DANCING ON THE EDGE:

THE DYNAMICS OF EXTERNAL DEBT IN THE UNITED STATES, SOUTH KOREA AND ARGENTINA.

SIVALINGAM SIVAKUMAR

Department of Politics, University of Adelaide.

November 1987.

Presented in fulfilment of the requirements for the Degree of Master of Arts.

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PREFACE

In recent years, the external debts incurred directly or indirectly by sovereign states have attained a renewed importance in the ongoing debates concerning various aspects of the global economy. The sheer magnitude of the debts involved, the apparent inability of many debtors to service these debts in a stable fashion, the vulnerability of the financial institutions which are the creditors, and the general intractability of the overall debt problem with no clear 'solutions' in sight, all serve to keep the external debt question in the spotlight.

This thesis is an examination of the experiences of three countries in handling their external debt burdens. The countries are the United States, South Korea and Argentina. The reasons for choosing these three cases for elaboration are detailed in the first chapter, but briefly, they are interesting because they represent three quite different sets of circumstances. America is, atypically, an advanced industrial country which is running up large deficits on trade and government spending which are both being financed, mainly, by external sources. Furthermore, America has had the luxury of not having to tailor its domestic economic policies to the wishes of foreign creditors, something which almost all other countries are having to do to a greater or lesser degree. South Korea is a newly-industrializing country with a large debt burden, but one which has had no trouble in meeting its obligations so far. The strategies it has pursued have paid off, but it may possibly be storing up problems for the future. Argentina is also industrializing

and has a large debt, but has already faced serious problems in keeping this debt serviced. Indeed, to many observers, the difficulties faced in handling these problems would appear to be intractable.

The thesis is divided into two parts. The first part consists of two chapters, which outline the background of the current problems with debt (Chapter One) and examine the positions of the commercial banks, central banks and international financial agencies involved (Chapter Two). The second part consists of three chapters, each examining one of the three cases. The emphasis in each of the cases is on those factors which are central to the dynamics of each country's external debt. This means that, in the case of the United States (Chapter Three), there is a concentration on the twin deficits of budget and trade. In the case of South Korea (Chapter Four), the emphasis is on the process of export-led industrialization and the push on to foreign markets. In the case of Argentina (Chapter Five), the concern is with the whole gamut of complications which arise from the inability to meet international financial obligations and, to some extent, the loss of control of the direction of domestic economic policy.

In addition to making judgements about each of the cases under study, the conclusion also draws out some of the themes which run through the body of the thesis. Judgements about the effectiveness of debt management strategies are reached and an attempt to formulate prognoses is made.

A central objective of the thesis is to demonstrate the inadequacies of current theoretical approaches to the whole question of external debt, approaches which are considered as part of the first chapter. Many of these were developed in times past when patterns in the global economy were more predictable and less volatile. At a time when exactly the opposite is true, these theories seem less and less valid. The problems of postulating new theoretical tools are compounded by the lack of clear understanding among development theorists of the actual state of play in global financial markets.

DECLARATION

I hereby certify that this thesis contains no material which has been accepted for the award of any other degree or diploma in any University and that, to the best of my knowledge and belief, it contains no material previously published or written by another person, except where due reference is made in the text of the thesis. I hereby consent to the thesis being made available for loan and photo-copying.

ACKNOWLEDGEMENT

I should like to acknowledge the following staff members of the Department of Politics, University of Adelaide, for assisting in various ways during the time I was preparing this thesis - Dr. R. Catley, Dr. N.D. McEachern, Prof. B. McFarlane, Dr. P.B. Mayer, Mr. P.F. Nursey-Bray and Mr. J.F. Scott.

A particular debt is owed to Richard Leaver of the Politics Discipline, Flinders University of South Australia, and to Dr. Carol Johnson of the School of Humanities and Social Sciences, New South Wales Institute of Technology, who read drafts and provided valuable feedback. Ms. Helen Bartholomaeus and Dr. S. Sivalingam provided substantial assistance with proof-reading. Mrs. C. Sivalingam printed out the final draft from computer disk.

I should like to publicly thank my friends, especially those who have also experienced the trials and tribulations of postgraduate study, in this department, for their moral support at difficult times.

This thesis would not have been written without the material support and encouragement of my parents, Dr. and Mrs. Sivalingam. This work is dedicated to them.

Siva Sivakumar.

Adelaide, South Australia.

November 1987.

PART 1

THE FRAMEWORK

CHAPTER ONE

BACKGROUND

Theoretical Perspectives

At the best of times, the field of international political economy is rife with theoretical conflict, much of which is ultimately born of ideological differences rather than any real contrasts of empirical evidence. As Robert Cox puts it: 'Theory is always _for_ someone and _for_ some purpose. All theories have a perspective ... There is ...no such thing as theory in itself, divorced from a standpoint in time and space'[1]. Despite this serious drawback, it is traditional to seek theoretical explanations of how the global political economy functions. As with most grand theories, the interpretation is of the total picture. The dynamics of individual phenomena, such as external debt, is sought to be explained within the larger setting.

Any survey of the existing theoretical literature requires some degree of organization into broad categories, to deal with the sheer proliferation of material. This is the approach used here. A classification utilized by Roger Tooze[2] is particularly useful and is adopted here, though Gilpin (1975)[3], Petras (1978)[4], Baldwin (1978)[5] and Cox (1979)[6] have produced analyses which explain and critique the theories in greater detail. To avoid needless repetition of what these authors have stated, there will only be a basic attempt to indicate the thrust of the literature within each approach.

Tooze approaches his classification in terms of a series

of commonly accepted perspectives, namely 'Liberal', 'Mercantilist', 'Structuralist', 'World Systems' and 'Marxist-Radical'.

Liberal:

Given its predominance as the mainstream philosophy of Anglo-Saxon society, it is not surprising that this became the defining perspective of the postwar international economic order, which was largely worked out between the United States and Great Britain. Its basic assumptions include the notions that, essentially, economic relations are harmonious; that a prime value be placed upon efficiency above all other social values; that a concept of the world economy be based on equilibrium processes; and that there be a goal of global welfare and a focus on the state, which provides secure political frameworks for markets.

Much of the conflict between international economics and political science tends to occur against the conventional liberal setting. What are perceived as the weaknesses of international economics have been criticised by those who examine the politics of international economic relations, an approach which has attempted to marry world politics and international economics.[7] However, critical assumptions brought from each of the two fields has meant that the mesh has not been as good as one might have expected. Different approaches within this perspective have run into different problems. For instance, the analysis of

economic interactions between national economies means that there is a limitation on the basis of state-centricity. On the other hand, models which are based on transnational relations and interdependence have different problems with their assumptions about the role of multinational corporations and transnational processes. Apart from severely underestimating the importance and power of the state, especially in such things as regulation and trade protection, this approach also overestimates the degree of ideological neutrality of economic processes and institutions. (Cooper, 1968[8]; Morse, 1976[9]; Keohane and Nye, 1977[10]; Michalak, 1979[11]).

Mercantilism/Neo-Mercantilism:

While the heyday of mercantilism was in the sixteenth and seventeenth centuries, it has been partially revived in contemporary debate as a response to what is perceived as the declining ability of the liberal perspective to provide both explanation and a basis for policy. A key assumption is that economic relations are inherently conflictual and dominated by national self-interest and extensive governmental involvement. Economics is held to be determined by politics and only makes sense in the context of the state (Gilpin, 1975[12]; Block, 1977[13]; Krasner, 1978[14]; Viner, 1948[15]).

Since government policy-makers are often faced with demands for protection from their constituents, they find

the neo-mercantilist approach very attractive. Yet, the approach is made less useful by its narrowness on two fronts. Firstly, the 'statist' view of international political economy is incapable of registering major changes presently occurring in the world economy. Secondly, the conception of political econy based on a particular definition of the state (Sylvan, 1981[16]) is quite limited.

Structuralism:

Structuralism is a perspective that seeks to analyze the development of the world political economy as a whole, and in so doing seeks to avoid the ethnocenticity of mercantilism and liberalism. Mainly, it is concerned with the nations at the center of the global economy have created and maintained structures and patterns of exchange which continue to systematically benefit center nations at the expense of those at the periphery. (Petras, 1978[17]; Galtung, 1971[18], 1981[19]; Prebisch, 1964[20]; Targ, 1976[21]). This structuralist perspective is the basis for demands for a 'New International Economic Order'. As it is based on a series of abstractions that relate directly to specific historical processes, it is quite a good explanatory tool at the level of generalities. Yet, it cannot handle instances of specific historical domination.

World Systems:

This approach also analyzes the development of the world

political economy as a whole, but takes as its major unit of analysis the world system of capitalism itself rather than nations within the system, as does structuralism. However, as in the structuralist perspective, the literature does not form a single coherent theory. Its basis is found in the critique of the 'developmentalist' view of liberal political economy (Gunder Frank, 1979[22]; Baran, 1957[23]; Cardoso, 1977[24]). More recently this view has been articulated by Immanuel Wallerstein[25] and other major 'dependency' school writers. In general terms, it is argued that specific events within the world system can only be explained in terms of the demands of the system as a whole, with all actions being related to the system. While there are many problems with this approach, the key objections to it center around the superficiality of such a far-reaching holistic view of the world, and its focus on exchange relations to the detriment of production relations in the structure of the world economy.

Marxist/Radical:

Again there is great difficulty in locating the literature from these perspectives within a single theoretical body of work, let alone trying to summarize this here. Apart from the world systems work, all other perspective do not have the same intellectual basis in historical materialism that the Marxist/radical perspective has. (Mandel, 1968[26]). The focus is not on the state, as such, but on the production process and its dynamics and

structures. Indeed some writers, such as Gunder Frank[27] and Baran[28], straddle both the world system and radical perspectives. The common factor would appear to be a relational interpretation of development and underdevelopment. Classical Marxist concepts and theories, such as imperialism and the internationalization of capital, have undergone change as new varieties of theory have been developed out of them: most importantly by Arghiri Emmanuel[29], Samir Amin[30] and Ernest Mandel[31].

Theoretical understanding of external debt issues tends to reflect these perspectives. For example, mainstream thinking on debt follows the liberal line. Hence, the World Bank/IMF perspective is largely shaped by this viewpoint. External debt is assumed to be a necessary adjunct to economic growth; all debt processes are assumed to be guided by economic reality (rather than political reality); domestic economic efficiency is deemed to be a sufficient condition for the servicing of the debt; ultimately there is a notion that a viable equilibrium between debt service and export earnings can be achieved. So plans to handle debt which are based on this perspective are usually noted for stressing the importance of economic and export growth as the vehicle for succesful debt servicing and ultimate debt reduction, an export-led growth strategy.

It could be argued that the mercantilist perspective shapes the thinking of the commercial banks. The assumption is of inherently conflictual economic relations between

banks and debtors. This may have been responsible for the outcome seen in the past several years where relations between banks and debtors are generally adversarial, resulting in a policy and negotiation deadlock. Often such deadlock can range over a number of issues but the banks are usually of the opinion that governments of debtor nations have to be forced to take 'hard' decisions in their own long-term interest. That this could be a counter-productive strategy does not seem to enter into the equation very often.

The converse of this is an amalgam of the structuralism/world systems perspectives which is, broadly speaking, subscribed to by debtor governments. In such a view the terms of exchange that already exist in the global economy would mitigate against any fair deal on external debt. As such, the debtors will always be at the mercy of the lenders, irrespective of any other factors which may favour them, such as the formation of debtor cartels. Hence, these governments see the issue of debt being tied in with broader issues such as calls for a New International Economic Order.

Marxist/Radical perspectives give rise to their own line of thinking on external debt questions. None of the major players subscribe to this school, other than for reasons of domestic or international propaganda. Yet, it is a popular viewpoint among critics of global capitalism who are engaged in looking at these problems. The notion of outright debt

repudiation is founded in the beliefs of this school which would maintain that, given the exploitative nature of the lender-debtor relationship, such a strategy is quite justified. In an ideal setting, such repudiation of existing debt would be accompanied by a withdrawal from the global economy and emphasis on a national system of economic planning and implementation of those plans. Inwardly oriented development policies would also be a consequence of such a strategy.

As stated in the introduction, a central objective of the thesis is to demonstrate the inadequacies of current theoretical approaches to the whole question of external debt. Many of these were developed in times past when patterns in the global economy were more predictable and less volatile. At a time when exactly the opposite is true, these theories seem less and less valid. The problems of postulating new theoretical tools are compounded by the lack of clear understanding among development theorists of the actual state of play in global financial markets. This failure of theory is one of the key reasons behind the lack of 'real world' policymaking impact by most theoreticians and the low esteem in which they are held by most practitioners in global finance. Certainly it is to be hoped that the development of theory will lead to a dramatic reversal of this situation but the current indications for this happening are not optimistic.

An attempt to draw conclusions of the sort discussed in the preface, requires examination of the current problems of debt and the circumstances that brought them about. The formulation is dependent on the overall functioning of global financial markets and institutions, and the factors which affect them.

Fundamentally, the essential prerequisite for the financial system to continue to function effectively, is that confidence in its viability is maintained. Lack of such confidence threatens the basis of all transactions within the system and undermines interactions with production and trade. Why has there been a developing crisis of confidence in the post-Bretton Woods financial arrangements? Why has this scepticism developed to the point where it threatens the long-term stability of money markets and financial institutions? Is it possible to identify the specific means by which this particular crisis arose and to find an implied commonality with previous crises? Seeking to answer these questions is a relatively difficult task, but the essential elements of the answers can be identified easily and stated simply.

It is usual to locate the beginnings of the Third World Debt Crisis in the aftermath of the first oil shock of 1973. The enormous surpluses being generated by certain OPEC members coincided with the need for the oil-importing developing countries to borrow funds to cover problems like current account deficits, trade credits, squeezes in cash

flow and, of course, oil-import bills.[32] Predictably, the demand for 'recycled' petrodollars was matched by their supply through the private international banks. It is now clear that this action helped stave off a major global economic crisis. The enhanced liquidity provided by the OPEC surplus helped keep the processes of production in developing and developed nations, and trade among and between them, from collapsing at a rather critical time in the developmental process for many Third World nations.[33]

In theory, private banks were making commercial loans to governments and corporations in developing countries, and in the process, were performing three basic functions. Firstly, they were finding an outlet for OPEC surplus at a time when Western economies were contracting and traditional consumers of loan funds were reducing demand. Secondly, such funds as they did advance to many Third World governments helped to pay for oil imports and enabled these nations to stay afloat economically during the global recessionary periods during which demand for their exports was reduced. Thirdly, these loans were useful in making up the increasing shortfall between Official Development Assistance (ODA) and the needs of developing nations for trade credits and developmental funds.[34] Admittedly, the profit potential of these loans would have been a prime consideration at the outset, but it must be stressed that, at certain times, competition to lend reduced profit margins, and the drive to lend was sustained by an imperative to maintain market share of new loans.[35] At this time, central bank intervention was minimal and often

favoured the lending policies of the private banks. In some cases, such as West Germany, there was even some degree of encouragement offered by the central bank in order to keep up levels of lending to Third World and Eastern Bloc borrowers.[36]

In any event, it was necessary for the global economy to be maintained in the face of serious difficulties caused by such unusual phenomena as escalating energy costs and 'stagflation'.[37] Flows of credit which were relatively unhindered were a key factor in any attempt to return to a steady state and, given the implications of a severe failure of the world economy, the banks were only too willing to cooperate.

The effects of the changes that arose as a result of the economic shifts of the mid to late-1970s were distributed unevenly between nations. In general, developed countries suffered some trauma in adjusting to the new higher prices of energy, though some, such as Britain and Norway, did quite well out of the price escalation. However, the general slowdown in economic activity did leave its mark on the industrial sectors in particular. The recession brought with it the expected increases in unemployment, but surprisingly not the corollary reductions in inflationary pressures. In the developing world, on the other hand, the effect was very mixed.[38] Certain oil exporters prospered while others, who were burdened with larger, poorer populations, did not fare very well. Almost uniformly, oil-importing developing

countries did much worse than they would have done with lower energy prices.

At what was obviously a very difficult time for the global economy, the roles played by the international financial system were extremely useful. Undeniably, the economic crises of the 1970s would have been far worse if not for the redemption, albeit limited, offered by the system. In the process, the organization of international credit has been undermined. Is it reasonable to expect that, since Peter rescued Paul in the 1970s, Paul will now oblige by pulling Peter out of a hole in the 1980s?[39]

In common terms, one would presume that the relationships of power that exist in the realm of global finance, mirror to some extent, the distribution of capital and the implicit capacity to influence the course of events that ownership of such capital delivers, with dominance being exercised by the richest. In this interpretation, one would expect that, for example, OPEC members who were investing surpluses in the Western financial markets would have some leverage over the operations of the system. Similarly, creditor institutions would be expected to have a large degree of control over debtors, in view of the hold on purse strings which they exercise.[40] This is to some extent an accurate picture, but at certain times and in certain cases, power relations seem to work the other way round, with debtors exercising power over creditors and deposit-holders being able to dictate to depositors.[41]

Why Borrow?

The perspective of the borrowers (Third World and Eastern Bloc national governments, their semi-autonomous agencies and private corporations which had government guarantees of some form on their securities) was essentially a simple one. Most were undergoing problems brought about by the changing price of oil. Oil importers had to find extra foreign exchange to keep pace with the increases in their oil bills. Many oil exporters had to come up with ambitious plans for accelarating development in order to disburse some of the benefits of higher oil prices among the population at large. (The latter was more difficult than one might imagine, for the sudden unleashing of large sums of money into an economy can bring difficulty with excessive inflation and help create shortages of even essential goods.)[42] To maintain ambitious programs of development, it was often necessary to supplement oil revenues with borrowings which were underwritten by expected future income not only from oil, but also from the products of economic growth and industrialization.

During the mid to late 1970s the real cost of oil, and indeed most other forms of non-renewable energy, was escalating, largely because of increasing scarcity of these resources and the lack of available economic alternatives. Much of the policy planning in oil exporting nations was based on this assumption. The nature of the OPEC cartel and

its ability to defy, for a while at least, the established laws of the marketplace by setting its own pricing regime at will, meant that OPEC members and fellow travellers alike were able to spend lavishly on whatever objectives took their fancy. When their revenues were taxed to the limit, it was a simple matter to arrange to borrow from international commercial banks, who were only too happy to lend against oil in the ground, which appeared to be as sure a security as gold in the bankvault.[43] Indeed, competition for this business was so great, that OPEC finance ministers often had more trouble avoiding having loans pressed upon them, than actually negotiating to get them.[44]

Other valid reasons for using overseas financing instead of waiting for eventual revenues existed. In a world that was experiencing both unusually high inflation rates and escalating energy prices, it made sense to hang on to energy resources as they appreciated more in value the longer they stayed in the ground. At the same time inflation meant that any borrowings would be repaid in depreciated future currencies.[45] The magnitude of inflation was such that once its effects had been discounted, the real interest rates being paid by borrowers were sometimes negative. Also, the value of the United States dollar against most currencies largely remained quite moderate, if not on occasion weak, so that there was no real need to be concerned about the potential gearing effect of currency exchange. Confidence in the dollar remaining low in value, if not going even lower, was such that very few, if any, governments and corporations

made serious efforts to hedge their currency risks on the futures markets.

The decisions taken by many Third World debtors to proceed with large scale borrowing during the last decade were quite justifiable ones in terms of the situation as it existed then, however disastrous they may seem in hindsight. It must be remembered that this was a time of great uncertainty for the Western industrial economies, given their heavy dependence on, often imported, fossil fuels which were widely believed to be running out at such a rate that exhaustion would occur within a decade or two at the most. Most Third World governments which had sovereignty over energy deposits of various kinds were in a sense justified at the time in feeling that they had the upper hand in their dealings with the advanced capitalist nations, which until then had enjoyed an unshakeable hold on the functioning of the global economy.[46] The success of OPEC in the cartel business was seen as a precursor for all sorts of other commodities and a road to massive injections of capital on a level undreamt of before this time.

Why Lend?

