent to 39% of aggregate GDP, with two thirds of this nominal increase attributed to the impact of exchange rate movements on the dollar value of debt denominated in other currencies. Thus, the underlying increase in debt was 4%, similar to the increases in 1985 and 1986. Also, the ratio of debt to exports decreased, from 169 in 1986 to 158 in 1987, and the overall debt-service ratio of developing countries as a whole decreased from 22 percent in 1986 to 30 percent in 1987.

The REPORT concludes asserting that the debt situation "continues to require a cooperative approach," characterized by "better domestic policies in the indebted countries, a continued favorable external environment, and adequate external financing."

VII. 5. IMF'S PERFORMANCE IN FINANCIAL YEAR 87-88 (WDW/27/88 - 21 September 1988)

A separate chapter in the last ANNUAL REPORT deals with the "policies and activities of the Fund." It describes a rather dynamic institution, successfully adapting itself to changing circumstances, by performing its prescribed tasks, as well as by transforming its procedures and facilities, its policies and activities.

The chapter on the Fund's performance, as the previous chapter dedicated to the world economy (WDW/26/88), reflects also the stratification of the world economy. It deals, on one side, with those activities pertaining to the relations among "the large economies with the biggest impact on international economic conditions" and on the other, with the financial support granted to adjustment programs, obviously, in the developing countries.

Consequently, part of the REPORT's second chapter describes issues such as surveillance and Article IV consultations on economic performance in individual G-7 members --United States, Japan, Federal Republic of Germany, France, United Kingdom, Italy, and Canada. Moreover, international liquidity and the role of Special Drawing Rights (SDR) are also addressed. The conclusion about the possibility of "renewed SDR allocations," is that "the degree of support has not reached the level required by the Managing Director to make a proposal for an allocation to the Board of Governors."

The other part of the chapter deals with the external debt situation and strategy and the financial support of adjustment programs. On the debt issue, the REPORT points out, first, that "the Fund has played a central role in developing a cooperative strategy for dealing with these difficulties and continues to be fully involved in its implementation."

Second, the "case-by-case debt strategy" is defined following the Interim Committee's communique of last April, as constituted by "three requirements: the sustained implementation of growth-oriented adjustment and structural reform policies by debtor countries; the maintenance of a reasonably favorable international environment; and an adequate flow of financing to debtor countries from official, multilateral, and private creditors."

Third, a list of the strategy's achievements contains the following: 1) "the significant external adjustment in many indebted countries;" 2) the containment of "the threat of a serious dislocation of the international financial system;" and 3) "the international banking system has been substantially strengthened."

Nonetheless, the REPORT recognizes that "serious problems remain that call for the continuation of strong cooperative efforts." Among these are mentioned: 1) "policy reforms in a number of debtor countries have not been undertaken with the desired speed, scope, or intensity;" 2) "the international economic environment has continued to be difficult;" and 3) "although growth has resumed in many countries with debt difficulties, it is still modest."

The support of adjustment programs leads directly to the issue of conditionality, which underwent the latest "comprehensive examination" in April 1988, with previous comparable examinations completed in 1968 and 1979. This last revision covered the following highly controverted matters: 1) how can adjustment programs foster growth; 2) how do adjustment programs affect poverty; and 3) how to monitor structural adjustment.

Admittedly, the overall objective of adjustment programs is to "foster sustainable economic growth in a medium-term perspective," as well as to mitigate, without sacrificing their goals, the impact these programs necessarily have on poverty. Even so, the most concrete results attained by this last comprehensive review of conditionality were related to the monitoring of programs. Thus, heretofore, certain arrangements will be submitted to semiannual rather than quarterly performance criteria.

By contrast, the most important modifications experienced by the Fund in the last year can be found in the design of what are called "facilities." First, the Structural Adjustment Facility (SAF), to provide balance of payments assistance to low income countries, was transformed into the Enhanced Structural Adjustment Facility (ESAF). This means that its resources were tripled through contributions from sources other than repayments, with the interest rates and loan maturities remaining at about the same levels as those prevailing under the SAF. A major innovative feature of both the SAF and the ESAF consists in the requirement that "a policy framework paper be prepared by the national authorities, with the joint assistance of the staffs of the Fund and the World Bank."

Second, a revision of existent external contingency mechanisms led to the creation, by the end of August 1988, of a Compensatory and Contingency Financing Facility (CCFF), by adapting the compensatory and cereal facilities and complementing them with an external contingency financial policy.

The purpose of this new facility is to maintain the momentum of adjustment programs in the face of unexpected adverse external shocks. Thus the CCFF will provide financial assistance to member countries that encounter balance of payments difficulties that arise out of: a) temporary export shortfalls; b) adverse external contingencies; or c) excess costs of cereal imports.

Finally, modifications were introduced to the Extended Fund Facility (EFF) and the Enhanced Access Policy, increasing the means of actual access to Fund's resources in support of medium-term adjustment efforts, particularly among middle-income countries.

The REPORT also acknowledges that the achievement of a viable balance of payments position and of sustainable rates of growth demand structural adjustments. In its turn, this has led to an increase in the interaction between the Fund and the World Bank, in such a way that "the policy advice and financial resources provided by the two institutions have been made consistent and mutually reinforcing." Even so, "cross-conditionality" is rejected specifically.

To perform these tasks the Fund, in financial year 87-88, employed around 1,700 persons and had actual administrative and capital expenses of SDR 172.3 million, down from the SDR 191.7 million spent during the previous financial year.

All in all, the REPORT projects the image of an institution placed at the center of the most crucial international financial rescue operations, undergoing simultaneously important modifications in its role and activities. Nonetheless, despite all these activities and transformations, economic performance was particularly feeble in two groups of countries, the middle-income heavily indebted, as well as the low-income countries. No wonder, the average rate of growth in developing countries as a whole fell from 4.2 percent in 1986 to 3.4 percent in 1987, with the consequent steady erosion of living standards. Thus, the Fund is still quite short of fulfilling satisfactorily one of its basic purposes. As stated in Article I, (v) of the

Articles of Agreement, the Fund's programs must be executed "without resorting to measures destructive of national or international prosperity."

VII. 6. <u>THE WORLD BANK'S ANNUAL REPORT 1988</u>
(WDW/28/88 - 28 September 1988)

With the yearly ritual of its annual meetings, the World Bank, as the International Monetary Fund (WDW/26-27/88), issues its ANNUAL REPORT of activities, covering the period of July 1, 1987 to June 30, 1988.

Divided in seven sections, the REPORT describes the activities of the Bank's Executive Board; it offers a global perspective of the economic scene; it describes the Bank's finances, as well as its policies and operations; it deals with regional perspectives, among which a special segment is dedicated to Latin America and the Caribbean; and finally, it summarizes the projects approved by the institutions forming part of what is known as the World Bank Group.

The description of the world economic scene focuses separately on the developed and the developing countries. Economic activity in the industrialized countries is said to have experienced a pick-up, with a further diminution of inflation and labor costs, as well as increases in productivity. Japan is singled out because of its "major contribution in setting the pace of global demand."

By contrast, the situation in developing countries is less encouraging. The resurgence in demand in the industrialized countries, especially in Japan, is credited with having a major stimulative effect on developing countries' exports, although overall growth figures are still not positive. For instance, growth in output in developing countries slowed down from 4.9% in 1986 to 4.5% in 1987. Actually, GDP in Sub-Saharan Africa fell, while average growth in the highly indebted, middle-income countries was only 1.6%, down from 3.4% in 1986. Also, growth in the middle-income oil-exporting countries was below 1% and India experienced a severe drought, which slowed down GDP growth in South Asia, from 4.7% in 1986 to 2.7% in 1987. Some exceptions to this rather bleak picture can be found among certain developing countries in East Asia, as well as some others in Europe, the Middle East and North Africa.