The recession that followed Oil Shock I, i.e. the quadrupling of oil prices in 1973, had two short-run effects on the international banking community. Firstly, it created a dramatic drop in demand for domestic loan funds in most of the Western nations which were the prime markets for such

funds. Such a decrease in able and willing borrowers was not very healthy for the profitability of the banks concerned.[47] The second effect was the relative flood of deposits coming into the banks from such sources as the OPEC surplus and even domestic investors, individual and institutional, who preferred to leave their money on deposit rather than risk direct investment in an uncertain business climate. Short of refusing to accept new deposits and divesting themselves of existing ones, the banks could not avoid having to meet interest payments. In any case, refusing deposits was not a viable option because of the loss of prestige and damage to standing and status.[48] The only other real alternative was to find borrowers for the money that was coming in.

Given the parlous state of the domestic financial markets in the United States and Western Europe, the banks had to look further afield to find channels for their loans: to Third World and Eastern Bloc nations which were seeking to expand their economies and, in the case of the former, private domestic corporations within these countries which were also seeking to expand their production and markets. Admittedly, at the outset, these were seen as borrowers who posed higher risks and as such were charged premium interest rates. However, as more and more of the commercial banks moved into this market, competition to maintain and if possible increase market share had the effect of driving down interest rates.[49] At one stage Third World borrowers were able to get funds at rates which were only fractional percentage points above the standard interbank rates. The

importance of market share lay in the long term objectives of the banks concerned. It was felt that expansion into the Third World was the best prospect for future growth and profits. An essential aspect of tapping this market was to be in early, if not among the first, and establish good relationships with the new borrowers. The negative effect of this on profitability had to be countered with expansion of the loan base, so that gradually the international banks came to be less selective and discriminating in their choice of clients. The ultimate unspoken hope was that eventually the market in Third World finance would become a stable, sound and essentially highly profitable one.[50]

Some would argue that the banks were the victims of their own greed for market share and profits; others that once all the factors had fallen into place, and given their avowed purpose for existence, the banks took the best of the bad alternatives facing them. Given the limitations of the time, one must ask whether there could have been any other possible avenues for action.[51] This question will be dealt with in a subsequent chapter.

What went wrong and how did it happen?

If events had gone according to expectations there would not have been a Debt Crisis, or at least not one of the present magnitude. Unfortunately, for the banks and their customers, the first half of the 1980s has brought unforseen changes which have acted to undermine the logic of the

1970s. Oil, for example, is presently undergoing a world glut, as a result of the continuing industrial slump in much of the developed world, more deposits of oil proving to be economically recoverable as the price rose and reasonably efficient techniques of energy conservation having been developed.[52] In spite of the heroic attempts of the OPEC group of nations to hold their current official pricing levels, (which in themselves have been somewhat reduced from their all-time highs), by such means as cutting production quotas and using financial reserves to cover the shortfall in revenue, the spot market continues to indicate a declining 'real' price for oil. The effect of this glut, which is expected in some quarters to continue for well over another decade, has in general been quite devastating for the oil producers.[53] Total revenue has declined for those producers who have abided by the quotas, thus slowing down their plans for development. Others, more desperate, have violated the agreed cutbacks in production to maintain, at least in part, a higher level of revenue inflow, but are largely successful only in putting further downward pressure on the price of oil. The situation is so bad that the viability of OPEC as a coherent and effective force is itself now in doubt. For the banks, all this means that they can no longer rely on using OPEC funds as a buffer.

Another negative factor is the performance of industries in the Third World borrower nations which were funded by loans from international banks. At the time, on paper at least, these should have been viable competitors in

international markets, when manufacture and export eventually got under way. In addition to much lower wage rates, the enterprises concerned were investing in newer plant and equipment which brought advantages in cost and efficiency.[54] Unfortunately, two things got in the way of their success, namely the slump in demand caused by the general global downturn and the rise of protectionism in the advanced capitalist countries which had been expected to be the main markets.

The effect of such misfortune was to create uncertainty about the viability of much of the outstanding debt to Third World borrowers and their ability to service and ultimately repay it, on terms that would be acceptable to their creditors. There is some debate about the amount of debt outstanding in the less developed and socialist bloc nations. Estimates range from US$800 to 1100 billion dollars.[55] The lack of a precise figure is caused by difficulties in obtaining accurate data from borrowers and even lenders, differences in accounting systems giving different totals, incomplete information on some types of borrowing and so on. If necessary, it is possible to use the figure settled on by one of the international financial institutions, e.g. the US$850 billion of the IMF,[56] but the most important aspect to grasp is the magnitude of the amount involved. By most standards this is a phenomenal sum of money and would of itself provide adequate cause for concern. When one adds to this the currently popular conception that this money was lent out irresponsibly by the

banks to Third World nations which were incapable of paying it back, it is easy to feel some degree of moral indignation. However, a more considered view would argue that this total amount of money owed by all those countries is substantially less than the estimated total outstanding debt of the United States government in 1984, which was US$1000 billion (1 trillion).[57] When such a comparison is made, the dimensions of the problem no longer seem to be as incomprehensible as they might appear to be at first.

The outstanding amounts of money are owed to a large number of creditors, among them Western governments, Western commercial banks both international and domestic in their operations, international financial institutions, private investors (corporate and otherwise) and the various global financial and bond markets. With hindsight, most of it is not adequately secured, with the most common form of security being some form of guarantee by the home government of the borrower. All too often these are one and the same, the borrower being the government, a semi-governmental authority or a 'quango' which had government backing.[58] The main reason for this state of affairs to have arisen was a misconception of the nature and applicability of 'sovereign risk'. This term is commonly used to denote the implications of lending to a sovereign state.[59] There has always been a tendency to assume that such lending is appropriate for a variety of reasons. National governments usually tend to have continued existence in the longer term, even if their composition might change. With some important exceptions,

they have in the past tended to honour their obligations to creditors.[60] In theory at least, governments have been considered to be a special class of borrower, incapable of going bankrupt.The problem arises because of the fact that the international banking system has never before lent so much to states that are experiencing such difficulty in servicing let alone repaying these loans.At the very least, this impression of the innate soundness of the state has meant that there is a willingness on the part of many bankers to lend to governments without any real security or collateral being involved.[61]

How the Debt Crisis built up!

While the Debt Crisis has achieved relative global prominence only in the past few years, it must be stressed that the possibility of its onset was a topic of concern in banking circles soon after the major expansion in international lending.[62] During the course of 1975, only 12-18 months after Eurocurrency financing was expanded several fold so that demand for short to medium-term loans from OECD countries seeking to finance sudden deteriorations in their balance of payments positions as a result of the oil price increase could be met by the OPEC surplus, questions raised in these circles were finding their way into the media. Complications caused by the increasing number of Third World borrowers venturing into the Euromarket added fuel to these worries, so that towards the

end of 1975, in the United States at least, the banks involved, particularly the large money-centre institutions which did business on a multi-national basis, had become targets for both media and Congressional critics.[63] The attack centred on what were perceived to be "huge, questionable"[64] loans which were now jeopardized by the global economic downturn. To be sure there was concern about the lending that had occurred to developing countries, but also fears were expressed about loans outstanding in other areas such as in the real estate sector, municipalities and the oil tanker industry.[65] There was a perceived emerging crisis of debt, though it had not yet become a Debt Crisis, let alone the Global or international Debt Crisis.

Soon it was more 'fashionable' to criticize banks for making international loans, in preference to the other areas. This distinction was not based so much on analysis or foresight, as on the fact that all except international borrowers had strong domestic constituencies and lobbies and thus could not be attacked with impunity.[66] So, the first period of concern about Third World Debt was an upsurge caused at least in part by such factors as a feeling that domestic capital must not be lent abroad at a time of economic hardship, but rather should be held at home for job-producing investment. Such a view does not take into account hardships being experienced in other parts of the globe.

Unfortunately, for themselves and ultimately for the

banks concerned, the critics of international lending did not recognize the true significance of the increasing stake in international loans. While some limited concern was expressed about the ability of developing countries to service their debt burdens, defenders of the banks and their lending policies were able to make what, under the circumstances, amounted to a convincing argument.[67] In brief, this ran as follows: in the past, US banks had extremely modest loss records on international loans because they were careful to ensure high quality in their portfolios. The vast bulk of overseas credits represented ultimately the obligations of governments or large, well-established banks which could almost always refinance or stretch out payments to cope with unforseen liquidity problems that prevented the borrowers from meeting maturities promptly. Even the relatively small number of loans to foreign corporations were concentrated with companies of international standing, with high returns on their investment and involved in growth areas such as airlines, mining and petroleum. The concentration of international loans, i.e. the very high percentage of loans held by a few large banks and the predominance of a dozen or so countries among the bigger borrowers at that time, was held to be a strength rather than a weakness.[68] In this interpretation, outstanding credits to 'high risk' countries, such as India, Pakistan, Bangladesh and much of Black Africa, were relatively modest and composed of mainly short-term trade financing. Given the immediate negative effects on the domestic economies of defaulters on such

finance, the expectation was that default was unlikely. On the other hand those dozen or so nations with heavy debt burdens to US banks, largely in the form of term and non-trade obligations, had rich natural resources (e.g. Mexico, Brazil, Argentina, Algeria, Iran, Indonesia) or long-standing ties to the United States government which had substantial economic and political influence over them (e.g. South Korea, the Philippines, Taiwan, Israel).[69]

This argument was quite convincing in the light of the then prevailing paradigms. It should be remembered that this was a time of rising concern about the future scarcity of natural resources, particularly energy and strategic minerals. Organizations like the Club of Rome were busily spreading the message of impending doom for global consumers of such resources.[70] Given that, in general, most commodities and raw materials were starting to show an escalating trend in prices, which ultimately resulted in the commodity price boom of the late 1970s, it seemed as if this view was valid. By extension, suppliers of these goods would be in quite good positions vis-a-vis their loans from Western banks. So, criticism of these outstanding international loans was somewhat muted for a few years.[71]

The second Oil Shock of 1979 begat fresh fears about the fate of international lending. The substantial boosts in the fuel bills of many developing countries showed signs of outstripping their ability to pay them, especially as certain commodities started to show signs of suffering from

a weakening in demand. The causes of this were essentially three-fold. Firstly, higher prices for raw materials meant a slow-down in economic activity because these increased costs were reflected in the higher pricing of finished goods, which in turn depressed consumer demand. This led in cyclical fashion to reduced demand for raw materials which in turn put downward pressure on their pricing. Secondly, as the price charged by traditional suppliers for their commodities rose, more and more producers were able to come on line in economically viable circumstances, thus increasing competition. Thirdly, in certain cases where recycling was an option e.g. aluminium, the cost of recycling became increasingly attractive in comparison to the cost of production from scratch.[72] By the early 1980s, these factors were to work in concert to drive commodity prices into a tailspin from which they have not yet recovered.

In the meantime, in spite of the general level of complacency about unsecured lending to developing nations, there were a few cases which continued to cause concern. The government of Zaire, more often than not representing the personal interests of President Mobutu and his family, had begun to borrow heavily in the early 1970s, against the promise of the potential offered by, among other things, deposits of diamonds, copper and cobalt.[73] Despite the golden opportunity offered by these resources for the development of Zaire to the benefit of the population at large, the unfortunate reality was the exact opposite, with

corruption and maladministration becoming the avenues by which the loan monies were frittered away. The original schedules for payment of interest and principal were no longer being adhered to by mid 1975. Over the next three years, a series of agreements were made between the Mobutu regime, its creditors and the International Monetary Fund, agreements which were supposed to lead to an improvement in Zaire's economic and financial management and consequently its performance as a debtor. Each of these in turn fell victim to the air of corruption and bad managerial decisions of the government. Ultimately, in 1978, the IMF virtually assumed control of the central bank of Zaire,[74] and embarked on a massive reorganization of the financial systems of the country, over the objections of Mobutu and his cronies.

Around the time that Zaire first got into trouble, another example of lending that was out of control surfaced. Indonesia, like many other countries in the emerging Third World, had vested a monopoly over the domestic oil industry in a state-owned company, Pertamina.[75] This was run, with an unusual degree of entrepreneurial latitude, by General Ibnu Sutowo, who was responsible only to President Suharto himself. During 1971-1973, Pertamina borrowed heavily from various banks in different countries, not only for the purpose of developing its oilfields, but also to diversify into areas in which it had no real expertise, such as hotels and charter aircraft.[76] When the Indonesian central bank became aware of the scale of Pertamina's borrowings it tried very hard to bring them under control, but was unsuccessful

because the foreign banks were only too happy to abide by Sutowo's wishes and not report formally the loans they were making to the oil company. In February 1975, Pertamina failed to pay the interest on a relatively small loan owed to a relatively small bank, which in itself was of little consequence except for the fact that the bank concerned, instead of doing the accepted thing and rescheduling the payment, decided to insist on its legal prerogative to declare a default. Standard 'cross-default' clauses in loan agreements would then oblige all of Pertamina's creditors to call in their loans, which would guarantee a massive collapse of the oil company and huge losses for the major banks involved.[77] This time, Pertamina had no option but to go to the central bank, in the hope that official intervention would lead to a reprieve. After long drawn-out negotiation, the central bank managed to obtain a rescue package to keep Pertamina afloat, but at the cost of having to expend most of its reserves to make good on due payments as a quid pro quo.[78] While this adversely affected Indonesia's credit rating, it did mean that a complete collapse of credit to the country was averted. Subsequent investigations revealed that hundreds of millions of dollars had been siphoned off into the private accounts of Sutowo and other Pertamina officials.[79]

In both the cases of Zaire and Pertamina, the risk exposure of most of the banks involved was minor in comparison to the present exposure of say, Chase Manhattan or Citicorp in Latin America. For instance, Citicorp,

although the chief private lender in Zaire at the time the crisis first erupted, was only owed 40 million dollars.[80] In both cases, it was possible to lay the blame for what occurred on a combination of corruption, maladministration and/or bad judgement on the part of the borrower. The banks could correctly claim, in a legal if not moral sense, that the incidents had not been necessarily the result of their lending policies. Theoretically, it could be argued that there was no real cause for wider concern about a potential crisis of debt among the broader spectrum of developing nations.

At this time, there were other indications of impending difficulties within the banking industry itself. The collapse of the Herstatt (Frankfurt) and Franklin (New York) banks and the near collapse of, among others, the National Westminister (London), served to illustrate that the postwar Western commercial banking system was more vulnerable than had been imagined previously. Again, plausible reasons which did not reflect badly on the lending policies of the banks at large, could be advanced to explain these failures. The collapse of Bankhaus Herstatt in 1974 could be blamed on wild speculation on foreign exchange markets by the managers, who concealed their losses by tampering with computerized accounts.[81] When the Franklin Bank collapsed in the same year, it had been under the control of the now notorious embezzler Michele Sindona, for over three years. Sindona had embarked on a series of rash ventures, the losses from which he concealed by falsifying records.[82] So

both of these could be written off to fraudulent or larcenous behavior by the respective managements, which was of concern in itself, but did not mean that there was something wrong with the banking system itself. The experience of NatWest was a salutory lesson in the danger of overextending resources in one particular sector of the economy (in this case property development) but the fact that it had been saved was an indication that the safety net provided by the Bank of England was a very effective safeguard which was quite capable of taking care of awkward situations whenever they arose.[83]

On the whole, this kind of logic, which admittedly seemed plausible or even sound, prevailed. Even those who had misgivings about the long-term future of credit extended to the Third World could not convincingly argue a contrary viewpoint. For all intents and purposes the banks were reassuringly in control of the situation and the possibility of widespread default and the resulting collapse of the banking system seemed remote and unreal. Most of the debtors who did get into trouble would have the option of rescheduling their loans to make payments more convenient and the banks would have no trouble 'rolling them over'. In essence, there was no real need to worry, or at least there wasn't until things started unravelling and the assumptions on which much of the complacency had been based were tested and found to be wanting. By the time most banks had woken up to its possible reality, the Third World Debt Crisis was already upon them.

The first clear and unambiguous indication of the Third World Debt Crisis having arrived with a vengeance was the experience of Mexico in 1982. For the preceding six or seven years, the country had rapidly accumulated a massive foreign debt, estimated to be about US$85 billion,[84] largely on the basis of the collateral value of oil in the ground. The Lopez Portillo administration's avowed goal of using the oil wealth to develop Mexico had fallen afoul of the temptation to be seen to be rapidly raising the standard of living (a trap into which the Polish government was also to fall). The relative lack of domestic production of consumer goods was compensated for by a flood of imports and even the plant and equipment for such eventual domestic industry had to be imported. The onset of the current global glut of oil served to aggravate already worsening current account deficits. Initial attempts to contain the damage on the trade front by borrowing yet more from overseas helped delay the crunch, but also compounded the problem by adding spiralling foreign debt to the imbalance in trade. By August 1982, the only option available to the Mexican government was to suspend payments on its outstanding foreign debt and seek negotiations with its creditors in order to determine mutually acceptable arrangements for rescheduling its debt and coping with the payments that were due immediately. The Mexican case was the forerunner of a localized set of panics, sometimes known as the Latin American Debt Crisis, as well as the first serious intimation of the wider Third World one.[85] The negotiations on coping with Mexico's

problems dragged on over several months. In September, President Lopez Portillo, on the advice of his central bank governor Carlos Tello, made serious attempts to set up a 'debtor's cartel' in conjunction with Argentina, Brazil and Venezuela, but was thwarted when these nations declined to declare moratoriums on their debts.[86] Ultimately, it was left to Lopez Portillo's successor, De la Madrid, to agree to abide by the terms of a US$5 billion rescue package, which was put together by Mexico's leading creditors and underwritten by a syndicate of some 600 banks worldwide.[87]

After Mexico, a series of other Third World nations had to resort to some form of rescheduling or renegotiation of their debt as conditions continued to become more and more adverse. Most of the major debtor nations in Latin America (e.g. Brazil, Argentina), had to reschedule several times as different portions of their outstanding debt came up for review at different times. Sometimes a rescheduling agreement itself had to be renegotiated when the country concerned was unable to meet the terms it had agreed to. The IMF, along with other international financial institutions, increasingly became involved in the process of debt management.

One of the central problems with trying to keep things afloat was that the commercial banks which had been so free with their largesse previously, took sudden fright at their customer's difficulties and severely restricted the flows of funds they were willing to commit in future, thus

exacerbating the very problems they sought to avoid.[88] The intermediary role played by the IMF was twofold. Firstly, it took on its traditional role of being a financial 'sheriff', demanding that the debtor nations enforce such things as financial and fiscal discipline, controls on government spending, curbs on domestic consumption and the like, held to be vital to the recovery of any country undergoing problems with debt.[89] The Fund's policymakers were only too aware that many of the 'hard' decisions were bound to be politically unpopular and that it would be tempting for the governments concerned to avoid taking them. So, any IMF assistance in seeking respite from the debt burdens being experienced by any given government was often dependent on that government demonstrating its political will to push ahead with unpopular measures which were nevertheless deemed to be necessary. Such conditionality was usually expressed in the form of various economic targets that had to be achieved or in terms of improvements in different economic indicators. This avoided the unpleasantness of stating the bald truth in the form of say, "We agree to give you the credit facility you require, if you cut back on your expenditure on food imports this year, even though this means food prices will skyrocket and some of your people will starve", or words to that effect!

In return for 'restraint', as evinced by such things as a reduction in imports, an increase in exports and a reduction in domestic consumption, the IMF would not only dip into its own relatively limited resources, but in its

secondary role, would use its influence to cajole the commercial banks into lending more than they had intended to, in order to help prop up the domestic economies of debtors who exibited economic 'good behaviour'. The present situation is such that most banks will not continue to lend to debtor nations which are not sticking by their agreements with the IMF.

Such perceived foreign interference in the making of economic policy poses dilemmas and difficulties for governments which have stronger than the average commitment to nationalism and the exercise of the will of their people.[90] For instance, the democratically elected government of Raul Alfonsin in Argentina has spent most of its term in office fencing with the IMF and foreign creditors in an attempt to get agreements that were less onerous from Argentina's point of view. The first document that was initialled did not provide for any major concessions, but was adhered to by the Alfonsin government. In spite of the failure of the 'Austral Plan', and the subsequent renegotiation of conditions with creditors, Argentina has effectively upheld the intervention of the IMF and foreign creditors in its economic policymaking process. However, it is open to question whether it would continue to do so in conditions which were somewhat more adverse.[91]

Effects of the Breakdown of Bretton Woods

The arrangements entered into at Bretton Woods in mid-1944, were meant to bring some degree of stability to the global financial and monetary systems and largely succeeded in achieving this goal for about two decades before running into serious trouble. Ultimately, however, these arrangements were undermined by a series of events and a variety of factors. The precise historical and chronological details of how this occurred are beyond the scope of this discussion, but it is instructive to examine some of the systemic stresses under which failure eventually occurred.