In 1987, the external trade environment for developing countries as a group is said to have "improved somewhat." The dollar price of oil "recouped in 1987 about half of its loss of 1986." Unfortunately, this does not seem to be the case of the prices of non-oil commodities, which remained "somewhat flat for the second year in a row." This is basically explained by a drop in the index of food and beverages, which offset the turnaround in the indices for metals and minerals and for nonfood agricultural products. Behind these "disparate movements" in commodity prices, the World Bank finds "the unwinding of the 1986 coffee-price boom, further depression of grain prices, and the boom in metal prices as a result of the industrial expansion in Japan, the United States and the United Kingdom."

To sum up, total nonoil commodity prices --in terms of special drawing rights (SDRs), to avoid the distorting effects of the depreciation of the U.S. dollar-- dropped substantially again from 1986 to 1987 (-8.7%), though not by as big a percentage as in 1985 (-10.6%) and 1986 (-13.2%). Consequently, "the impetus to renewed growth in 1987-88 that is conveyed by international market prices is being felt especially by oil-exporting countries, while countries exporting nonoil primary products (especially food and beverages) have not yet benefited much from the pick-up in world trade."

Dealing specifically with the indebtedness of developing countries, the REPORT points out that the net transfer of financial resources --defined as the difference between gross disbursements and total debt service-- continued to indicate an annual net outflow for the developing countries of well over $30 billion." The conclusion is thus derived that "increasing flows of financial resources from the developing countries, taken together with the data on growth of output, exports, and imports ... add up to a pattern of shortfalls from reasonable expectations and progress that cannot be sustained in the medium term."

In these terms, "progress towards an acceptable solution to the debt crisis requires a resumption of growth in per capita terms in the debtor countries." No wonder, it is concluded that "1987 must go down as another difficult year for the highly indebted countries."

Finally, in 1987, official development assistance (ODA), from the member countries of the Development Assistance Committee (DAC) to the developing countries, amounted to an estimated US$41.2 billion, up US$4.5 billion in volume terms over the level of 1986. Nonetheless, in real terms, this amount represents a decline of 2% compared with 1986, with net disbursements of ODA from DAC countries representing 0.34% of their GNP. Only five of these countries --Denmark, France, the Netherlands, Norway and Sweden-- provided more than 0.7% of their GNP in development assistance.

The World Bank contributed to the negative flow of resources from the developing countries. Net transfers to current borrowers turned negative in 1987-88, partly as a result of the sharp decline in the U.S. dollar, which led to rapid increases in repayments, as expressed in U.S. dollar terms. In addition, during the year, there was "an absence of fast-disbursing loans to some major borrowers."

Consequently, net transfers by the World Bank to seventeen highly-indebted, middle-income countries --Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia-- after a positive $776.1 million in 1986, turned to a negative $1267.4 billion in 1987.

The segment specifically dedicated to Latin America and the Caribbean begins by recognizing the poor growth performance of the region in the last two years. Per capita growth in GDP fell from 1.6% in 1986, to only 0.4% in 1987 and early 1988. Also, excluding Brazil, GDP growth in the rest of Latin America and the Caribbean was -1% in 1986 and 0% in 1987. There are few exceptions to this rather dismal performance. Colombia and Chile are singled out as countries where recovery has been sustained for more than two years, while in Jamaica and Uruguay recovery dates from early 1986.

Furthermore, the debt problem persists despite so-called "encouraging developments." For instance, in the "menu" approach, or in the application of some mechanisms for debt reduction, as in the Bolivian restructuring agreement, or by means of other specific mechanisms, such as those applied in Chile and Mexico. Nonetheless, it is asserted that debt reduction "will not be sufficient by itself to permit the resumption of steady growth in the absence of crucial domestic reforms." Finally, in 1988, net transfers from the World Bank to Latin America and the Caribbean were negative by $361.8 million.

VII. 7. A COUPLE'S QUARREL (WDW/29/88 - 5 October 1988)

A rift has burst open between two international financial institutions that, theoretically, are expected to lead more than a harmonious existence. The announcement was made in Berlin, just before the opening of the annual joint meetings of the Boards of Governors of the World Bank and the International Monetary Fund, that Argentina and the World Bank had agreed on a $1.25 billion loan, without first arriving at an economic program with the Fund.

Rarely, if ever, has the financial community witnessed such an overt manifestation of a rupture in the habitually concerted procedures observed by these institutions, otherwise reputed to coexist, as a true Victorian marriage, without embarrassing explosions of disagreement.

Still more crucial, the World Bank loan to Argentina opens the door to a "bridge loan" of $500 billion, granted under the leadership of the U.S. Treasury, by the industrialized countries, to attend to emergency needs. Also, the agreement signals the almost immediate opening of conversations between Argentina and its commercial creditors to clear arrears in interest payments, estimated to amount to $1 billion. Finally, to comply with traditional ritual, the agreement is contained in a "Letter of Development Policy," from Argentina's Minister of Economy, Juan Sourrouille, to the President of the World Bank, Barber Conable. This document so-baptized, obviously, corresponds to the "letter of intent" signed by every recipient of IMF finance.

Nonetheless, rather than considering it an ordinary marital squabble, these events have been viewed as evidence that the rift between the Fund and the Bank is, in fact, only one aspect of a wider confrontation between the IMF's Managing Director and the U.S. Treasury.

To the surprise of those who perceive both institutions as obedient pawns, Mr. Michel Camdessus is seen as embarked in an unusually outspoken and critical confrontation with the Reagan Administration, about almost all the issues constitutive of today's international financial agenda.

Thus, the Fund's Managing Director has criticized the process prevailing among industrialized countries for the coordination of their economic policies and for exchange rate management. Also, on international indebtedness, Mr. Camdessus is said to be speaking "warmly" about debt relief, while he is said to consider insufficient the dollar exchange rate depreciation, to contribute decisively to correct the trade deficit of the United States.

No wonder, the new Secretary of the Treasury of the United States in Berlin, in his first major public address since taking over the job, on the issue of a proposed doubling of IMF quotas, stated that the institution should "remain faithful to its basic principles," warning that it must make "a compelling case," in order to request more resources.

Be it as it may, these quarrels have already allowed for unprecedented degrees of flexibility, which at least have proven to be an exception to the "cross-conditionality" allegedly practiced, always monolithically, by the Bank and the Fund. Consequently, amidst allegations of laxity emanating from "unidentified IMF staff members," although the conditionality is as stringent as usual, Argentina's economic team has achieved the rare accomplishment --ambitioned by every Third World negotiator-- of finding an alternate source of finance to bypass a recalcitrant IMF.

The focus has now turned towards other manifestations of divergence. For instance, one of the most recent was found in the presentation under one cover, to the last meeting of the

Development Committee, of separate papers on the highly controverted matter of the impact of adjustment policies on poverty. Although a note prepared jointly, by the staffs of the Bank and the Fund, summarizes the individual papers submitted, apparently, it was not possible to integrate them in a single body, except at the end, only for listing a number of issues for discussion.

Finally, immediate denials did not make themselves wait. One of the first came, although not very persuasively, in the rather cryptic language of the Interim Committee's communique. On the indebtedness of developing countries, the Committee "emphasized the continued central role of the Fund in implementing the debt strategy by helping members design medium-term growth oriented adjustment programs, monitoring the adjustment process, supporting these with its own resources, and mobilizing other financing." Nonetheless, almost as an admission of guilt, the Interim Committee immediately adds that "it noted the importance of close collaboration with the World Bank in these endeavors."