As early as 1958, concern was being expressed about the increasing United States balance of payments deficit which was the result of basic contradictions in the world economy, which in turn were caused by the inability of the United States to both pursue its global aims and live within the international monetary order that it had been responsible for shaping.[92] The start of European convertibility of dollars for gold meant that the drain on US gold reserves soon attained intolerable levels and the American authorities were forced to take action to limit the damage they perceived was being done to the United States and its interests. The problems of managing convertibility were complicated by the difficulties raised by speculative pressures on currencies and the response of governments and central banks to such pressures.

In theory at least, the United States on the one hand and its European allies on the other had a common interest in maintaining some semblance of order and predictability in the functioning of the global economy. Unfortunately for them, such mutual objectives did not preclude a lack of congruence in many matters of detail in regard to monetary management. For example, actions taken by one government in support of its currency could quite easily become detrimental to the health of other currencies and provoke intervention by other governments which in turn was perceived to be somewhat hostile and so on.[93] While recognizing the ultimate limits of their freedom of action in monetary terms, US policymakers were able to cope with some of these difficulties by adopting a series of active and passive strategies such as ending convertibility and encouraging (somewhat dirty!)[94a] floating exchange rates. Since the policies formulated by the United States were not without cost to European governments and central banks, these had to, some extent, be imposed on them.

The key to the collapse of the Bretton Woods monetary order was, arguably, the changing role of the United States dollar in the period after the end of the Second World War. Reconstruction of Western Europe's war-devastated economies was deemed to be vital for a whole variety of reasons, among them political ones like the desire to check the spread of socialism and the strengthening of the Left in Europe, and economic ones like the need to find viable export markets

for the relatively large volume of goods that were being produced by a US economy that had expanded massively with the war and which required outlets for continued civilian production in order to maintain the strength that had been built up by the demands of war. Given the parlous state of European finance, the bulk of these imports from the US had to be paid for in dollars that were underwritten by American aid programs, such as the Marshall Plan.[94b] This, in conjunction with the prevailing basic strength of the US economy ensured that America played a crucial role in the reconstruction of Western Europe and Japan, while the US dollar became the major medium of exchange not only for purchasing American goods, but also for purchasing products from other countries as well. Thus the American dollar emerged as the major currency in a world that was low on gold reserves, and had difficulty finding any other means of financing the desired level of economic transactions. In addition, the United States held at the time, the overwhelming share of existing total gold currency reserves – 73 percent in 1940, 63 percent in 1945, and 68 percent in 1950.[95] The effect of this gold shortage was to turn the dollar into a reserve currency, so that in addition to becoming a means of exchange for most goods and services around the world, it also became an asset for settling accounts among and between states.

The postwar role of the dollar conferred on the United States a number of important political and economic advantages. The ready acceptance of the dollar as payment

for goods and services helped facilitate the penetration of the rest of the world by American interests, political, economic, commercial, corporate, military and otherwise. Given the dollar's value as a reserve currency, foreign governments were, at least at the outset, willing to hold balances in dollars rather than demand convertibility into gold. The unexchanged dollars piling up in foreign central banks gave the American policy makers the luxury of operating internationally without the constraint of limited finances and without incurring the domestic and international monetary costs of doing so. For instance, the domestic inflationary effects of this gross expansion of the supply of US dollars was minimal.[96] The pervasiveness of the dollar gradually came to be associated with the pervasiveness of American influence and power.

Unfortunately for the US authorities, this happy state of affairs was not to last for ever. As the economies of Western Europe became stronger and to a degree less dependent on American goodwill, resistance to the dictates of US monetary policy began to harden. For a start, the worsening US balance of payments deficit was potentially destabilizing, since devaluation of the dollar could take place at any time, substantially decreasing the value of the large dollar reserves being held by European central banks.[97] Secondly, as Western Europe became more prosperous, it also became somewhat more united in the shape of the European Economic Community and less dependent on American 'leadership' and direction. The movement for greater freedom

of action, spearheaded by Gaullist France, resulted in a push for the decoupling of Europe from American economic, political and military goals.[98] The pursuit of the first was somewhat more facilitated by the demand for and acceptance of European convertibility. By exchanging their dollars for gold, the central banks concerned were able to bring home to the Americans the full economic effects of their foreign policies which were often at variance with the stated preferences of their European allies, e.g. American policy in Southeast Asia and the US approach to Western relations with the Soviet Union and China.[99]

When faced with this non-cooperative attitude, American officials realized that the acceptance of convertibility would bring with it severe problems of internal adjustment for the American economy, leading to politically untenable situations in regard to the levels of real economic growth and unemployment. Their failure to deal with these problems early on led to a sequence of events which ultimately were the cause of repeated dollar crises in the early 1970s which included massive speculation against the dollar.[100] Having conceded the European demand for convertibility and thus, in theory, ensured that the dollar was once again as good as gold, US policymakers were distressed to find that European and Japanese central banks were still insistent on actually going through the process and handing over their dollars for gold. In a sense, this was unexpected. Surely, if dollars could be exchanged for gold at anytime, why should anyone be hesitant to continue to hold dollars? Once this trend was

established and began to make itself felt as a drain on US gold reserves, the failure of the system became apparent. (The later attempt to create an additional international reserve asset, in the form of Special Drawing Rights - SDRs - was to run into trouble for similar reasons). As the drain on American gold increased the US moved to protect its reserves by suspending convertibility, delinking the dollar from gold and introducing floating rates of exchange.[101]

The irony of the collapse of Bretton Woods is that ultimately the US was caught within contradictions of its own creation. The established rules were designed originally to give the Americans, and to a lesser extent their allies, control over the directions in which the global economy would expand. However, as unforeseen complications began to arise, step by step the United States either broke the rules of its own choosing or else forced other countries to break them. Each time the justification was the need to avert an even greater crisis and prevent the downfall of the international monetary system, yet each action made some contribution to the system's ultimate demise.[102]

The demise of Bretton Woods and the consequent encouragement of speculative behaviour exacerbated the already existing tendency to inflation that is deeply rooted in the structure of contemporary capitalism. Given that national boundaries are relatively porous to the flows of capital and goods, it is quite understandable that inflation is transmitted with these flows and leads to the broader

destabilization of the world economy. Third World debt was largely run up during the 1970s against such a backdrop of speculation, inflation and general financial instability. Unfortunately, in view of the lack of a return to 'normality', problems caused by it have been exacerbated and the situation has become critical. The different players who are involved have been adapting to the demands of this situation in various ways, economic, political or all too often a mixture of the two. Who are these key players and what have been their responses?

Western Commercial and Central Banks and the International Financial Institutions.

These agencies play the pivotal role in managing the debt of Third World countries within the framework of their own interests. In terms of the immediate effects of default or financial collapse, the commercial banks have the most to lose of the three, though central banks are hardly likely to make light of the failure of private financial concerns for which they have the responsibility of supervision. International institutions, on the other hand, are more concerned with maintaining the viability of the global financial networks which are essential to the functioning of the larger world economy. The driving factors behind the responses of the commercial banks are pretty much the same as those which encouraged them to get involved in lending to developing countries in the first place. The maintenance of profitability and/or market share, the desire to expand into

new forms of lending in order to compete more effectively and the urge to find and keep valued new customers and disengage from those who are no longer considered to be good risks are among these factors.

Some commercial banks are more heavily exposed in unsecured international lending than are others. Similarly, some have concentrated their lending to relatively few borrowers in a smaller number of countries. Some have domestic difficulties which compound and exaggerate the effects of their more awkward international loans. Ultimately, all the private banks all over the world have a vested interest in maintaining their established systems of international credit and ensuring that the mechanisms involved do not break down.[103] This is something they have in common with the central banks.

The central banks have the prime motivation of ensuring the smooth functioning of their domestic financial systems, thus helping their domestic economies to perform at acceptable levels. Yet, in some instances, they are more broadly involved. Certain Western governments tend to either use their domestic monetary and financial policies as deliberate means of achieving their foreign policy goals or, more often, take decisions at home which have serious repercussions elsewhere. When this occurs, the central banks often have the task of monitoring the effects of government actions and helping to implement desired policies, while at the same time acting as a conduit for interaction with those

responsible for financial decision-making in other nations which are affected by the actions taken. This inevitably means that the central banks of the larger industrial powers do become involved in maintaining the health of the international system of credit transfers and tend to take defensive action whenever a threat seems imminent.[104] In this they are at one with the major international financial institutions such as the International Monetary Fund (IMF) and the World Bank.

The IMF is the organization which is perhaps most involved in attempts to stabilize international lending and thus minimize the global economic consequences of the outstanding Third World and Eastern Bloc debt. In the absence of an International Lender of Last Resort (ILLR), the IMF fulfils some of the functions that may reasonably be expected of such a hypothetical institution by providing limited short term funding to extricate debtors who are having difficulty making payments and by organizing larger 'rescue' packages when the need warrants it. From the point of view of the creditors, The Fund serves a useful purpose by providing a degree of supervision over the way in which debtor nations frame and implement economic policies, thus helping to safeguard the existing investments of the creditors and hopefully opening up the way for further financing at some future stage.[105]

It is clear that the interests of commercial and central banks and organizations like the IMF are significantly

intertwined. So the actions taken by one often enhance those taken by the others. Of course, this affects the ways in which they are perceived by debtors who may decide that these three sorts of players are cohesive and united in trying to propose and implement policies that are antagonistic, if not downright hostile, to the interests of the debtors themselves.

Developed Capitalist Countries.

The advanced capitalist or Developed Countries (DCs) have major concerns about the present problems with Third World lending. In the light of the role played by banks based in these countries, this is not surprising. The exposure of these banks and the resulting threat to their stability also poses risks for the banking systems within these capitalist nations and thus is under close scrutiny by the governments of the DCs. The rationale is that, if the banks were to get into difficulty, the governments responsible for them would bail them out by some means or other and prevent the possibility of collapse.[106]

Superficially, such action may seem fairly simple to conceive and relatively straightforward to execute, yet on a deeper level several complications arise because of competing demands on governments to act in different ways when dealing with such crises. Action to 'rescue' banks may run counter to the economic and fiscal policies that governments have been pursuing.[107] In any event some choices

have to be made about where intervention should take place, not to mention the timing of the intervention and other technical details. Also, domestic political difficulties may be raised for governments irrespective of whatever course of action they determine to pursue.

At least the aforementioned are obvious ways in which DC governments interact with the question of Third World Debt. Less obvious connections occur in terms of aid and trade. The recipients of government to government aid flows are more likely to receive larger degrees of assistance, if they are deeply in debt to banks from the donor nation and show signs of difficulty in meeting payments.[108] They are also more likely to qualify for better terms of trade with the donor and perhaps be able to exploit unusual avenues such as barter or countertrade.

DC governments probably have the most serious impact on Third World Debt when they put into place domestic economic policies, which may nominally have the soundest of rationales, but which adversely affect international debtors and/or creditors. For instance, the bidding up of domestic interest rates may be appropriate within the framework of an industrial economy trying to deal with inflation by the rigid application of firm controls on the money supply, yet the fact that this automatically means higher interest rates for foreign debtors is not necessarily a matter of consequence in the determination of such policy.[109]

Also, domestic policies followed by DC governments in relation to such matters as trade, manufacturing industry, protection, agriculture and a host of other areas, can and do affect the positions of debtor nations.[110] Either alone, or in conjunction with deliberate foreign policy goals, these can have a major effect on many Third World countries.

The Organization of Petroleum Exporting Countries (OPEC) and Successful Non-oil Industrializing Countries (SNICs).

With some important exceptions, notably Mexico and Nigeria, the members of OPEC do not have many direct concerns with the critical nature of outstanding debt in the Third World. In fact, the main concern of the cartel is trying to remain a cohesive force in the face of the pressures brought by the global oil glut and the increasingly divergent aims of its member states.[111] Those that are better off are more concerned with maintaining floor prices for the different grades of oil even at the cost of production cuts which lead to reductions in revenue. Cash-strapped members, on the other hand, are more concerned with increasing their revenues, even if it means a diminution of prices. As OPEC has become more involved with its internal problems, it has become less influential on the global scene. Major beneficiaries of OPECs past successes, such as Saudi Arabia, still have abundant cash reserves, which for the main part they were wise enough to funnel to borrowers through Western banks. While this may have been originally motivated by a lack of expertise in the area of

international lending, the fact remains that these OPEC depositors are covered by the guarantees of the international financial system.[112]

The position of the SNICs is somewhat similar. They have almost uniformly adapted to the changing conditions of the global economy, including the higher price of energy, and consequently are well-placed to maximize their potential for economic growth and prosperity.[113] Some, such as South Korea, are significant, indeed major debtors on the world's financial markets.[114] However, so far, they have not encountered any major problems with servicing debt and maintaining credit ratings. Trends in global interest rates are of importance to economic planning in their governments and strategic development in their industries, because changes in charges can significantly alter future prospects, but there do not seem to be any indications of major trouble ahead that could deteriorate into a crisis. They could be said to be in a fairly positive position to cope with such problems, if they did eventuate.

Unsuccessful Non-oil Industrializing Countries (UNICs).

UNICs are perhaps in the most critical situation of all in regard to their vulnerability to the negative effects of their international indebtedness. This is true even in comparison to the extremely poor, non-industrial countries of the so-called Fourth World. The latter, while certainly suffering from chronic poverty, did not qualify on

commercial banking criteria as acceptable borrowers and are thus spared the pain of coping with the fallout from the failure of the system of repayment.[115] The only non-industrial countries to receive significant loans from international banks were those that were extremely rich in resources, such as Zaire. Yet, even these received only relatively small amounts of funds.[116]

Two of the world's three largest debtor nations fall into the category of UNICs, namely Brazil and Argentina. The other Mexico, though an oil-exporter and a member of OPEC, has more in common with UNICs than with OPEC and rightly perhaps should be placed in this section. Common factors include ambitious industrialization programs, underwritten by foreign loans, that failed to achieve their intended goals; massive problems of poverty and unemployment which show signs of worsening rather than easing; lack of reliable markets for products of industrial development; hyperinflation and negative real growth rates and so on.[117] The three major debtors in Latin America provide valuable material for comparing and contrasting experiences of Third World Debt dynamics, though Argentina has been chosen as the case study. It is expected that this case will illustrate clearly the variety of response tracks available to UNIC governments in coping with the demands of international creditors.

In the following chapters, the rationale for the classification and the justification for the grouping

together of certain types of players, will become apparent. Superficially disparate groups will be demonstrated to have common interests, while others which are thought to pursue the same objectives will be shown to have different aims and goals.

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32. Versluysen, E.L., The Political Economy of International Finance, Gower, Farnborough, England, 1981, pp. 49-54.

33. Yassukovich, S.M., "The growing political threat to international lending", Euromoney, London, April 1976, p.12.

34. Independent Commission on International Development Issues (ICIDI - Brandt Commission), North-South: A Programme for Survival, Pan Books, London, 1980, pp. 239-41.

35. Sampson, A., The Money Lenders: Bankers and a World

in Turmoil, Viking Press, New York, 1981, p. 143.

36. Examples of cases where this has occurred are discussed in Spindler, J.A., The Politics of International Credit: Private Finance and Foreign Policy in Germany and Japan, The Brookings Institution, Washington, D.C., 1984.

37. The term refers to the previously unfamiliar phenomenon of having high rates of inflation in an economy that was simultaneously undergoing stagnant growth and high unemployment.

38. This was another example of the fallacy of treating the developing world as one amorphous mass, rather than as different countries, groupings and regions with varying characteristics.

39. For some examples of the kind of unsound banking practices engaged in during the 1970s, see Lipton, M., "Brandt: Whose Common Interest?", International Affairs, London, 56(2), April 1980, p. 319.

40. Sampson, A., The Money Lenders ---, pp. 140-5.

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42. For an elementary overview of how this connection works see Trevithick, J.A., Inflation: A Guide to the Crisis in Economics, Penguin Books, Harmondsworth, England, 1977, especially Ch. 7.

43. Indeed, oil was sometimes perceived to be a better bet than gold, for oil, it seemed, could only go up in price, while gold was subject to the vagaries of the market (after its de-linking from the dollar).

44. Since oil was the best collateral, naturally OPEC members were considered to be the best risks.

45. Since the purchasing power of currencies was continually declining, the payments due in future would not be so onerous in terms of the prevailing market prices of goods and services, especially those supplied by the debtor as a means of international exchange.

46. Graf., W.D., "Anti-Brandt: A Critique of Northwestern Prescriptions for World Order", in Miliband, R. and Saville, J. (eds.), The Socialist Register, Merlin Press, London, 1981, pp. 24-6.

47. This was especially so in view of the domestic difficulties being experienced because of problem loans, such as those to municipalities and real estate investment trusts in the US. See Ganoe, C.S., "US banks' international loans under scrutiny", Euromoney, London, March 1976, p. 11.

48. The banks have in general maintained that they did

the opposite, i.e. found worthy borrowers before seeking deposits for loan funds. See Gut, R.E., "The Point of View of a Commercial Banker", in Fair, D.E. and Bertrand, R., (eds.), International Lending in a Fragile World Economy, Martinus Nijhoff Publishers, The Hague, 1983, pp.9-10. Unfortunately, not many people are willing to believe them.

49. However, these rates were usually variable. In the longer term the volatility of these interest rates was very destabilizing. See Cooke, W.P., "A Supervisory Perspective", in Fair, D.E. and Bertrand, R., International Lending ---, pp. 20-1.

50. Yassukovich, S.M., "The growing political threat ---", p. 12.

51. Particularly so, in view of the differing demands placed upon the banks by the variety of other parties involved.

52. See "Opec's sunset", The Economist, London, October 27, 1984, pp. 14-5.

53. See "Oil and the Gulf", The Economist, London, July 28, 1984, (Survey) p. 3.

54. Lipton, M., "Brandt: Whose Common Interest?---, p. 324-5.

55. For example see Lever, H., "The Debt Won't Be Paid", The New York Review of Books, New York, XXXI(11), June 28,1984, p. 3.

56. Much of this was owed by developing countries directly to banks (excluding offshore markets), i.e. at end-June 1982 $ 347.5 billion. See Morgan Guaranty Trust Co., World Financial Markets, New York, February 1983. By the end of 1982, this figure had reached $ 362.7 billion. See Dale, R.S. and Mattione, R.P., Managing Global Debt, Staff Paper, The Brookings Institution, Washington, D.C., 1983, p. 9.

57. On Congressional Budget Office figures.

58. Given the high level of public ownership within many developing economies, this is hardly surprising.

59. Heller, H.R., "Managing International Indebtedness", in Fair, D.E. and Bertrand, R., International Lending ---, pp. 282-99.

60. The exceptions are Cuba, North Korea and China after the 1949 revolution. See Yassukovich, S.M., The growing political threat ---, pp. 12-4.

61. ibid., p. 14.

62. Schweitzer, P.-P., "On the financing problems of the Third World", Euromoney, London, March 1976, pp. 14-18.

63. Ganoe, C.S., "US banks' international loans ---, pp. 11-3.

64. ibid., p. 11.

65. ibid.

66. ibid.

67. Ganoe summarizes this argument in his article. ibid., p. 14.

68. Strangely enough, at this time, diversification of loan portfolios to spread risk was not considered to be necessary, with the emphasis being on specialization in lending to certain countries on the basis of certain types of projects.

69. Ganoe, C.S., "US banks' international loans ---, p. 13.

70. Meadows, D.H., Meadows, D.L., Randers, J. and Behrens, W.W., The Limits to Growth: A Report for the Club of Rome's Project on the Predicament of Mankind, Pan Books, London, 1974, pp. 45-87.

71. Yet, in some informed quarters there was ongoing concern about this and a growing sense of disquiet. See, for example, Cleveland, H.van B. and Brittain, W.H.B., "Are the LDCs in over their heads?", Foreign Affairs, New York, July 1977, pp. 732-50.

72. This was particularly so in view of the very high electrical energy demands of the process by which bauxite alumina is turned into aluminium.