Others, more skeptical, saw this confrontation only as a manifestation of a normal contradiction, in an otherwise successfully harmonious relationship, between two institutional components of the present international system, with no major consequences beyond the Argentine "exception."

VII. 8. THE IMF'S WORLD ECONOMIC OUTLOOK
(WDW/31/88 - 19 October 1988)

As if more evidence was required, that the international economy is functioning at two, very different tempos, the staff of the International Monetary Fund issued in Berlin excerpts of the recently published WORLD ECONOMIC OUTLOOK.

The world economy seems to be performing with very different signs for at least two of its major segments. There is one bright side, represented by the industrialized economies, as well as by some newcomers, better known as the "newly industrialized economies (NIEs)," whose economic performance is characterized as "more satisfactory than was expected." For the industrialized part of the world, output "has grown strongly, world trade has been robust, and inflation appears to have remained under control."

By contrast, the other side of the world economy is bleak and here are found the low income and the highly indebted, middle-income countries. On this side, the Fund's staff sees "less cause for satisfaction," because the "positive aspects of international economic developments need to be tempered by a recognition that progress has been uneven and that important uncertainties remain." Particularly, the OUTLOOK highlights the fact that "the low income and the heavily indebted countries have failed to share fully in stronger economic performance and prospects."

The last WORLD ECONOMIC OUTLOOK contains a section dedicated to the short and medium-term prospects of the world economy; another section depicts a medium-term baseline scenario, as well as alternative scenarios of possible developments; finally, two sections describe separately the policy issues for the industrialized and the developing countries, if need be, to emphasize even more the prevailing dichotomous behavior of the world economy.

On the current situation and short-term prospects, first of all, the OUTLOOK deals separately with the levels of economic activity in industrial and developing countries. For the industrialized economies, the staff of the Fund proposes an upward revision, to 3.9%, of the projected growth rates for 1988, that is 1.1% above those envisaged in the previous OUTLOOK, issued in April 1988. Furthermore, "the central feature" of this "unexpected robustness of growth" in the industrialized countries is found in "the strength of investment," which represents "the component of aggregate demand subject to the largest revisions in the projections."

Several factors account for this relatively bright state of affairs. Among them, "the most important seems to have been the lagged influence of the large exchange rate and terms of trade changes that occurred in 1985-86." Also, some stimulus is recognized to have come from "the relative low level of short-term interest rates and the rapid growth of money supply in most of the major countries in recent years."

The contrast with the developing countries' performance is glaring. In this other part of the world economy, growth is expected to "strengthen only moderately, from 3.4% in 1987 to 4% in 1989," with certain variations found among different groups of countries. For instance, the lowest growth rates are expected to be experienced by the heavily indebted and the fuel exporting countries.

Some of the factors brought forward to explain what is called the "weakness of spillover effects from the buoyancy of growth in the industrial countries and the strength of commodity prices and world trade." First, there is the sluggishness in oil markets. Second, "despite the general strength of commodity prices, the prices of a number of products that are important for many developing countries, notably tropical beverages, have tended to weaken, so that some exporters of primary commodities are actually registering terms of trade losses." Third, interest rates are said to have "increased debt servicing costs, partly offsetting the gains from higher export earnings." And fourth, there is the "sharp deterioration in inflation performance in a number of developing countries."

After a review of other subjects such as inflation, trade and current accounts and international monetary developments, a special section is dedicated to financing and debt in developing countries, where current account financing is dealt with separately from indebtedness itself.

The weakness in oil prices is expected to lead to a tightening of the oil exporters' financial position, which is contrasted with the situation of the newly industrialized economies (NIEs), which are expected to "continue to add significantly to their reserves and begin to repay substantial amounts of their outstanding debt."

In the non-fuel exporting developing countries, it is outrightly admitted that the financing of the growth projected in their current account deficits "will depend in part on the evolution of various schemes for restructuring debt service payments." In other words, this can be interpreted in the sense that not all hopes are placed exclusively on the Baker plan.