73. Beim, D.O., "Rescuing The LDCs", Foreign Affairs, New York, July 1977, p. 726.

74. Sampson, A., The Moneylenders ---, p. 154.

75. ibid., p. 148.

76. ibid.

77. ibid., p. 149.

78. ibid., p. 150.

79. ibid.

80. ibid., p. 152. Outstanding commercial bank loans to Zaire at the time were estimated to be of the order of half a billion dollars, see Beim, D.O., "Rescuing the LDCs", ---,

p. 726.

81. Sampson, A., The Moneylenders ---, p. 133.

82. ibid., p. 134.

83. For a concise discussion of the role of central banks as lenders of last resort (LLRs), see Griffith-Jones, S. and Lipton, M., International Lenders of Last Resort: Are Changes Required?, Midland Bank International, Occasional Papers in International Trade and Finance, March 1984, pp. 5-7.

84. Branford, S., "Tumbling to a second disaster", South, London, April 1984, p. 16.

85. For a broad discussion of some of the debt problems confronting the Latin American region see Enders, T.O. and Mattione, R.P., Latin America:The Crisis of Debt and Growth, Studies in International Economics, The Brookings Institution, Washington D.C., 1984.

86. Branford, S., "Tumbling ---", p. 18.

87. ibid., p. 16.

88. Lipton, M., "Third World Debt, Financial Crisis and the International Lender of Last Resort", Speech to the Australian Institute of International Affairs, Adelaide, South Australia, 6 May 1984. Notes made at this speech.

89. ibid.

90. Especially when their power base is unstable and they have to do deals with disparate interest groups within the various sections of society, such as the labour unions, the military, the church, the middle class, business and so on.

91. Compare, for example, the changes in perceptions that have come about between December 1984 and March 1985, of the ability of the Alfonsin government to pursue the terms of its agreement with the IMF. See "Argentina: Perhaps a sip of champagne", The Economist, London, December 15 1984, p. 20 and "Latin American Debt: Baroque around the clock", The Economist, London, March 30 1985, p. 89.

92. Block, F.L., The Origins of International Economic Disorder:A Study of United States International Monetary Policy from World War II to the Present, University of California Press, Berkeley, 1977, p. 164.

93. ibid., p. 165.

94a. A 'clean' float is one in which the government or central bank concerned do not intervene in the market to influence the exchange rate of the domestic currency,

irrespective of whether this would be advantageous or not. A 'dirty' float occurs when the temptation to intervene gets the better of the regulatory authorities.

94b. Blake, D.H. and Walters, R.S., The Politics of Global Economic Relations, Prentice-Hall, New Jersey, 1976, p. 49.

95. ibid.

96. ibid., p. 50-1.

97. Some of the attempts to counteract this threat are discussed in Block, F.L., The Origins ---, pp. 177-81.

98. Cooper, R.N., "Prolegomena to the choice of an international monetary system", in Bergsten, C.F. and Krause, L.B. (eds.) World Politics and International Economics, The Brookings Institution, Washington D.C., 1975, p. 88.

99. See Blake, D.H. and Walters, R.S., The Politics ---, pp. 51-2. Interestingly, these concerns were shared by certain elements of American capital which viewed some of the more provocative actions of the Vietnam war as being counterproductive in terms of opening up what was seen to be potentially highly profitable trade with the USSR and China. See Kolko, J., America and the Crisis of World Capitalism, Beacon Press, Boston, 1974, pp. 22-3.

100. Strange, S., "The Dollar Crisis 1971", International Affairs, London, 48(2), April 1972, pp. 191-215.

101. Block, F.L., The Origins ---, pp. 193-9.

102. ibid., p. 203.

103. This common interest is exemplified in the willingness of these banks to join in syndicated rescheduling of problem loans, even though they are aware of the dangers and may not have been involved directly in the first instance.

104. See Basagni, F., "Approaches to the Prudential Supervision of International Lending", chapter in Cohen, B.J. Banks and the Balance of Payments:Private Lending in the International Adjustment Process, Allanheld Osmun & Co., New Jersey, 1981, pp. 147-67, for a broad discussion of some of the difficulties involved in taking on this role.

105. Guitian, M., "Economic Management and International Monetary Fund Conditionality", in Killick, T. (ed.), Adjustment and Financing in the Developing World:The Role of the International Monetary Fund, International Monetary Fund, Washington D.C. and Overseas Development Institute, London, 1982, pp. 73-83.

106. Friedland, J., "Debt: Changing Roles", South, London, April 1983, p. 10.

107. Admittedly, this in itself is not necessarily cause for ruling out intervention, especially when it is dictated by political expediency.

108. Lipton, M. "Third World Debt ---". Notes.

109. Bosworth, B.P., "Lowering the Deficits and Interest Rates", in Rivlin, A.M., Economic Choices 1984, The Brookings Institution, Washington D.C., 1984, p. 36.

110. Gauhar, A., "Brandt II: forging weapons to beat a common crisis", South, March 1983, pp. 30-1.

111. See "Opec's final split comes another meeting closer", The Economist, London, February 2 1985, pp. 55-6.

112. Unless, of course, such guarantees prove to be valueless and the system does indeed collapse!

113. Cohen, B.J., Banks ---, pp. 199-202.

114. Cline, W.R., International Debt and the Stability of the World Economy, Institute for International Economics, Washington D.C., September 1983, p. 54.

115. Indirectly though, most have suffered as a result of the system failure as aid is being redirected away from them to important debtors with repayment problems.

116. For example, Zaire received in total less than 500 million dollars, which is relatively small given the promised potential of its resource deposits. See Beim, D.O., "Rescuing ---", p. 726.

117. These factors are discussed at some length in Enders, T.O. and Mattione, R.P. Latin America ---, but also see Williamson, J.W. (ed.) Prospects for Adjustment in Argentina, Brazil and Mexico:Responding to the Debt Crisis, Institute for International Economics, Washington D.C., June 1983.

CHAPTER TWO

BANKS AND INSTITUTIONS

"May you live in interesting times!"

— Confucian Curse.

The 1980s are proving to be very interesting times for the major Western commercial banks, for the central banks responsible for their supervision and for international institutions such as the IMF.

Risk Evaluation and Management

Banking as a business is based on the ability of those engaged in it to evaluate risk successfully. This is the key element in deciding profitability and, ultimately, survival of individual enterprises. Broadly speaking, risk is evaluated on two fronts.[1] The first, the chance that a particular debtor will default, is credit risk. Banks generally have accumulated substantial experience in estimating the likelihood of this occurring and selecting the better risks. The second, the probability of the the underlying price of something (e.g. interest rates or the market value of a particular security) changing in an unexpected fashion, is market risk. Given the relatively short history of volatility in market pricing of financial instruments, banks have less experience in evaluating this market risk.[2] What is worse is that when the two types of risk are taken together, they interact in unpredictable ways, which are only now becoming clear.

Most of the problems facing banks involved in lending to

sovereign debtors in the Third World and elsewhere, are traceable to inadequate risk management. For example, at the time when many of these loans were being made in the early to late-1970s, when the notion of market risk was first starting to become a serious concern, most banks made little or no provision in their lending arrangements to pass on the risk to customers or even speculators, until late in the game.[3] Under the impact of relatively unregulated Euromarket and other offshore markets, government after government in the industrialized countries was forced to lift controls on local deposits, on such things as interest rates and capital flows, in order to enable their domestic banks to compete.[4] The ultimate expression of this trend, at the time, was the emergence of offshore banking centres[5] in places like New York and London. These centres tapped directly into Euromarkets and were treated differently, in an administrative sense, to the domestic markets.

These early moves very rapidly led to market risk for banks acting as intermediaries in channelling funds to Third World borrowers, from OPEC surpluses and elsewhere. To offset this market risk, banks eventually moved towards flexibility in pricing their products. For example, this meant that floating interest rates became the norm, with a margin above a common indicator such as LIBOR being negotiated and the cost to the borrower being adjusted according to market fluctuations.[6] While this was fine as an offset to market risk, what banks seem to have failed to understand is that these very changes then had an adverse

effect on their borrowers, even those which were sovereign states. In protecting themselves from market risk, banks took action which adversely affected the credit risk implicit in lending to many of these debtors, while at the same time failing to realize that this had happened, until the repayment crunch of the early 1980s.[7]

This hidden problem tended to be compounded by the relatively poor procedures followed by too many banks on the management of credit risk itself. This was exemplified by the all too frequent cases of bank officers marketing the loans, often on a commission basis, and also being responsible for assessing the credit risk involved. Even in cases where approval from head office was involved, too much reliance was placed on the mere fact of sovereignty being a guarantee of proper servicing and repayment. The fact that many banks have changed their loan marketing procedures is a tacit admission of their previous shortcomings, although they still vary widely in the degree of autonomy given to those in the field and the degree of risk taken on by the individual banks involved.[8]

One point which needs to be stressed is the degree to which differences in thinking about risk exist across the wide spectrum of banks, and the varying extent to which they are able to cope with risk. The big money-centre banks in the US, Citicorp or Chase Manhattan for example, have very heavy outstanding loans to many of the worst-off international debtors, such as Brazil and Mexico. Yet, they

also have global reach in their business activities and many of the overseas and even domestic divisions are quite profitable, enabling substantial loan-loss provisions to have been made against the possibility of default.[9] On the one hand, risk management has been sharpened up considerably, but on the other the larger operators are still more likely to look for credit risks which are higher than the industry norm, on the basis that these provide better profits. The smaller, often regional or rural-based banks which abound in America as a result of the McFadden Act and its prohibition of interstate banking, are now much more cautious, and much less likely to get involved in lending to Third World debtors, except in rescheduling loans they are already involved in. They are generally the model of cautious propriety.[10] However, they are also more likely to be the ones which go under. The 145 banks in the country that failed or were forced to merge in 1986 were exclusively small banks with regional bases.[11] They suffered on several counts of poor previous lending practice (agriculture, energy and other poorly performing sectors being over-represented in their portfolios). This concentration of risk in particular areas was itself a result of regionalization of the banking system, with many banks unable to diversify their credit or market risk across state borders.[12] Even those smaller banks which had been caught in problem syndicated Third World loans were more likely to have to bail out of these at a significant loss, while the big operations did not and were able to avoid, so far at least, serious disruptions to their profitability. On the

other hand they did have access to more stable, cheaper deposits than the large banks, though by being restricted in their geographical spread, they found it increasingly hard to find good prospects to lend to.[13]

The McFadden Act and the Glass-Steagall Act (which insists on a separation between retail and investment banking) have now become the twin bugbears of the finance industry in America. While these originally came into existence as a response to the excesses of the 1930s, the argument now is that in trying to impose outmoded legislation on a much changed banking system, US regulators risk threatening the very stability that they wish to bring about. This is obviously the start of a push for some sort of modification by Congress, in conjunction with the US Federal Reserve, of the existing legal framework in which American banks operate. It seems likely that, given the loopholes that exist in the current legislation and the pressures on the American banking sector to rationalize and consolidate, major changes will almost certainly be approved over time.[14]

Japanese banks too are hamstrung by the legislation that covers their operations. The Ministry of Finance and the Bank of Japan, have established strict divisions between them and delineated precisely what sorts of business they may involve themselves in. For a start, Japan's equivalent of Glass-Steagall, Article 65 of the Banking Code, forbids deposit taking institutions from dealing in securities, much

more strictly than the American regulations.[15] City banks do not deal in foreign exchange transactions. Long-term credit banks do not touch short-term securities. The general thrust of banking in Japan has been to be conservative in assuming risk and to accept the resulting low profitability, though this too is changing with deregulation. In the past, the Japanese government had a vested interest in maintaining a banking system that was the main source of cheap finance for its massive program of postwar reconstruction and industrialization. As is so often the case in Japan, the banks themselves were willing to go along with this enthusiastically, given the central role that many banks played in the major industrial groups, including the cross ownership of each others shares. The compensation for accepting restrictions was the maintenance of low interest on deposits by regulation, tight controls on the channelling of money overseas except through the banks, and the relatively unfettered freedom to become significant players in overseas markets as the banks followed Japanese industry offshore. Given these conditions it was not necessary for many Japanese banks to maintain large loss reserves or maintain too many prudential requirements, and this was to their benefit.[16]

European banks have, on the whole been much freer to operate as and how they wish, without formal legislation restricting too many of their options. This is partly due to historical circumstance, partly because of their much greater experience in managing the hazards of the

Euromarkets, and partly in recognition of the fact that they tend to be quite receptive to the wishes of central banks,[17] often expressed as 'nods and winks' rather than formal directives.

Problems of Internationalization

Irrespective of the domestic situation of banks, once they have begun to move outside the home market and become involved in international lending and other services, problems arise on a variety of levels.

Apart from the obvious decline in accuracy of forecasting credit risk as banks begin to deal with debtors with whom they are less familiar, and the resulting possibility of debt default, there are also magnified prudential risks, not the least of which is that regulatory responsibility is either blurred or inadequate. This led to such debacles as the Italian central bank refusing to support Banco Ambrosiano's Luxembourg operation because it was a holding company and not a fully fledged bank or branch, even though it had engaged in most standard banking practices (and some non-standard ones!) while under nominal Italian supervision.[18] Luxembourg itself, like most offshore havens which lack a central bank or other obvious lender of last resort, does not regulate or supervise the activities of financial institutions in its jurisdiction, except in the most basic of ways, such as collecting licensing fees or other operational charges.

An OECD policy study (Pecchioli, 1983)[19] of issues involved in the internationalisation of banking identifies the problems associated with prudential control and regulatory oversight as a central factor that needs to be addressed. It specifically points to such things as different disclosure rules between countries, obstacles to cross-border transfer of information such as 'secrecy' provisions in some countries, and incomplete reporting by the banks themselves of all activities undertaken for reasons of commercial sensitivity or the desire to keep certain types of business off the balance sheet.[20]

The OECD's Committee on Financial Markets also commissioned an enquiry into banking structures and regulations, in order to identify and assess the most significant changes that have taken place in the past twenty years or so. (Expert Group on Banking, 1985).[21] The report of this enquiry points out how current trends in banking, ranging from new products and services to the new technologies (e.g. computerized clearing systems) required for handling them,[22] have complicated the regulatory process and made it more difficult. The growing importance assumed by market-oriented policy development is reflected clearly in this study.

When considered together the two OECD documents sum up the overall picture in relation to global banking in the 1980s. On the one hand, there have been many developments

which are seen as positive by most players. These include the spread of new financial services, increased competition on pricing leading to reduced costs for industry, easier access directly to the markets for many corporations which previously had to rely more heavily on banking intermediaries, and so on. On the other hand, governments have tended towards losing traditional control of their national banking sectors thus making it more difficult to utilize them as agents of general economic or monetary policy. There has been a blurring of prudential and regulatory responsibility with a consequent risk to the safe and effective functioning of individual banks and the systems in which they operate. The global financial system itself is appearing to be more at risk than it has been for some time.

Difficulties Facing Banks and the Banking System

Much concern has been expressed about the issue of so-called Third World Debt, and its impact on the banks involved and the international financial system generally. Yet, since the problems associated with this type of lending came to the fore in 1982 when Mexico ran into difficulty, very few banks involved in loans to Third World debtors have suffered any unbearable losses because of them. Only the small minority of banks which lent to private corporations without government guarantees or sold off their Third World portfolios at a substantial discount and absorbed the losses, have suffered concrete harm so far.[23] The others

have, until the recent round of provisioning, been able to maintain their outstanding loans as performing assets, given that interest has continued to be paid, in spite of the periodic moratoriums. Until recently, few banks have engaged in any significant writing down of their holdings of LDC government securities. This position has been made possible by IMF intervention, and the threat of witholding further credits for trade or essential imports or new money with which to service old loans.

So, apart from some depressive effect on the share prices of the more heavily exposed banks, the actual impact of the problems encountered so far has been negligible.[24] The threat is a potential one, especially if it is not taken seriously enough to enable some sort of manageable position for all those involved. This is even clearer when one examines the banks which are going under or being forced into protective mergers in places like the United States. Often these were institutions which were exposed too heavily to concentrated risk, either in terms of geography or sector. Thus the slump in energy-related business in Texas and the collapse of agriculture in the Midwest have claimed victims in the banking industry.[25] Sometimes the fundamental risk involved was further complicated by institutional managers who lacked adequate judgement in investment decisions. For example, in 1986 the State government of Ohio, in conjunction with the Federal Savings and Loans Insurance Corporation (FSLIC) had to rescue several thrift institutions in the state which had exposures on a wide

variety of fronts, including rural credit and farm machinery. What made this worse was that some of these Savings and Loans (S&Ls) had made big purchases of high-yield bonds and securities ('junk bonds') from Wall Street investment banks.[26] Given that, by definition, junk bonds are below investment grade, did these S&Ls have any business getting involved in them in the first place? Having done so could they expect to be bailed out by the state? Did the purchase of junk bonds indicate a particular recklessness on the part of those in charge? On the other hand, given that the historical rate of default on junk is only marginally above that on investment grade securities, and in view of the fact that returns were much higher and no S&L was brought down by a default by the issuers of junk, (but rather by the failure of previously blue-chip clients), did the purchase of junk bonds just indicate good business acumen? It becomes apparent that the main problem facing most lenders in today's financial markets is evaluating risk correctly, being aware of its changing nature and then managing it successfully.[27] Failure to do this well leads to failure in the marketplace.

The Nature of the Threat

While it is widely agreed among most observers that there is a distinct threat, or the possibility of one, to the banking systems of the major advanced industrial countries, there is much debate about its nature, scale and managability. The difficulty involved in pinning down

precise notions about debt problems run afoul of the usual hurdles of ideology, self-interest and narrow perceptions. Yet, one may still feel free to indulge in some fundamental judgements.

It is necessary to remember that only a potential threat exists, albeit a serious one. Too many observers make the mistake of assuming that matters are already out of control, and this is patently not the case. Now what combination of factors would lead to the realization of the threat? Keeping in mind the imprecise nature of forecasting, it is still possible to identify individual elements. For the threat to materialize, a significant number of debtors or their sovereign guarantors have to default on their obligations, clearly and systematically. In the view of some, this has already happened, but given the fluid nature of creditor-debtor relations and the flexible definition of default, in practice this is very hard to do.[28] The norm is some sort of deal on rescheduling or some degree of renegotiation. So far the indications are that this exercise in crisis management and damage limitation has worked without any major disasters. Even those instances where major debtors suspend payments on interest, as Brazil and others have done recently, are viewed increasingly with equanimity by a market which sees these moves as a part of the hard bargaining involved in the renegotiation process.

The rescheduling process is often long and complicated due to a variety of factors including the nature of the

particular portion of debt obligation being dealt with, the number of creditors involved (in syndicated loans) and whether the particular political regime being dealt with is harder or softer than its predecessors on the matter of its external obligations and so on.[29] Having to rearrange the terms of existing loans is not a new phenomenon for most lenders, though it is fairly unusual for commercial banks to have to do it on this scale for such a large number of sovereign borrowers. Multilateral and governmental institutions are however much more attuned to this and have a wealth of experience in handling large scale rescheduling, and are thus proving to be of immense help to the banks.[30] Although the IMF is often the main institution involved in this activity, others also play key roles, among them the World Bank, the Bank for International Settlements, the Paris Club (of Western aid donors to developing countries) and assorted United Nations agencies.

While creditors and debtors recognize that they do have a mutual interest in reaching agreement on new arrangements, the negotiating process itself is always tough and sometimes acrimonious. The degree of toughness is illustrated by a telex leaked to the banking magazine Euromoney by the Costa Rican government in 1982.[31] The sender of the telex was Stanislas Yassukovich, then Chief Executive of European Bank in London, and later head of the European operation of Merrill Lynch. In November of the previous year, representatives of the Costa Rican government had met in London with the commercial banks which had lead-managed

their syndicated loans. At this meeting these commercial banks had brought pressure to bear on the Costa Ricans to take certain steps which would have advantaged the situation of the lead-managers, at the expense of some of the other bondholders, including investment banks like European Bank.[32] When Yassukovich became aware of this he telexed the government of Costa Rica, on 4 February 1982, indicating that this would not be acceptable. A specific threat was included, namely that if Costa Rica's commercial bank creditors forced the government to accept their terms, then European and other creditors would "campaign vigorously" to stop any further financing by multilateral institutions. It was implied that this campaign would be guaranteed success, because preliminary lobbying had been favourably received.[33a] Costa Rica apparently felt it had no option but to go along with this demand from Yassukovich, but derived some small comfort by leaking the telex.

The threats made to ensure no defaults would in all probability have been much worse. It is known that during the Latin American crunch of 1982, some banks drew up contingency plans for making life very inconvenient for any governments that flirted with notions of default, or even of forming a 'debtors cartel' which they hoped would give them some added leverage with creditors.[33b] These ranged from irritations like obtaining court orders for the seizure of the assets (e.g airliners, cargo vessels) of defaulting governments in neutral third countries to far more serious moves to deny them all new forms of credit for trade and

essential imports. It seems certain that these threats were a factor in the decision of almost all governments to avoid outright default at almost any cost. Yet, the few governments that actually have defaulted in the past have not been visited with total and absolute retribution. Certainly most lost any access to trade finance and were reduced to paying cash for their imports like North Korea has had to do since repudiating its debt in the early 1970s. However, creditors have not attempted to seize these cash payments as they are processed through the system, even though this would have reduced North Korea's trade to barter only and put pressure on it to seek some accommodation.[34] In the case of Poland, _de facto_ default arguably did take place when the Polish government refused to seek a rescheduling of its debt obligations on anything other than its own terms but _de jure_ recognition of this fact was avoided by both the Paris Club and the commercial banks that had lent to Poland. They were saved from having to do so by making a threat on 29 September 1981, after several months of fruitless negotiation with the increasingly recalcitrant Polish government.[35] If a memorandum of understanding which enabled rescheduling on terms acceptable to the banks was not signed within 24 hours, all 501 banks involved in lending to Poland would declare their loans to be in default and take all steps to freeze Poland out of the global financial system.[36] This ultimate threat of the ultimate sanction possibly could have been ignored. It would have been interesting to see if sanctions actually eventuated, given that the declaration of default could only be done once and this would have meant

abandoning any hope of the banks getting their money back. Default would probably have created serious problems for the West German banks which were among the largest creditors and corresponding headaches for the Deutsche Bundesbank. In the event the Polish government decided to blink first and signed the memo on 30 September, before obliging the banks further at the end of that year by applying to join the IMF.

In some respects, having tackled Poland in 1981 helped the global banking community prepare for the problems that were to follow in Mexico, Brazil and Argentina. Poland was after all a fairly tough case to deal with. To begin with it was a Communist state with no clear track record of dealing with demanding capitalist bankers. It was not a member of the IMF or any other effective international financial institution which would at least have given the banks some leverage in their negotiations.[37] Moreover, Poland's strong integration into the Soviet bloc, along with membership of CMEA, gave it some alternatives in terms of future economic cooperation, which were not available to most Third World debtors. In theory, this should have strengthened the hand of the Polish government to enable it to follow its preferred course of action without being too susceptible to threats made against it. Inexperience in handling balance of payments crises and a poor understanding of the realities of international finance on the part of the Polish bureaucracy were also handicaps to the negotiating process.[38]

In attempting to reschedule their debt or renogiatiate

the terms on which they had borrowed, certain countries followed a fairly hard-line policy, including floating the concept of forming a cartel of debtors which would provide a united front in dealing with the banks. The debtors' cartel idea was floated from a variety of sources, including some unlikely ones like the Indian government, which was not really beholden to private finance to any significant extent, and was not having any real problems with its repayments on concessional loans under official development assistance.[39] For a time, the notion of the cartel was quite popular, because of frustration with the Western commercial banks and their home governments, the desire among LDC governments to push the NIEO agenda as hard as possible in the climate created by the Brandt Commission, and for reasons of South-South solidarity. The lack of progress in reaching any understanding with the Western governments at the Cancun meeting only reinforced the idea of banding together and repudiating debts.[40] Yet, it soon became apparent that for all the idealism of this move, there were always short to medium-term advantages for individual debtors that stayed with the system and avoided getting caught up in an unwieldy and unstable group dynamic.[41] The different repayment schedules of each debtor would have meant that they would have had to default individually at different times. The one to go first, relying only on the promises of the others to do likewise would risk being made an example of, with significant pain to its government and people. Its effective isolation from much of the global economy might then weaken the resolve of the others to do

likewise, and the first defaulting debtor would find itself alone, having taken a great deal of punishment, for no practical benefit to anybody, least of all itself. In the light of this, it is not surprising that the cartel never got off the ground. In any case a confrontationist stance on the part of either side is often counterproductive and is only a last resort. Standard approaches to dealing with debt problems tend to stress the commonality of interest between those involved.

The Role of the IMF and the World Bank

Throughout the current problems being experienced with the question of debt, the IMF has played a pivotal role and is continuing to do so. While its own fairly limited resources prevent it from acting as a major contributor of funds or even as an international lender of last resort, it is a fairly effective facilitator of sustained and, on occasion, even new bank lending. The World Bank has been less involved in the past with balance of payments adjustments and in spite of the efforts of its current head to get it involved in this to a greater degree, still does not play a large role in the overall debt problem.[42]

The IMF tends to act in certain standard ways when faced with serious current account imbalances in its member states. The details, pitfalls, economic and political consequences of IMF intervention have been described at length in a variety of sources and will not be dealt with

more than superficially here.[43] The well known problem of conditionality and meeting its requirements have often proved to be the biggest stumbling block to good relations between debtors and the IMF.[44] The general line of argument pursued by the Fund is that its package of policy measures is the only proven means of handling the severe crunch in balance of payments that many member nations are already in when they eventually approach the Fund for assistance. At this late stage there are then few real options available and the Fund's prescriptions, while bitter medicine, are the best way of trying to get the economy of the country involved back on track, at least according to the Fund.[45] The counter argument to this is that the IMF stabilization program lacks imagination, fails to take into account local political and other factors, and does not give any government willing to implement it much latitude, except to do so by force often against stiff opposition. It is argued correctly that the harshness of the measures involved, (such as scrapping a range of social welfare programs and subsidies on food), are felt at their worst by the poorest sections of the target country's population, which are least equipped to survive them.[46] Thus finding the will to push through an IMF program may be close to a suicidal move for some governments which are already unpopular. In the past most governments have declined to jump over the edge and have had to be pushed.

Lately however, there is some evidence that the IMF's controversial policy prescriptions are finding some degree

of favour with hard-pressed Third World governments. Observation of recent economic strategies pursued by some of these, leads one to wonder at their change of heart. Bolivia's New Economic Plan (NEP) is being held up as a model of a successful adjustment program, having slashed its hyperinflation (at one time estimated to be as high as 20,000% per annum) to two digit levels, and triggered a new round of business investment in the country.[47] The Argentine Austral Plan and the Brazilian Cruzado Plan originally had strong monetary and wage restraints built into them along with the scrapping of many state subsidies for everything from basic foodstuffs to transport. A key part of these programs was the withdrawal of the state from many state-controlled companies and industries, with the implicit threat of mass sackings of substantial numbers of employees.[48] In both cases, pressure from unions and other organized opposition, forced major revamping of the policies and so far they have not continued to deliver the kind of success originally promised in tackling problems like hyperinflation, capital flight, lack of investment, severe unemployment and underemployment, and drastic falls in real living standards.

To further amaze external observers some LDC governments, such as that of Nigeria, have first rejected IMF recommendations and then proceeded to impose adjustment programs on their economies which are far harsher than anything the IMF required.[49] There is often an element of nationalism being manipulated here. On the one hand, the IMF

programs are rejected as being a form of foreign economic dictate bordering on neo-colonialism or imperialism. Many Third World governments find it useful to have the IMF available as a convenient scapegoat[50] for most of their failures of economic policy. Certainly, IMF programs would make harsh circumstances even harsher in many cases and cause a lot of hardship, but this approach fails to deal with the question of why those harsh circumstances arose in the first place. Third World governments should have realized quite early on, that the cards in the global economic game are stacked heavily against them, and that this in turn would dictate a sense of prudence in the management of economic, fiscal and monetary policy. A poorly thought-out strategy of borrowing large sums which did not go into financing sustainable growth, but rather was frittered away in terms of consumption, corruption, windfalls for the elite and capital flight does not fit a picture of responsible economic management.[51] On the other hand, now that some of these governments find themselves in unenviable positions in respect of their policy options, they have had no qualms about appealing to patriotism as their last refuge. In Nigeria, Ghana and even many Latin American countries, the people were told how vital it was that the possibility of 'foreign' (i.e. IMF) intervention in their economy was avoided,[52] even at the very high cost of stringent domestic austerity. The fact that in some cases the programs adopted were far tougher than anything the Fund generally required was never mentioned. In this way these governments were able to satisfy the banks and the IMF while

at the same time appearing to be heroic nationalists in the eyes of their people. Also, this meant that a rationale and precedent for future harsh economic policy decisions was set.

Essentially the Fund's role is to maintain some degree of coordination and discipline among both creditors and debtors. While it is well placed to act as the chief disciplinarian for both sides, this role in itself leaves it open to criticism from all quarters.[53] This is even more the case when there are hamfisted attempts to bring political pressure to bear on it, prime examples of which have surfaced during the tenure of the Reagan administration and the past two sessions of the US Congress. Added to this are the overt activities of powerful lobby groups which seek to influence, through the US and EEC governments, the course of decision-making in the Fund and the Bank.[54] A credibility gap already exists, insofar as many observers doubt the ability of the twins of H Street to maintain a truly impartial stance, and such moves can only further widen this gap.

In spite of this, the Fund has been fairly successful so far at maintaining a certain degree of discipline among those players with whom it has to contend. Failure to have done so may have resulted in some degree of chaos in rescheduling arrangements and other debt management measures.

Official Attitudes Towards Creditor Institutions

A central problem for the IMF and the key OECD central banks which often act in concert with it, has been maintaining a common front among the hundreds of banks which are usually involved in lending to individual debtor nations.[55] This is even more of a problem than maintaining discipline among the various individual debtor entities, since the latter were often beholden to their home governments for guarantees and were therefore not keen to antagonize them by adopting strategies which were not approved of. The banks, especially those involved in syndication were very different. Smaller, regional banks which had often committed smaller amounts to syndicated loans and therefore had less to lose, were more likely to engage in certain types of disruptive behaviour.[56] For instance, when new lending to a debtor nation is part of an IMF sanctioned rescheduling package, the smaller banks have less incentive to 'throw good money after bad', given that they can in most cases sustain the loss of whatever they had subscribed to the original syndicate. This is usually not an option for the large money-centre banks which are often heavily committed and just cannot afford to withdraw. This relative independence of action also extends to the ability of any bank within a syndicate officially to declare a default and invoke the mostly automatic cross-default clauses, even when such action is counterproductive, unnecessary or pointless.[57] The official agencies have to walk a fine line between active encouragement of common

action and coercion to bring it about, especially in regard to coping with these potential 'free riders'.

Cline (1983)[58] has identified three basic ways in which to enforce joint action and overcome the free rider problem. The first is through official pressure. While the IMF does have some influence here, and has demonstrated its ability to get cooperation from the banks in the past, the central banks of the advanced industrial nations have more clout within their individual jurisdictions. After all, they are ultimately responsible for the supervision of commercial banks within these jurisdictions and also act as lenders of last resort when the need arises.[59] Central bank pressure seems to have been exercised most in the United Kingdom, particularly in cases like the rescue of the Natwest and County Banks. Traditionally the Bank of England has relied on the strong 'network' that exists in the City of London, and the responsiveness of this network to moral suasion in times of crisis. Indeed, it is often the case that the central bank does not have to take drastic action, such as actually forcing banks to come up with emergency funds, since the custom of signalling intentions by means of 'nods and winks' is well established. Far from being a quaint hangover from times past, this system has proved quite effective in dealing with crises as they occur. The massive deregulation of British financial markets, known as 'Big Bang', and the arrival of many large overseas institutions which are unused to such polite civility, may force the Bank of England to change its ways, so that foreign bank

executives unschooled in its code do not misunderstand what is expected of them. In any case there is always the possibility that these new players may not be as amenable to the Bank's wishes as it might like, though it would be foolish of these firms to antagonize central bank officials needlessly.

In the United States there is some confusion about the extent of pressure that the Federal Reserve has applied, or indeed is capable of applying. At least some of the regional banks, which tend to be the more vulnerable, have the impression that the Fed could be uncooperative in future individual bank difficulties, if these banks do not cooperate on the debt problem.[60] However, the powers of the Fed are somewhat more dispersed than those of the Bank of England. In Britain, the Bank's authority and through that the potential power in the hands of the Governor, is enormous and largely untrammelled. The US system is littered with checks and balances which, in theory anyway, prevent the Fed chairman from exercising anything approaching the power available to his English counterpart. For a start, the US Federal Reserve system includes 11 regional Federal Reserve Banks, each with their own Presidents and boards.[61] These are coordinated by the Federal Reserve Board, but its Chairman only has one equal vote among the seven board members and can often be frustrated by them, as the experience of Paul Volcker in the past few years has shown. Further division of responsibility occurs in such bodies as the Federal Open Market Committee which has most influence

on monetary policy in the United States. In addition to these regulatory and policy-making roles, any attempt by the Fed to act as lender of last resort automatically involves FDIC[62] which is charged with protecting depositors and therefore carries the risk of any individual bank going under. In spite of this diversity of responsibility the system works relatively well because the threat of bank collapses is sufficiently alarming to all participants to concentrate their minds in times of crisis and make them receptive to rapid and decisive action.

A second avenue for enforcement of collective bank behaviour is the network of influence that the larger, particularly money-centre, banks have on smaller ones. These can apply sanctions, such as exclusion from profitable joint syndicates or termination of correspondent services, against small banks which indulge in 'boat-rocking'.[63]

The third avenue depends for its success on the common knowledge of bankers, namely that today's bad credit risk could very well be tomorrow's good one and vice versa. If debtor governments stipulate that banks which refuse to participate in debt-rescheduling would be black-listed permanently and prevented from doing any business in their respective jurisdictions, this may serve as a handy means of slowing any tendency for banks already involved, to disengage themselves.[64] Of course those banks which are already heavily involved would be least-likely to 'cut and run', because they have so much to lose. Such institutions

would be more likely to be ardent supporters of any IMF sponsored moves to stabilize the individual and collective debt profiles of debtor nations. A more drastic step would be for creditors to be warned that those among them who refused to participate in IMF and major bank sanctioned credit extension programs, would be treated differently in terms of their outstanding obligations.[65] This would mean that banks which failed to act 'responsibly' could be left 'out in the cold' in terms of their position in the order of creditors. In the event of future breakdowns in debt servicing they would be the last to redeem their exposure.

Official Attitudes Towards Debtors

Keeping the banks in line is only one part of the equation for the official agencies involved. An equally serious problem is stopping the debtor governments from taking actions that threaten the efforts of the IMF and major central banks to bring some order to the confusion about debt. While debtor governments are keenly aware of the possible sanctions that can be applied to them in the event of a default or other 'unacceptable' behaviour, for domestic reasons they are sometimes encouraged to play politics with the debt question.[66] This is particularly so in Latin America and Africa, where populism brings its own rewards and complaints about foreign economic imperialism and neo-colonialism strike a deep and resonant chord with the general populace. From time to time, governments facing intractable economic difficulties resort to this strategy as

a means of shoring up their own domestic support. A prime example of this is the behaviour of the Garcia government in Peru, though most of the major Latin debtors and even African nations such as Nigeria and Ghana have had similar episodes.[67] A standard tactic is to use short, sharp, intermittent deteriorations in the balance of payments as the rationale for occasionally suspending the payment of interest on outstanding obligations. This action is never portrayed as a real or intended default. Care is usually taken to reassure creditor banks that the intention is to come to some agreement on future arrangements. The preferred outcome of this forced renegotiation is to try to seek more favourable terms or interest rates as Mexico has recently done and Brazil is trying to do. Usually, however, these periodic interruptions are portrayed domestically as the government standing up to foreign capitalists. This strategy does have its dangers, particularly if one of the players involved miscalculates and overplays its hand.[68] Yet, it is becoming almost institutionalized as a means of exerting leverage against creditors.

In theory such relatively destabilizing behaviour by debtors should draw the disapproval of the IMF and the major central banks and perhaps lead to the imposition of some sort of 'punishment' in economic terms. In practice, the evidence is that such penalties are avoided. For example, the suspension of payments by Mexico in 1986 did not lead to any form of reprisal by the banks, under pressure from the US Federal Reserve and the IMF. The American central bank

was particularly concerned about the implications any adverse pressure on Mexico would have on the 'Baker Plan'[69] which was viewed as the centrepiece of the Reagan administration's response to the problems of Third World, and more specifically Latin American, indebtedness. Despite its name, the Baker Plan was masterminded by Paul Volcker, then the Chairman of the US Federal Reserve. Given the importance of convincing all players of the seriousness with which US policy was being formulated and implemented, it was vital that the Baker Plan be seen to deliver its promised benefits. This could not have happened if the plan were derailed by banks which were upset with Mexico. Therefore Mexico's creditors were pressured not only to avoid retaliation, but also to come to rescheduling terms which were favourable to the Mexican government, such as agreeing to a reduced interest rate of 13/16 of a percentage point above the LIBOR.[70] This action served to annoy the government of the Phillipines which had just been refused such favourable treatment by its creditor consortium, and may have accelerated the decision of the Brazilian government to emulate Mexico's example. The banks involved in Mexico resented being presented with a fait accompli on the terms of the renegotiation, the details of which were largely worked out between the Mexican government, the IMF and the Chairman of the Federal Reserve with minimal reference to the bankers' representatives, and have become less compliant as a result in other dealings. The perceived benefits for the Reagan administration of pushing through the deal on Mexico, thus benefitting a friendly government

and stabilizing its control over a potentially explosive neighbour, must be balanced with the loss of some future flexibility in relation to the banks and to other debtors who seek similar treatment and would resent being treated unfavourably.

The role of central banks in providing direction in coping with debt servicing problems is vital. They carry more influence within their respective jurisdictions than the IMF or World bank do, have more direct lines of communication with politicians and government treasury/finance officials (though they are careful to see that these links are not too close for fear of compromising their varying degrees of independence),[71] and tend to have very good relations with commercial banks which, after all, are under their nominal supervision and regulation. The fact that these commercial banks are aware that their ultimate salvation rests in the hands of the central bankers, in their role as lenders of last resort, is a useful lever in negotiations. Furthermore, BIS being in effect a key clearing house and coordinating centre for joint central bank actions, gives these substantial weight when and if they are required. The global network of central bank governors and other key officials is also a powerful tool in managing real and imagined threats to the global economy.[72] Often the network is able to act in concert to convince individual governments or politicians that some actions may be preferable to others, thus lending weight to the arguments of their colleagues on the spot who have been

unable to get the consent of their political masters. A strong and demonstrably independent head of a central bank, such as Paul Volcker, carries much credibility with financial markets and is often able to deliver far more favourable conditions than governments realistically could expect. However, if this independence is seen to be compromised or if the official concerned is clearly a political appointee who attempts to implement blindly the wishes of his government, this credibility vanishes.[73]

In debt negotiations the IMF and central banks, (and of late the World Bank under Barber Conable), tend to enhance each others credibility and ability to deliver specific targets on such things as new loans, levels of repayment and agreed conditions for maintaining lines of credit. Commercial banks have found it difficult to resist their combined power and have tended to go along with much of what is required of them. The problem with this sort of forced lending though is that, when pressured to abandon their normal criteria of creditworthiness (however flawed these might be!), the commercial banks would have moral, and possibly legal, recourse to recover bad debts from the official institutions if the forced loans were to go sour.[74] This could partially explain why the IMF and the central banks have been fairly careful and selective in their moves for new loans for problem debtors, even though the maintenance of new lending is arguably also dictated by the self-interest of the lenders.