On indebtedness itself, the decline in the aggregate ratio of debt to exports is highlighted as significant, although the figure is not as encouraging, since it went from 169% at the end of 1986, to 158% at the end of 1987.

Economic policies in the industrial countries are described as taking place against "a background of increasing evidence of the resilience of economic activity." For the developing countries the policy background is described as constituted by "sizable external and internal imbalances, persistent foreign exchange constraints, a large debt overhang, and the recent surge of inflation."

The medium-term scenarios confirm even more the dichotomous performance of the present world economy. First, the baseline or "reference" scenario assumes unchanged policies, constant real exchange rates, the absence of financial market disturbances, and unchanged oil prices in real terms. Under these assumptions, aggregate demand in most industrial countries is expected to slow somewhat in 1989, which serves as the basis to project broadly stable inflation and interest rates.

A second scenario envisages stronger momentum for aggregate demand growth in the industrial economies, which allows for the projection of a widespread acceleration of inflation in the absence of fundamental policy adjustments. Finally, two additional scenarios are drawn to evaluate the effects of anti-inflationary monetary policies in the industrial countries, as well as to highlight the need for an early monetary correction. This section concludes with a discussion of the influence that a cut in the U.S. fiscal deficit would have on the curbing of inflationary pressures, while limiting the rise in world interest rates and avoiding undesirable movements in exchange rates.

With these prospects, two major policy challenges are said to be confronted by policy-makers in industrialized countries: 1) "how to sustain the current expansion, without falling victim to the boom-and-recession syndrome characteristic of earlier cycles;" and 2) "how to improve economic performance so as to reduce unemployment, strengthen capital formation, and move to a higher trend in productivity growth."

The policy challenges for developing countries are described under two different headings: first, the debt strategy and second, the debt-problem countries, where separate treatment is given to the low-income countries and to the heavily indebted middle-income countries.

On the debt strategy, its three essential elements are emphasized, as follows: improved domestic policies in the indebted countries, adequate flows of external financing to supplement domestic resources for investment, and the maintenance of a favorable external environment. Furthermore, it is said that these "three pillars of the debt strategy" are interdependent. Thus, even when the "external environment has in a number of respects improved more than expected," it is once again recognized that the "strong growth in world trade and of commodity prices has not benefitted all developing countries equally."

This last point is illustrated by describing how "the strength of world trade in 1987-88 has been particularly beneficial for countries that have avoided debt servicing problems." By contrast, "the benefits from the strength of world activity have been less apparent for debt-problem countries." In these conditions, it is suggested that "more efficient utilization of existing resources and policies to foster increases in private savings are parallel requirements."

Even so, it is admitted that "high and accelerating inflation in a large number of countries have greatly complicated the management of the debt problem." To emphasize this, it is recalled that there is "a notable (and two way) relationship between inflation performance and debt servicing difficulties." Consequently, "among the countries that have avoided debt problems, inflation averaged 10 percent in 1987 and is projected to remain at that level over the forecast period."

By contrast, "countries with a history of debt difficulties had a rate of inflation that reached 90 percent in 1987, and this rate is expected to go to some 155 percent in 1988." It is also asserted that "the success of domestic adjustment policies is clearly associated with the availability of external financing," to conclude that "the growth prospects of the countries with debt difficulties are intimately bound up with a recovery of private financing flows."

Finally, debt problem countries are classified in two subgroups. First, the small low-income countries, especially those of Sub-Saharan Africa, which are said to "clearly require both additional resource flows on concessional terms and improvements in domestic policies." The other subgroup is constituted by the highly indebted middle-income countries, where it is required that "improvements in domestic policies must be accompanied by market-oriented mechanisms that call forth appropriate amounts of new financing, while addressing issues created by the constraints of the heavy debt overhang."