In general, debtor needs and problems are receiving a somewhat more sympathetic hearing from the institutions which are endowed with the power to oversee the world's monetary and financial systems, than was the case a few years ago.[75] In some ways this is not as surprising as it would seem at first sight. The relative inaction in tackling debt problems since 1982 has resulted in a strange and unsustainable set of circumstances. On the one hand, till recently, most banks persisted in maintaining their full book value of outstanding loans to Third World debtors listing them as performing assets. While this may have been justified when these were being serviced regularly, or even intermittently, at a time when this is no longer clearly the case, the rationale for treating them as normal assets disappears. The banks have tended to argue against interest-rate reductions for Third World debtors and against the use of specific devices to assist them, such as interest-rate caps or ceilings on the valid basis that this would be a serious distortion of market forces.[76] Yet, they shy away from valuing their loan portfolios at the level that the markets think they are worth. To achieve such a valuation would not be a difficult task since there is an emerging secondary market in 'bad loans'. This market enables smaller banks which wish to get out of Third World lending to offload their outstanding liabilities at a discount to some purchaser who is willing to accept the credit risk involved, in the hope of making a substantial profit if and when the securities are ever redeemed at anywhere near face value. On the other hand, banks have so

far been able to benefit from a five year period of grace from 1982 when the viability of their loans first became suspect.[77] This period during which, for the large part, the costs of adjustment were largely borne by debtors, enabled them to do several things. Firstly, the banks were able to avoid any sudden and drastic write-down of their assets which would have damaged severely their credibility in the inter-bank markets and done terrible things to their share price. Secondly, the breathing space gave them time to rationalize their portfolios of outstanding loans and to seek new areas of business which would be vital sources of profits necessary to offset future losses. Thirdly, this drive for new areas of profitability was helped by the global shift towards deregulation of the finance industry and the explosive growth of financial services. The clear perception of the need for more profitability within the sector probably helped to convince regulatory authorities and governments of the merits of deregulation, given the underlying liabilities that they would otherwise have had to assume as part of their supervisory responsibilities.

The consolidation that has taken place during this time has been of enormous benefit to the Western banking system. Certainly some banks, almost exclusively in the United States, have failed and others are in the process of failing, but these were mainly smallish, relatively obscure operations (with the notable exception of Continental Illinois!), and most of their depositors were protected by the FDIC, which prevented any general panic.[78] Most of the

large money-centre banks have improved their capital reserves and in terms of their balance sheets are not as overextended as they were previously. A variety of innovative mechanisms have been employed to minimize the potential fallout from Third World debt difficulties. Perhaps the most creative of the 'creative accounting' strategies to have come to light so far is that pursued by a consortium of large Japanese city banks which have relatively heavy Third World exposure.[79] This consortium, which includes Mitsubishi, Sumitomo and Dai-Ichi Kangyo, has established a jointly-owned subsidiary company in, of all places, the Cayman Islands, whose capital George Town is a haven for tax avoidance, unrestricted banking activity and money laundering. The banks then sold off to this subsidiary, at a substantial discount, parcels of Third World loans which they no longer considered to be performing assets. The losses that each incurred in discounting from face value were then available to be offset against their tax liabilities in Japan which were quite large given that most Japanese banks have made extraordinary profits by speculating for their own account on the yen/US$ exchange rate. Having been able to claim substantial tax relief on the basis of what are really only paper losses, the banks through their Caymans' company stand to make reasonable profits on the deal, if and when the Third World debt situation improves. They have been able to 'have their cake and eat it too', insofar as tax losses are being taken even though no real change has taken place in actual ownership of the outstanding scrip. The Japanese authorities are well

aware of the strategy and its implications for their tax revenue but have accepted it as a valid transaction. The main reason for this attitude seems to be concern about the consequences of the US-Japan trade war that is currently gathering steam. The Japanese government is worried about the implications of the much higher yen for its exporters, especially since the effects of the Baker-Miyazawa pact[80] of September 1985 seem to be having a far wider consequence than originally imagined. Soon after the first round of changes in exchange rates fed through, the Nakasone government began encouraging Japanese business to utilize the windfall currency profits to begin a new program of investment in upgraded production facilities which would enable them to continue exporting profitably as the yen climbed ever higher. This investment was underwritten by tax credits against increased earnings which were the result of the higher yen value. Most of the substantial number of manufacturers who took advantage of this concession scrapped older existing production capacity and replaced these with more automated, but flexible, manufacturing capacity. The aim of this strategy is to retain some ability to be able to export profitably as the yen climbs even higher.[81] The Japanese government seems to be of the view that any drawn out trade conflict with the US and/or the EEC will require their major banks to be in relatively sound positions vis-a-vis their balance sheets and creditworthiness. Hence the willingness to indirectly fund some of this restructuring of Japanese industry through taxation concessions. So the strategy adopted by the banks to offload

their bad debts and claim tax credits has been given the official nod.

Certain US banks have also got some option to use tax credits to offset their non-performing Third World assets, especially as they have windfall profits from the new financial services that they have introduced over the past five years or so. (Others which were caught badly on a variety of fronts, including oil, real estate, farming and sunset industries do not have such an option as they battle to stay afloat and solvent - witness Bank of America).[82] The problem with these profits now is that they are being eroded by competition, a better informed market which is more keenly aware of the finer margins that can be expected on any business that is written, and the increasingly diminishing returns on new innovations in the way of financial products.[83] There is seemingly also an inability on the part of many banks to find specialist niches into which they fit comfortably. Most seem to be pursuing, in competition, whatever business is felt to be the most profitable at any particular time, thus eroding its profitability. For example, retail banking services are the current favourite, but in addition to each other, the banks are also having to compete with the quaintly-termed 'non-banks', i.e. entities, such as the Sears retailing chain, which are not legally banks but increasingly are providing many if not all of the services that were traditionally provided by banks.[84] These non-banks are not expected to observe the statutory reserve requirements and

other rules of banking, and their increasing impact on the finance industry has led to calls for a more equitable system of regulation (with some implicit deregulation) in the US. Such deregulation, when it comes (and it no longer seems a question of if!), will wash away the increasingly shaky foundations of Glass-Steagall, McFadden and a host of other finance related legislation. There seems to be a hardening consensus between regulators, the Reagan administration and certain elements within Congress that major changes in the way banking is structured in the US will have to occur to preserve the viability of the finance industry in the US. For instance, the notion that major industrial corporations (some of which are very cash-heavy after some very profitable recent years) be allowed to purchase financial institutions, is now being mooted, something that would have been unthinkable not too long ago.[85] Indeed, as this is written, certain of the major money-centre banks such as Citicorp, Chase Manhattan and Bank of America have announced their intention to increase dramatically their loan loss provisions against their non-performing Latin American loans, even though this has negative implications for their stockmarket valuation. If such things were allowed, which is not the general case under existing legislation, this would make them more attractive as takeover targets. Similarly, the divisions between investment and commercial banking, and the securities business are becoming unclear.[86] The replacement of Paul Volcker as Fed chairman by Alan Greenspan is expected to accelerate the pace of change. It could be

argued that the US is about to see one of the most wide ranging and thorough reorganizations of its financial sector which it has ever seen, with substantial rationalization, consolidation and the creation of smaller numbers of very large financial institutions.[87] The sorts of objections which initially caused the wide fragmentation of the industry in the last 50-70 years will not be able to hold back the pressures built up by the setbacks which have been suffered in this decade. Such changes to the finance sector may ultimately prove extremely beneficial to the US economy in a period when competition with Europe, Japan, other East Asian countries and even Latin America becomes a major struggle for deciding global economic dominance and the future of America as a political and economic hegemon.

Plans for Salvation and Redemption

Rescheduling and renegotiation remain only temporary measures which buy some time but do little to resolve the complex problems in which creditors, debtors and the essential components of the global financial system, are currently enmeshed. It has been clear from the outset that something else would have to take their place. Recognition of this fact has created a mini-industry in framing plans for saving the banks and/or the global financial system.

Since 1982 and the crunch faced by Mexico, when the problems involved in lending to Third World nations could no longer be denied, many plans to resolve these difficulties

have been put forward by various individuals and agencies. An implicit assumption of all of these plans is that the players actively involved in the problems of Third World lending, somehow lack the ability to see solutions and if only someone would be kind enough to give them direction then they would willingly pursue any scheme which claimed to be able to get them out of their present predicament. This is not necessarily so.

All told there are probably about two dozen or so widely touted rescue plans. It is not proposed to deal with each of these individually, since they have been covered extensively elsewhere, for example by Kettel and Magnus (1986).[88] As these authors point out, virtually all of these plans attempt to deal with two broad issues.[89] These are, firstly, the distribution of any losses arising from bad debt and secondly, the nature and magnitude of reforms necessary to discourage a similar situation occurring in the future. On the first issue they argue that there are three possibilities:

* Debtor nations tighten fiscal policy and cut expenditure to the level required to continue to service external debt;

* Banks and other institutional creditors absorb the losses stemming from what has turned out to be poor assessment and control of risk;

* Losses involved are shifted ultimately, to a greater or lesser degree, by a variety of mechanisms to the tax-payers of creditor countries.

Kettel and Magnus argue that the last option should not be contemplated while some combination of the first and second can be implemented without there being a serious risk of collapse of the international financial system, on grounds of supposed fairness and avoiding dangerous precedents.[90] They seem to be unable to recognize that lack of fairness is already endemic. So far, there has already been a disproportionate reliance on the first option and all too often, in the countries which do have to adjust, the cost of adjustment falls too harshly on the poorer sections of the community.

Resolution of the second broad issue depends on any proposed schemes being able to deliver one or more of the following results, as listed by the Amex Bank Review of June 19, 1984:[91]

* Banks being able to replace existing LDC loans with more secure assets;

* Adequate time being given to banks to write down non-performing loans;

* The current debt servicing burden of LDCs being reduced by waiving or delaying current interest payments;

* Reduction of the overall burden of LDC debts by forcing banks to take a loss, usually in return for some form of guarantee;

* LDCs having access to new lending which can be directed to more productive use.

In the long term, however, any measures have to be widely acceptable to the majority of participants for them to have a chance of working. This tends to be one of the major stumbling blocks to attempts to resolve the situation by imposing a grand design of one form or another, since in most cases the distribution of trade-offs is not perceived to be equitable. Also these plans, in many cases, do not take account of political realities in both developing and developed countries. For example, at a time when the dominant and radical ideology in both Britain and the United States argues for less state intervention, it would be difficult to make an argument for the governments of these countries to use taxpayers funds <u>overtly</u>[92] to assist banks which have struck problems with their Third World lending but are not necessarily about to collapse.

NOTES.

1. For a concise discussion of the nature of risk in banking and its management see "The Risk Game", International Banking Survey, The Economist, March 21, 1987, pp. 4-40.

2. *ibid.*, pp. 47-50.

3. One aspect of this belated move to offload risk is the global trend towards "securitization", i.e. turning bank debt into tradable commercial paper securities.

4. On the few occasions when authorities tried to resist this trend, such as the US introducing its interest equalization tax and the well-known Regulation Q, there was largely a negative impact on their domestic financial markets and they were soon forced to reverse their decisions.

5. Also known as International Banking Facilities (IBFs), these were physically located in places like London and New York but were treated as if they were outside the jurisdiction of regulatory and even tax authorities.

6. "The Risk Game",--- pp.4-18.

7. *ibid*, p. 47.

8. Profitability of banks and its evaluation has undergone some striking changes in the past few years. For instance, in 1979 average return on equity was almost 14%, but was just under 11.5% in 1985. Yet return on assets was almost 1/3 higher in 1985 than in 1981. *ibid*, p.3.

9. *ibid*, p. 8.

10. *ibid*, p. 3.

11. *ibid*, p. 8.

12. This is not to argue that all regional banks are doing badly. Some are in regions where they have been able to establish a stable retail base (i.e. one that is not dependent on one or two key industries), have enough reach to escape concentration, and possess little in the way of sovereign debt. Some, such as First Wachovia and BancOne, have had higher profitability in 1985-86 than any of the money-centre banks, with the exception of J.P. Morgan and Bankers Trust.

13. This is also true of the some 6,000 US 'thrift institutions', particularly, Savings & Loans.

14. Certain moves by the Fed and FDIC to allow the acquisition of weak thrifts by money-centre banks, or to permit big banks to fully own securities brokers, are seen

as a first step towards this by most observers, though any major changes would have to go through Congress.

15. It has been demonstrated by the very fact that some commercial banks have been able to move indirectly into the investment banking business that there are some loopholes in Glass-Steagall. No such move has been made by any institution in Japan.

16. Since the early 1950s no Japanese financial institution has collapsed or had to be rescued by government intervention or merger.

17. There is an argument that the needs of the commercial bankers and wishes of the central bankers are complementary in any case. See Spindler, J., The Politics of International Credit: Private Finance and Foreign Policy in Germany and Japan, Brookings Institution, Washington, D.C., 1984, especially Chapters 3, 4 and 6.

18. The Italian authorities do have a point in strictly legal terms, but their approach ignores the fact that central banks do not as a matter of course, do what is required by law; they do whatever they have to do in order to maintain confidence. In this case settlement was finally made from the proceeds of asset sales and additional funds from the Vatican Bank.

19. Pecchioli, R.M., The Internationalization of Banking: The Policy Issues , OECD, Paris, 1983, especially Chapter IV.

20. ibid, pp. 55-61.

21. Committee on Financial Markets (Expert Group on Banking), Trends in Banking in OECD Countries, OECD, Paris, 1985.

22. ibid, pp. 38-58.

23. In some instances though, such losses have not been too harmful. For example, First Wachovia wrote off all of its private-sector exposures in Chile and Peru and $3.5 million in loans to Mexico in the third quarter of 1986, but this has only improved its standing on the stockmarket because of its otherwise excellent position.

24. In comparison to what could happen in the case of a serious disruption.

25. While certain of these institutions were involved in Third World lending, they were brought down by their domestic obligations.

26. This move by thrift-type institutions to get involved in wider financial markets is a global phenomenon. For example, even in Australia, some building societies are

setting up their own money-market dealing rooms and speculating in foreign exchange.

27. In true innovative fashion, some Wall St. investment banks are now offering a service in 'Strategic Risk Management' to other financial institutions, which they helped involve in riskier business in the first place.

28. See Friedman, I.S., The World Debt Dilemma: Managing Country Risk, Council for International Banking Studies, Washinton, D.C., 1983, especially Chapters 8, 9 & 10.

29. ibid.

30. ibid, Chapter 7.

31. Euromoney, London, August 1982, p. 40.

32. ibid. For greater detail of the circumstances surrounding this incident see Milivojevic, M., The Debt Rescheduling Process, Frances Pinter, London, 1985, pp. 52-54.

33a. ibid.

33b. Cline, W.R., International Debt and the Stability of the World Economy, Institute for International Economics, Washington, D.C., 1983, pp. 89-93.

34. Far Eastern Economic Review, Asia 1982 Yearbook, FEER, Hong Kong, 1981, p. 180.

35. Milivojevic, M., The Debt Rescheduling ---, p.181.

36. ibid, pp. 50-51 and 180-181.

37. ibid, p. 49.

38. ibid, p. 52.

39. Admittedly though this was a time when the Brandt Report, the NIEO and South-South cooperation were all high priority items on the agenda of action.

40. Particularly in view of the attitude of the Reagan administration at that time, which was, to put it kindly, disinterested.

41. Cline, W.R., International Debt ---, pp. 91-92.

42. In strict terms, any major involvement in the debt problem would be against the World Bank's charter.

43. A variety of good sources exist on this topic, for example, Williamson, J. (ed.), IMF Conditionality, Institute for International Economics, Washington, D.C., 1983, or Williamson, J., The Lending Policies of the International

Monetary Fund, Institute for International Economics, Washington, D.C., 1982.

44. ibid.

45. ibid.

46. See Independent Commission on International Development Issues, North-South: A Programme for Survival, Pan Books, London, 1980.

47. While the adjustment program seems to have worked so far, there is doubt about whether it is a useful model since there were some special circumstances at work. For example, there is a substantial, illegal and unquantified inflow of dollars into the country as a result of its high integration into the cocaine trade.

48. It has long been an IMF contention, with some justification, that public enterprises in Latin America are usually severely overstaffed.

49. Among measures that Nigeria has imposed, which were not expected by the Fund, were the widespread sackings of government employees, especially foreign contract workers, and the mass expulsion of many illegal aliens, especially those from Ghana.

50. In this they are not alone; many international bankers also find this a useful strategy to distract attention from their own shortcomings.

51. This statement has to be qualified. It is by no means a blanket condemnation of the economic strategies pursued by most of the governments involved, but there were serious lapses in planning. For instance, it would seem obvious that a project which was funded in, and paid interest in, dollars but produced a return in pesos or cruzeiros, was patently unworkable given the vagaries of foreign exchange markets, but such projects were entered into without adequate thought about basics like this. Western governments also do similar silly things, but are affluent enough to live with the consequences.

52. This beating up of fear about the consequences of IMF intervention is not confined to developing countries. Britain and France have also endured similar episodes. Currently, there is a small campaign along these lines under way in Australia.

53. Thus lending credence to the 'Scapegoat' or 'Whipping Boy' theories of the IMF's role in the global economy.

54. The IMF has maintained consistently that its decision-making is independent. Recently, some very senior Fund staff resigned in protest at what they saw as undue and unacceptable political pressure brought to bear by the

Reagan administration.

55. Cline, W.R., *International Debt ---*, p. 74.

56. *ibid*, pp. 78-81.

57. *ibid*, p. 81.

58. *ibid*, pp. 78-80.

59. Swoboda, A.K., "Debt and the Efficiency and Stability of the International Financial System" in Smith, G.W., and Cuddington, J.T., (eds.), *International Debt and the Developing Countries*, World Bank, Washington, D.C., 1985, pp. 156-162.

60. Cline, W.R., *International Debt ---*, p. 79.

61. The regionalization of the Federal Reserve system is an artifact of the moves to decentralize the banking sector in the 1920s & 1930s.

62. FDIC itself has recently had an enormous drain on its resources as a result of the unusual number of bank failures. There is talk of increasing the premiums for deposit insurance, in order to avoid any possibility of a crisis within FDIC!

63. Cline, W.R., *International Debt ---*, p. 80.

64. *ibid*.

65. *ibid*.

66. See Cohen, B.J. and Basagni, F., *Banks and the Balance of Payments: Private Lending in the International Adjustment Process*, Allanheld, Osmun & Co., Montclair, N.J., 1981 for some examples.

67. Milivojevic, M., *The Debt Rescheduling ---*, Chapter 5.

68. *ibid*.

69. This plan is named for US Treasury Secretary James Baker and is a belated response from the Reagan administration. Its stated aims are to stabilize the debt situation and to encourage a consistent flow of new lending to debtor nations. Apart from some limited success with Mexico, it has not done much to further these aims.

70. *The Economist*, May 30, 1987, p. 25.

71. The Bank of Japan has somewhat less freedom of action than the US Federal Reserve, which in turn is a little more circumscribed than most of the European central banks.

own accounts, which are becoming more important areas of group revenue.

86. "Wall Street Survey", The Economist, London, July 11, 1987, p.25.

87. As American banks drop lower in the various annual 'league tables' and Japanese banks take their place, pressure is building up within banking lobbies for changes which will enable the creation of American 'superbanks', which would once again dwarf the Japanese. It is not clear how existing anti-trust legislation would be circumvented to achieve this aim.

88. Kettell, B., and Magnus, G., The International Debt Game, Graham & Trotman, London, 1986, Chapter 10.

89. ibid, p. 163.

90. ibid.

91. AMEX Bank Review, American Express Bank Ltd., London, June 19, 1984, p.2.

92. A covert cost to taxpayers funds in a variety of ways probably cannot be avoided. See also Lessard, D.R., and Williamson, J., Financial Intermediation Beyond the Debt Crisis, Institute of International Economics, Washington, D.C., 1985, for possible future approaches to maintaining existing external finance and finding new sources.

PART 11

CASE STUDIES

CHAPTER THREE

THE UNITED STATES

The responses of the advanced capitalist countries to the instabilities attributable to the debt question are interesting, if for no other reason than the complexities they involve. On a superficial level, it could be assumed that the difficulties experienced by Third World nations in repaying their debt, or indeed servicing it, are of only marginal consequence to the developed capitalist states.[1] Closer examination, however, reveals a network of interconnections which affect several areas of policy in the developed countries, creating quite complex problems for the governments of DCs, and interacting with domestic policy formulation.[2] The main purpose of this chapter is to describe some of these interconnections, the policy areas on which they impinge, the kinds of responses they have provoked, and the effects that may become apparent in the longer term.

The problems caused by difficulties with debt repayment have implications for most advanced capitalist countries, particularly those like West Germany and Japan[3], whose banks have been involved heavily in overseas lending. Yet, none is affected more than the United States, which is most heavily involved by virtue of a variety of factors: American banks have heavy and narrow risk exposure, particularly in Latin America;[4] the dangers to the stability of the banking system that this introduces, in turn poses problems and challenges for the US government's program of financial deregulation;[5] financial instability of client states has implications for

the conduct of US foreign policy;[6] the major role that the US plays in such international financial institutions as the World Bank and the IMF means that any upheavals which are debt-related and which involve these institutions, automatically involve the US government in setting directions of policy and practice within these institutions. This often means resolving the question of increased financial inputs by the US government.[7] The debt question also has some implications for the domestic policies of the United States government. The formulation of policy in the areas of trade, industrial strategy, agriculture and energy, for example, owes something to the present predicament of Third World debtors.[8] It would be untrue and unwise to argue that the debt question has a major effect on the way in which policy is ultimately carried out. Yet, it is not possible to ignore entirely the impact of the problems of debtors on the thinking of the US government.

Domestic Economic Policy

As in most other nations, the primary role of US economic policy is to ensure that certain objectives are achieved within certain time frames, often with notional targets for such things as the reduction of inflation, the expansion of growth, the creation of more jobs etc. The government aims to forge a policy mix which will enable it to put into practice the economic and social doctrines of the ruling party, while at the same time trying to ensure the continuation of political power in the longer term.[9]

Ultimately compromises are made.

The current US administration of President Reagan came to power on a platform which promised to restore the US economy after what were seen as the ravages of four years of the Carter presidency. The economic strategy adopted by the Reagan administration is an unusual combination of monetary and fiscal policies. Monetary policy is fairly tight, and has been so from 1979, even before the advent of the present advocates of Reaganomics. The continuing trend during the 1970s for inflation to escalate and the sharpening of this tendency as the after-effects of Oil Shock II filtered through the system, was sufficient incentive for the US Federal Reserve to restrain the growth of money supply.[10] The 'Fed' established very restrictive targets for such growth, measured both narrowly (M_1) and broadly (M_2), with the aim of slowing inflation by reducing demand, leading to decreased production and employment. While the Federal Reserve is largely autonomous and relatively free of government interference, it does ultimately have to be responsive to difficulties encountered in the US economy. Accordingly, a sharper than expected contraction of economic activity caused the 'Fed' to ease monetary control somewhat in the first half of 1980, but by early 1981, restraint was once again the key aim and this continued until mid-1982.[11]

Fiscal policy, at this time, did little to contribute towards restraint. In the middle of 1981, a set of reductions in corporate taxes had a small but significant

stimulatory effect, running counter to the goals of monetary restraint. The inevitable clash of these two policy directions resulted, predictably, in intense competition for restricted credit supplies between the private and public sectors, leading to sharp increases in interest rates.[12] For example, between mid-1978 and mid-1981, the short term Treasury (T-) bill rate went from 8 percent to 17 percent,[13] and the rate on long-term US government bonds went from 8 percent to 15 percent.[14] When adjustment is made for the effects of inflation, (i.e. the 'real' interest rate is calculated), the change is more dramatic. In 1978 the real interest rate had a negative value of 2 percent (the interest rate being two percentage points lower than the inflation rate).[15] In 1981, the real interest rate was of the order of 8 or 9 percent, and now continues at historically high rates, e.g. 5 to 6 percent in 1984,[16] though slightly less in 1985 and 1986.

The effects of the recession which began in 1979 and lasted virtually until the end of 1982, were exacerbated by the tight monetary policies instituted by the 'Fed' and supported by the Treasury. Arguably, these policies were successful in their aim of reducing inflation, (consumer price inflation dropped from an average of 12.7 percent in 1979-80 to 3.3 percent in 1983)[17], but only at the cost of the aforementioned high interest rates and a severe decline in demand and consequently in production. This decline in demand was most heavily concentrated in those sectors which were most interest sensitive, i.e. residential construction,

business investment, consumer durables and net exports. Also, unemployment rose from a low of 5.8 percent in 1979 to a high of 10.7 percent in 1982.[18]

Policy since 1982 has tended to be based largely on the massive expansion of the Federal government's spending, mainly on a variety of defence-related programs, linked with a program of taxation cuts which have acted as an additional stimulus to demand. The defence programs themselves have tended to place more emphasis on areas such as weapons and equipment procurement, research and development, and defence construction, in preference to the building up of numbers and quality of personnel or improving preparedness to cope with the wide range of tasks required of the military.[19] The procurement program in particular is open to criticism for being extravagant,[20] needlessly duplicative and unplanned.[21] Irrespective of the validity of these criticisms, and the evidence would suggest that they are valid, the economic effects of the defence buildup are relatively clear. Unlike, say, the buildup which occurred during World War II, the biggest peacetime rearmament program undertaken by the United States government is relatively low in labour intensity, and thus has not been a great generator of employment.[22] Weaponry being acquired today is far more likely to be a smaller number of high value-added items, such as the F-15 fighter aircraft and the DIVAD (Sergeant York) anti-aircraft gun,[23] which are both packed full of complex, sophisticated (and expensive!) electronic systems and computers. As such they require smaller numbers of

highly skilled workers to put them together. The same is true of expendable munitions, the state of the art today being $500,000 Phoenix air-to-air missiles rather than conventional shells and bullets. The economic effects of the expansion in funding of the military are therefore quite distorted. On the one hand, defence contractors, sub-contractors and component suppliers are in a position to set about investing in new or updated plant and equipment to cope with the boost in demand for their products. On the other hand, such equipment tends to be highly capital-intensive and requires fewer, highly-skilled people to operate it.

Taxation cuts, however, have been useful in stimulating the demand for consumer durables, such as motor vehicles, which may have been delayed by the recession.[24] Much of the strength of the present US recovery has been sustained by an increase in consumption - both public and private, financed by the liquidation of net US assets, both foreign and domestic. The result of this has been an increase in borrowing, in all sectors of the economy, much of it sourced overseas. Eventually the smaller capital stock and the burden of repaying foreign debt should, in all probability, lead to a reduced standard of living for American citizens.[25]

What is the evidence for this conclusion? Firstly, a large part of this increased demand for consumables which do not enjoy considerable domestic protection is being

satisfied by imports. In the past this was due mainly to the trading disadvantage caused by the extremely high exchange value of the American dollar, but now increasingly because imports have carved out their own market niches. As the US economy acts as a sponge, drawing in imports from Japan, Western Europe, the Asia-Pacific region and even Latin America, domestic industries are placed increasingly under stress and there is a disincentive on the part of domestic capital to invest in expanding production capacity. Very few industries in the US have made major investments in such new capacity. Motor vehicle manufacturing is in this minority. Arguably, the reason that this has happened is that car manufacturing has enjoyed some considerable degree of protection from the US government. In addition to small but significant tariffs, the imposition of 'voluntary'[26] quotas on Japanese exporters has helped create periods of relative scarcity of new vehicles, which has worked to the advantage of domestic manufacturers. If this action had not been taken, it would be plausible to argue that the American automobile industry would have been in as poor a state as many other sectors of the US economy.

Trade Policy.

In theory at least, successive American governments, and the Reagan administration in particular, have espoused the cause of 'free trade'. This ideology was particularly useful in the days of US industrial supremacy, but is perhaps less appropriate in a world where new challengers to this

dominance have risen and continue to rise. The trade frictions which have arisen with Japan[27] are merely the symptom of larger problems that face American companies both at home and in the global marketplace.

The effect of this has been that the reality of international trade policy today is the 'new protectionism' which has made itself felt since the late 1970s. Broadly speaking, most of the period after World War II was marked by a process of progressive trade liberalization, which could rightly claim to have been a major factor in the economic success of most advanced industrial countries. The new tendency to protection is in the process of rolling back and, arguably, more than offsetting these gains.[28] Advocates of truly liberalized trade, argue that protection and trade-distorting subsidies are economically costly, and given the poor performance in economic growth recorded in most recent years by OECD members, claim that the additional costs of these measures make it much harder to preserve acceptable living standards. Protection against imports directly increases costs to consumers by raising domestic prices, of both imports and local import substitutes, and creates artificial scarcities. Protection measures, along with direct and indirect subsidies, reduce economic potential by inducing producers to shift resources from goods and services which can be produced efficiently, to those which can only be produced inefficiently.[29] In addition to these static costs there are also dynamic ones. Competitive pressures which would under

different circumstances speed up the rate of technological change, are stifled. By worsening inflation, through raising prices, protection also tends to cause macroeconomic losses as policymakers are forced to accept more recession to bring down inflation. Specialization of the economy is inhibited, thus limiting the potential for achieving economies of large-scale production.[30] Ultimately, of course, domestic consumers pick up the bill for all of this. Over and above this, there is an additional cost to the exporters within the domestic economy, who are unable to pass on their share of inflationary pressures to the global markets in which they compete, without undergoing some loss of sales or becoming entirely uncompetitive.

A comparison of the major groups among the industrial countries reveals to some extent their tendency to protection. The phasing in of tariff cuts agreed to under the Kennedy and Tokyo Rounds[31] of international trade negotiations have helped reduce rates of tariff applying. Average tariffs on dutiable industrial products after the Tokyo Round were only 4.4 percent for the United States, 4.7 percent for the European Community, and 2.8 percent for Japan.[32] As tariffs have come down, however, nontariff barriers (NTBs) have become relatively more important.

In the case of the United States, quotas on steel, oil, meat, and sugar were eliminated in 1973-74, and similar reductions in protection occurred in other industrial countries seeking to moderate high worldwide inflation

triggered by Oil Shock I. Some even went so far as to institute export controls,[33] but such measures were shortlived, as the difficulties of coping with excess production capacity became apparent. By 1977, the US was negotiating 'orderly marketing agreements' with South Korea and Taiwan, limiting their exports of footwear, while at the same time using the Multi-Fibre Arrangement to decrease imports of textiles and garments from emerging producers. In 1978, the United States began a Trigger Price Mechanism (TPM) of accelerated antidumping procedures[34] mainly in the interest of providing protection for the steel industry. In electronics, the US negotiated 'orderly marketing agreements' on colour television sets with Japan in 1977 and with Taiwan and South Korea in 1979.

The new protectionism of the 1970s was particularly notable for its concentration in the same product sectors in several industrial countries. These sectors included textiles and garments, steel, television sets, footwear and shipbuilding. The pattern reflects not only the similar ailing condition of these industries in most of the industrial countries but also the 'ricochet' dynamics of protection. When one group of countries raises barriers, a second group fears that its markets will be inundated by diverted supply and implements protection of its own.[35]

In 1981, in the midst of even deeper world recession and an even more severe bout of currency imbalances, a second wave of the new protectionism arrived. The most spectacular

case of this in the United States was the imposition of restraints on motor vehicle imports. Given the increasing penetration of Japanese motor manufacturers into the US market, and the difficulties being experienced by domestic carmakers, especially Chrysler, this was perhaps expected. Yet, this constituted the first time an American government had introduced effective import quotas into the industry, albeit supposedly temporary ones. The Japanese, largely through the coordination of Japan's Ministry of International Trade and Industry (MITI), were 'persuaded' to accept a 'voluntary' quota on exports to the US of initially 1.68 million vehicles per year. Later this was raised to 1.85 million and then to 2.45 million in 1985 and after.[36] The instrument of 'persuasion' was the threat by Congress to introduce legislation requiring all vehicles sold on the US market to have a fixed proportion of local content. Congress and the Reagan administration were well aware of the consumer impact of this move and the quotas were partially an attempt to get Detroit back into the black by giving American car manufacturers the opportunity to raise unit prices substantially and use some of their windfall profits to modernize their model ranges and production techniques.

In the process, this attempt to cope with Japanese competition has created conditions under which motor manufacturers from newly-industrializing countries are now well placed to enter the US market.[37] This has happened in the following manner: In the past, Japanese manufacturers were so successful on the US market because they were able

to deliver small, fuel-efficient, well-made cars which were very reasonably priced. Since the American car industry has had difficulty producing such small cars, the quotas were meant to put a price penalty on them (through premiums for scarcity) and make it more attractive for buyers to purchase locally-made vehicles. Effectively, though, three things which were not bargained for have happened.[38] Firstly, Japanese exporters became aware that American consumers were willing to pay premium prices for their vehicles and responded by exporting larger, more expensive (and more profitable!) units. Thus, though unit volume has fallen, the value of US sales and the resulting profits have in fact increased for most Japanese car companies, helped along by the very favourable exchange rate.[39] Secondly, the price of fuel in US dollar terms has fallen substantially, making fuel economy a less relevant factor for most buyers just as US manufacturers bring on stream new models utilizing expensive fuel-saving technology. Thirdly, all price segments in the market have been pushed upward with new cars priced under US$8,000 being positively rare. This shift in the market has been noticed by manufacturers from newly-industrializing countries who have discerned for themselves a market niche. These manufacturers, among them Hyundai and Daewoo of South Korea, Volkswagen of Brazil[40] and Ford Mexico, are finding that they can deliver small cars of reasonable quality onto the US market at prices in the US$5-6,000 range and still make good profits. Even more importantly, countries such as Mexico and Brazil are becoming major suppliers of components for cars manufactured

in the US. Since their home countries are all major debtors to US banks, it would be in the interest of the American government to encourage them in terms of improving export earnings. On the other hand, the appearance of these new foreign competitors could be seen as a threat to domestic manufacturers anyway, even though the cars they sell are in an entirely different price bracket. It will then be up to the US government to decide which is more important.

Such a decision would have to recognize the decline in the US share of world automobile production, which fell from 65 percent in 1965 to 20 percent in 1980, while Japan's share surged from near zero to 27 percent, and that of semi-industrial countries (especially Spain, Brazil, Mexico, Poland, and South Africa) has risen from 2 percent to 15 percent.[41] In the meantime Western Europe has shifted from being a net exporter to a net importer of cars.

Among the reasons for US producers losing ground to the Japanese are: higher labour costs, not just in terms of pay per hour, but also in the number of man-hours required to build a car (an estimated 90 man-hours per car in Japan compared with 140 man-hours in the United States)[42]; special government and bank support to Japanese industry in the 1960s, including special tax treatment and access to foreign exchange for technology and equipment; good labour relations; low-cost diversified supply of components; early, widespread introduction of robotization; complacency among US producers during the 1960s and early 1970s which made

them slow to respond to shifts in the market's demand towards small cars; and the competitive disadvantage brought about, until recently, by an undervalued yen and an overvalued dollar.

The evidence so far is that decisions on protection are being made on a case by case basis. For instance, the blanket restrictions which have been introduced incrementally over the past few years in regard to steel imports do have serious consequences for Brazil, among other Third World debtor nations which are also exporters of steel. Yet, the US decision to terminate quotas on footwear, of which Brazil is now a major producer, could be seen to be compensatory to a degree. For even partial repayment of many of the outstanding loans to occur, access to the US market for manufactured goods has to continue and even improve. This requirement is dictated by the structure of the original loans made to manufacturing enterprises in such places as Brazil and Korea, since repayment is dependent on the ability to market finished goods. It is true that many of these loans are covered by government guarantees, but it is not inconceivable that the respective trade representatives would be instructed by their governments to raise the issue of withdrawal of these guarantees, as a bargaining chip for market access. Again, it is also true that such action may be precipitate and would lead to significant negatives for the debtor nation concerned.

Presently, most US trade conflict is focussed on the

relationship with Japan. This has been exacerbated by the ballooning bilateral trade deficit. Conventional wisdom holds that Japan is highly protective. This view has some validity in the agricultural sector, where quotas apply on 22 different items (including beef and oranges), but in the industrial sector only 5 quotas apply (on charcoal briquettes and four leather product categories)[43a]. Critics of Japan contend that there has been very effective use made of nontariff barriers (NTBs): restrictions on imports by state-trading companies (tobacco, salt, livestock, telecommunications); burdensome procedures for customs evaluation and for meeting health and environmental standards; and Japan-specific safety standards. Japanese retorts to this run along the lines of: many of the retrictions on the activities of state-trading companies have been lifted, (for example, Nippon Telephone and Telegraph has been broken up along similar lines to America's AT&T, and is being semi-privatized and encouraged to purchase equipment overseas); health and environment standards are stricter in Japan because of greater perceived problems of pollution and in any case are not much different from standards elsewhere (e.g. vehicle emission control standards are very similar in Japan, California, Switzerland etc. and if Japanese manufacturers can adapt to overseas markets why can't US and European manufacturers adapt to Japan's?); in the absence of world standards on safety, most countries have come up with their own (e.g. US Federal Automotive Safety Standards, Australian Design Rules), so why is Japan not entitled to do the same? Independent

analysis tends to conclude that the Japanese implementation of Tokyo Round agreements and further concessions made during the last few years, have been effective enough to overcome most barriers, at least in nonagricultural products. The American Chamber of Commerce in Japan has produced a report that supports this view, by failing to find pervasive patterns of major NTB protection.[43b]

Now that Congress, and to a lesser extent the Reagan Administration, are talking in terms of trade retaliation against Japan and introducing legislative restraints on access to the US market, the question becomes one of what type of retaliation is envisaged? Broad gauge retaliation against all-comers would probably destabilize the recoveries of many major Third World debtor nations, creating problems for them, not only in meeting IMF and bank-directed targets, but also, if the disruption to export-based industries at home is sufficient, in coping with labour relations, domestic unemployment and underemployment, and ultimately civil order itself. Trying to design specific proposals aimed at keeping out the Japanese, while trying to maintain the present market share of the debtors, would involve the US government in passing measures which not only constitute even grosser violations of the General Agreement on Tariffs and Trade (GATT) than those which occur at present, but would also run afoul of existing domestic legislation designed to encourage free trade. Two models of trade retaliation can be identified. Firstly, it is possible to impose measures which are aimed fairly precisely at specific

sectors or even products. The recent battle over 256K dynamic random access (DRAM) memory chips manufactured by the Japanese semi-conductor industry is one example of this.[44] Another is the treatment of Toshiba Corporation for its sale of sensitive technology to the Soviet Union.[45] These have not been overly drastic steps and since they have only a limited lifespan have not provoked significant counter-measures.[46] The second model would be to impose 'blunt' measures against individual trading partners who are deemed to be 'unfair traders'. This sort of approach, though popular with some of the Democrat presidential hopefuls, has not been tried, for good reason, and probably never will be. It would be bound to bring massive retaliation, widening the dispute beyond the trade issue. For example, if Japan were to be hit by a concerted campaign, it is not inconceivable that the Japanese may withdraw defence cooperation and institute a capital strike[47] by demanding immediate payment of their outstanding loans. The consequences of this scenario are difficult to imagine. It will be of interest to see how the dilemma of punishing trading partners, without doing too much damage to all concerned, is resolved.

Industrial Reconstruction

While the recent travails of some areas of US manufacturing seem to be symptoms of the decline of the sector as a whole, it is too early to write off America as the loser in the trade wars which have begun and will, in all probability, continue over the next decade or so.[48] With

the cooperation of Congress, the administration, the Pentagon and other key players in the American economy, significant sections of US industry are being reconstructed to deal with the 'threat' from overseas, particularly Japan and East Asia. Early signs are that, if this is successfully carried through, there is every possibility of a sizable resurgence in US manufacturing. Certainly this will be an uneven process. Despite a degree of technological change in steel-making, and the introduction of innovations like the 'mini mill',[49] it is unlikely that this will become a major area of growth. The motor vehicle industry, on the other hand, has done spectacularly well in the past few years. While the dramatic recovery of Chrysler is the most visible sign of this, other manufacturers have also shown large profits, with the notable exception of American Motors. It should be remembered that these days, many non-American corporations, such as Nissan, Honda and Volkswagen manufacture or assemble vehicles in the United States, for domestic consumption and these operations are also generally doing very well.

The recovery in domestic motor vehicle manufacturing is attributable to a range of factors. There has been a general economic recovery under Reagan, and even though it would appear to be based on shaky economics and unsustainable budget and trade blowouts, it has led to much increased consumption by a substantial part of the population, i.e. those with jobs, particularly well-paid jobs.[50] Interest rates were, until recently, on a strong downward trend and

some manufacturers, such as General Motors, were offering vehicle financing at below market rates through their financial subsidiaries. Scarcity meant that competing imports, as opposed to the very low-priced ones which virtually occupied their own price niche unchallenged by domestic products, were selling at premium prices and enabled domestic manufacturers to raise unit prices substantially while taking care to keep them significantly below those of comparable imports. At the same time, the United Auto Workers (UAW) and other unions involved in the industry stuck by binding agreements made in the early 1980s, which resulted in lower labour costs, closures of outdated plants, layoffs, little opposition to the introduction of new technology and increased productivity. The hostility of the Reagan administration to unions per se, evidenced by the wholesale destruction of the air-traffic controllers union (PATCO)[51], encouraged many manufacturers to hire more non-union labour, relocate plants to states or areas where union power was weak or non-existent, or exclude unions entirely from new plants where costs were cut by degrading working conditions. This explains the rash of new plants in depressed semi-rural areas where labour costs are in any case much cheaper and workers less likely to organize.

Also, there has been a major trend within the US motor vehicle industry to invest substantially in high-technology manufacturing. In part this has been the result of a perception that becoming competitive with the Japanese

requires this type of investment. In addition though it mirrors a global trend among vehicle makers. Many European companies are following similar strategies, whether they are mass-market producers like Fiat of Italy or specialized firms like Volvo of Sweden. There is a widespread expectation that the next decade or so of automotive design will see much greater reliance being placed on incorporating advanced electronic systems into vehicles to fulfil a variety of functions. Already it is commonplace for vehicles to have electronic monitoring and control of engines. This has led to the acquisition by some leading motor companies of substantial subsidiaries in the electronics field. Examples are the purchase of AEG by Daimler-Benz and that of EDS by General Motors (GM).

It is becoming apparent, however, that a massive injection of high-technology alone is not the solution to the problems faced by the motor industry worldwide. Technology is clearly not a substitute for good management. A classic example of this is the GM plant at Hamtramck in Detroit, Michigan, a $500 million dollar investment which was built from scratch.[52] With 260 static and 50 mobile robots and state of the art computer-integrated manufacturing (CIM) techniques, it has been described as a prototype for the 21st century. The only problem is that, in terms of quality and productivity, it barely matches an aging GM plant in Fremont, California which is now managed by Toyota under a joint venture agreement.[53] The cars which are manufactured here, without fancy automation, achieve

high levels of product quality almost solely on the merits of painstaking Toyota management. Similarly, GM has become dissatisfied with the performance of another high-tech plant at Buick City in Flint, Michigan, built at a cost of $ 400 million. Despite flexible tooling and an efficient 'just-in-time' (kanban) inventory control system, it takes twice as long to begin producing a new model as does the Fremont plant.[54] GM has rethought its investment in such ultra-expensive technology and has even cancelled $ 88 million worth of orders for new robots from its part-subsidiary GMF Robotics.[55] In the light of this, its purchase of the electronics firm EDS is beginning to look like a costly mistake. The rationalization that took place in GM early in 1987 was due partly to financial pressures brought about by this, but it is an even bet that most of the plant closures and layoffs which took place would have eventuated anyway.

Motor vehicle manufacturers in the United States are not alone in investing large sums of money on technological upgrades of their production facilities. Other large industrial concerns have invested similar amounts in factories that produce everything from electronic typewriters (IBM) to dishwashers (GE).[56] They currently appear to be engaged in a costly stage of trial and error experimentation. As awareness of the need to tighten up performance and sharpen management skills becomes more widespread, it is likely that some optimal balance will be struck. It should be remembered that European firms have not

put anywhere near this level of effort into improving automation and management skills. Quite sophisticated islands of automation do exist, but these are yet to be successfully integrated into systems of production. So, on this score at least, the main competition is between the US and Japan. The Japanese seem to be currently ahead on points, but it is far too early to write off the Americans.

Outside of the leading industrial corporations in the US there is less of a drive to engage in such investments. Part of the problem is that many smaller companies lack the capital base to make large commitments which only pay off in the longer term. The current boom in sharemarkets and corporate takeovers also places pressure on the managements of these firms. Performance, as demonstrated by earnings and profits, is the key to retaining credibility with shareholders and the markets. This also helps in staving off unfriendly takeovers from other firms and corporate raiders. In such circumstances, a major long-term investment which does not produce tangible results quickly is unfavourably reflected in quarterly, or even annual, balance sheets. Poor results in the current stockmarket climate are an open invitation to both friendly and unfriendly takeover bids which usually result in some displacement of existing management. Can management then be blamed for concentrating on the short-term?

A variety of factors, ranging from the sheer size of the domestic economy to the innovative nature of American

research and development, would assist the drive to re-establish industrial production in the US on a more even keel. The current boom in financial 'paper-shuffling' will eventually come to an end, and investors will have to look for more traditional and productive areas to absorb their funds.[57] Apart from static assets like real estate or artworks, longer term industrial investments (in the form of bonds rather than equities) and direct investment in technology development, would seem to be key areas where cash would flow. So it is quite feasible that the funds to underwrite the kind of reconstruction which will be necessary to restore some competitiveness to the broader US industrial structure, will become more freely avilable.

Budgetary Measures and the Budget Deficit

The large US federal budget deficit is a powerful force for economic recovery and has helped create conditions in which the overall economy is doing relatively well, though it has become less buoyant in recent months. The continuation of this deficit trend threatens to create severe problems for the United States and the world economy.

The Congressional Budget Office (CBO) has produced projections of the federal budget, under spending policies and tax rates in force at present. It must be kept in mind, when considering these estimates, that the CBO's budget estimates are based on a highly optimistic set of economic projections.[58] It is assumed that the United States will

experience no recessions till 1990, that unemployment will continue to decline substantially, that inflation will remain steady or even fall further, and that there will be at least a slight decline in prevailing interest rates. If many, or all, of these conditions are not fulfilled, the estimates will in all probability greatly understate the actual deficits which will be recognized. The deficit is projected to rise from $197 billion in fiscal year 1985 to $308 billion by fiscal year 1989.[59] As a share of GNP, the deficit would rise from an average of 1.9 percent in the 1970s to an average of 5.5 percent in 1987-89. The cumulative effect of these budget deficits is reflected in a nearly fourfold rise in public debt from $716 billion (28 percent of GNP) in 1980 to $2,636 billion (49 percent of GNP) in 1989.[60] In the process, present government policy means that the very nature of the deficit itself will change. This is because, much of the budget deficit in 1983 was a product of the recession and the associated revenue losses, but that will not be true in the future. Future deficit figures already take into account increased tax revenues and therefore reflect a structural imbalance between taxes and expenditures that cannot be solved by increased economic growth, as the Reagan administration was maintaining not long ago.

Almost nobody, whether in Congress or in the Reagan administration itself, explicitly advocates growing structural deficits as desirable fiscal policy for a recovering economy. Efforts to reach a compromise on

budgetary measures which would reverse the trend, have foundered on ideological divisions about the spending priorities and appropriate size of government. The administration supports measures to reduce the deficit by making further cuts in domestic spending. A significant group within Congress opposes this and argues that slowing the defence buildup and raising taxes is the answer. Any talk of tax increases is opposed by the advocates of smaller government, who believe the deficit exerts pressure for reduced spending, wrongly so, as it turns out, in the light of the rising public debt and the cost of financing it, which has actually led to an expansion of government spending as a share of GNP.[61]

An examination of the tax picture gives the superficial impression that the Reagan tax cuts of 1981 on individual and corporate income were a major reason for the decline in government revenues and the resulting stress on deficit financing of government spending. This is only partially accurate since the trend towards lower collections of taxes which go into the general fund (which ultimately pays for most outlays, including defence), long predates Reagan. There has been a steady decline over the past twenty odd years in the ratio of general fund taxes to GNP, from 16.4 in 1960 to 12.9 in 1983.[62] Conversely, there has been a rise in the corresponding ratio for employment taxes (Social Security and Medicare), from 2.1 in 1960 to 4.6 in 1983 for Social Security and 0.5 in 1970 to 1.1 for Medicare. Until 1981, the decline in general fund taxes was the result of a

slight increase in income tax rates which was offset by sharp cuts in effective rates of corporate income tax and excise taxes. The reduction of income tax rates by Reagan only exacerbated the decline.

In view of the reduction in general revenue to the federal government from taxation, and the lack of any reduction in outlays (spending being shifted mainly from non-defence to defence programs), the deficit is being financed largely by borrowings on the capital markets, and mainly foreign ones at that! The rate of capital inflow into the United States has accelerated to such an extent that it is now not only a net foreign debtor, but is also well on the way to having by 1990, much more foreign debt than all developing countries together have today. Though it now appears that this realization is beginning to sink in, at long last, to both the American legislature and the administration, the means of dealing with the deficit question is far from being resolved.

Suggestions for coping with the deficit range widely. There is, of course, a fallacious minority view that argues that the deficit will look after itself as economic growth continues. Those who believe that some action has to be taken, tend to vary in the complexity of their respective advocated approaches. A 1984 study by staff members at the Brookings Institution,[63] tended towards the complex by examining the broad sweep of current policies on such matters as domestic spending, defence procurement and even

taxation policy and recommending a series of proposals which were designed to reverse current trends and restore some stability to future budgetary planning. For instance, Pentagon proposals for weapons procurement were itemized and costed, and suggestions made about which weapons systems could be cancelled or reduced in number, without adverse implications for the military posture of the United States. Some of the cost savings from the reduction of outlays, it was argued, would have had to go towards restoring some of the social welfare programs which were severely cut in 1981-82 in the name of smaller government. Somewhat more controversially, the Brookings study advocated an overhaul of the system of taxation, designed to raise more federal revenue and simultaneously create incentives for saving and investment. The then prevailing tax system would have been scrapped and replaced by new cash flow taxes on individuals and corporations that were dependent on the rate at which spending occurred.[64] As envisaged, such taxes would, in theory, have encouraged saving and investment. The rate of taxation on expenditures would have been scaled, with a tax-exempt threshold somewhere above the poverty line, and the percentage of tax would have increased with the level of spending. The study did not discuss the problems of enforcement that might be encountered by this scheme. In any event, the radical US federal tax reform which was eventually passed by Congress, and is currently being implemented in stages, was very different.[65] It was 'revenue-neutral' in order to adhere to the wishes of both the administration and a large part of Congress. It did

nothing to attack the deficit substantially. The positive aspect of the tax reform which eventually passed was that it removed many of the distortions which were caused by the existence of a multiplicity of tax shelters. By increasing the incentive for those with the funds to invest, to act in economically rational ways rather than in ways which minimize tax, it is hoped that more economic growth will be possible. Also, given the substantial reduction in taxation for taxpayers who did not have shelters available to them, there should be more in the way of spending power as they are the group most likely to benefit from the reforms. There is of course no guarantee that this spending power will not go towards imports thus worsening the already bad trade deficit and negating any advantage of growth.

A somewhat simplistic proposal is being pushed by the advocates of increased protection within the United States. What is proposed is an import surcharge of 20 percent on all manufactured goods that enter the United States from any other country, thus generating deficit-cutting revenue for the federal government, reducing the trade deficit and restoring the position of much of US industry, which is currently having difficulty competing on the domestic, let alone world, market.[66] While this may seem an attractive solution, in theory, the practical difficulties associated with such a move, including trade and other retaliation against US exports, probably mitigate against this sort of proposal becoming a reality. Such a radical measure would probably upset foreign, particularly institutional,

investors and trigger a capital exodus which could, given the large proportion of short-term money that has flowed into the US, turn into a stampede which seriously destabilizes the US financial system. It is important to recognize the significance of such proposals, especially in a climate where more and more, protectionism is becoming a 'respectable' philosophy and is endorsed by a number of US politicians including some of the aspirants to the Presidency. One only has to examine some of the trade legislation recently passed by Congress, and mostly vetoed by Reagan, to confirm this view.

Congress, or at least some elements of it, has also been active in bringing pressure to bear for a deficit reduction, with the most tangible evidence being the Gramm-Rudman bill.[67] Gramm-Rudman has not been as successful as it should have been, mainly because of a Supreme Court decision to declare unconstitutional some aspects of the final bill as passed by Congress. However, it should also be remembered that Senators and Congressmen have conflicting vested interests. On the one hand, it is useful for them to be seen as proponents of major reductions in the size of budgets and of deficits, at a time when arguing for smaller government is a fashionable exercise. At the same time, any serious attempt to implement reductions in government spending, or even to hold it constant in real terms, carries the risk of ending 'pork-barrel politics' and threatening the hold that many of these elected representatives have on their bases of support. Similarly, even Democrats who do not have any

significant philosophical objections to tax rises, do not wish to be seen to be advocating them loudly, for fear of an electoral backlash. In the fashion of so much of domestic politics in the United States, this ambivalence has produced a series of stalemates and delaying tactics which have prevented any meaningful steps towards resolution of the US fiscal crisis.[68] This inertia has compounded the folly of the open-ended Reagan defence buildup, which was one of the biggest drains on Federal government resources in recent years. What makes it worse is that the expenditure of all that money, with the accompanying ridiculous level of waste, has not produced a military machine that has a proven capability. Too many times now the new gaps in US defence and the shortcomings of the current strategy have been exposed publicly. The rationale behind this policy must be questioned seriously, especially in the light of the economic and debt problems it has brought. Money which was taken away from valuable social programs to feed the defence 'monster' would probably have been better spent on those original purposes.

The malaise which seems to have gripped the budgetary process in both the administration and the legislature has not afflicted some of the key Washington 'think-tanks'. At present, these seem to be the main sources of any attempts to order priorities for the budgetary process. For example, the Brookings Institution publishes annual analyses of the budget. Typical of these is the analysis for 1984[69] which examines each of the programs in detail. It argues for

reductions in many of the high cost items, especially in defence and emphasizes the need to place more stress on areas like social security, medical care and job training programs. While the case is often cogently argued with obvious long-term implications, it receives scant attention on Capitol Hill or in Pennsylvania Avenue.

There have been some fairly simple suggestions for new taxes which would help reduce the deficit substantially without impacting too heavily on individuals or corporations. These include arguments for a relatively small rise in federal excise on petroleum products,[70] which is considered politically defensible because the current excise is quite low by OECD standards. In spite of only marginal inflationary impact and the added bonus of some pressure for fuel conservation, which would make it easier for Congress to support them, such measures are doomed because of the Reagan administration's dogmatic refusal to raise new taxes or to increase those which already exist.

While arguments continue about the best way of dealing with the deficit, what are its consequences for the domestic and international economies? Any considered response to this question would have to take note of the fact that there is not much agreement about this either. The weight of opinion, certainly in the rest of the world and to some extent in America itself, is that the high real interest rates within US money markets which are a result of the widening deficit situation, are acting as a magnet for capital from

elsewhere, draining it off to help feed the demands of the ever-increasing trade and current account deficits. Till the Baker-Miyazawa pact of 1985 and the subsequent managed fall of the US dollar and rise of the yen,[71] these interest rates helped push the dollar's value to record highs against most other currencies, except those which had formal or informal links to the American currency.[72] The rationale is that this attraction for capital accounted for the demand for the US dollar. This may have been the case at the early stages of the recovery, but there are problems in trying to pinpoint interest rates as the determinant of dollar value. For example, Japanese investors are finding that the new rate of exchange makes US property, real estate, stocks, bonds and even factories bargain investments. It should be remembered that, until recently, a very large proportion of the foreign capital in the US was being held not in fixed investment such as plant and equipment, but in easily disposable instruments like bonds, T-bills and negotiable certificates of deposit (NCDs). There is nothing to prevent this money leaving as fast as it came in (or even faster!). The drop in the dollar has encouraged the Japanese and to some extent even other Asians and Europeans to move into more stable assets, and to look at US production to offset the negative consequences of new pricing regimes.

In turn, the rise and fall of the exchange value of the American dollar has had several consequences. Imports on the US market were priced very competitively, taking a larger share of demand, and having established market shares, are

now able to ride out some of the drop in sales using a variety of strategies.[73] The import boom had been useful to some extent in bringing about a degree of recovery in parts of Western Europe, and substantially improving the reserves and repayments position of big debtors like Argentina and Brazil.

Problems of Deregulation

The deregulation issue has been covered briefly in the previous chapter but it is essential to stress the degree to which deregulation has changed the shape of financial America. Apart from the more obvious links of domestic and Third World debt to the US economy, there are further ramifications that interfere, albeit in marginal terms, with the processes of policymaking. Ultimately, a large part of the fallout from this debt crisis will not be in terms of direct and dramatic events such as default and bank collapse, but rather in the way in which limitations are placed on the players in the American economy.[74] The difficulties being encountered by certain banks which are carrying loans which threaten their balance sheets, have raised questions about the wisdom of widespread financial deregulation, with some critics arguing that the financial sector in the United States requires, if anything, more rather than less regulation. It is true that moves towards freer financial markets in the US have created significant problems with certain financial bodies within the country. The period 1984-85 has seen major crises and/or collapses of

the Continental Illinois National Bank, (at the time the eighth largest bank in the US), Savings & Loans Associations in two states and a host of minor banks. So far, these failures have not had any significant long-term effect on depositors or on investor confidence.[75] This is because the institutions concerned were shored up by the existing financial safety net, including direct intervention by the Federal Reserve Bank and the Federal Deposit Insurance Corporation (FDIC),[76] before eventually being either taken over or merged with other financial institutions which were on sounder footings. Sometimes, this has been a mistake from the point of view of the acquiring bank, when the acquisition has proved to be damaging to its financial health. For example, Crocker National Bank of California, ranked 13th biggest in the US in 1981, got into trouble when its lending to Argentina ($452 million) and Brazil ($ 804 million)[77] and to domestic ventures in energy-related projects, was complicated by a risky plunge into the Californian property market.[78] A majority stake (57 percent) in Crocker was purchased in 1981 by Midland Bank of Britain, which had to agree to a stipulation that Crocker executives would retain maximal operational autonomy, in order to avoid the opposition of Congress and the Federal Reserve. As a result of the lack of real control, Midland was to some extent the hostage of bad management at Crocker, and saw its own profits eroded and its balance sheet strained. As Midland's international reputation, and its share price, plunged, Midland management was forced to push for full ownership and control in an attempt to limit the damage.

Ultimately, the exercise in damage control was designed to restore the credibility of the bank, something which never really happened. The result of the exercise was that Midland eventually had to sell off Crocker National at a price that did not reflect the costs of acquiring the American bank. Midland, itself still suffering from serious cash-flow problems, is much smaller than it used to be because of asset sales and has not shown a profit since the disastrous acquisition.[79] In spite of management changes, and heroic attempts to turn its position around, it is so weakened that it is being talked about as a possible takeover target, the British authorities willing.

The picture is further complicated by the fact that the traditional division between bank and non-bank financial institutions is blurring to such a degree that there is often little to tell them apart. In the past, banks had clear-cut monopolies on certain kinds of financial activity. Only banks could both accept deposits and make loans, and provide certain other types of financial services, under the terms of their licences. In return for this, they were required to maintain acceptable levels of reserves, including minimum reserve ratio deposits with the US Federal Reserve Bank and were expected to carry cover with the Federal Deposit Insurance Commission, which guaranteed the safety of the money invested in the banks by small (under $100,000) depositors.[80] In theory, this was among the factors that led to the perception that the big regional and money-centre banks were very sound financial investment

mediums. Given the limitations imposed on the banking system by state-centred banking laws and demarcations, this is not necessarily true of the majority of the 14,000 odd commercial banking enterprises in the United States. Yet, the maintenance of confidence in the system was assured in relative terms, because it rests ultimately with the ability of the bigger banks to cope with any difficulties encountered, even by the smaller ones.

In recent years, however, deregulation has meant that many other types of financial institutions, such as Merrill Lynch the stockbroking firm, and even non-financial corporations, like the retailer Sears, have begun to encroach on the turf formerly reserved for the banks.[81] They are providing a range of financial and investment services, and even finance-related services like insurance, and have been able to use their national networks of branches to market them very effectively.[82] Existing anti-trust legislation has meant that the big banks are not permitted to set up national branch networks. This restriction was aimed mainly at preventing smaller banks in several states from suffering adverse competition. The worry now for the money-centre banks is that their attempts to get the rules relaxed are not proceeding fast enough to prevent the non-banks, which (since they are not classified as banks and thus do not have to obey the rules) are in the process of stealing the advantage. If the big banks, especially the ones with worries about awkward debts, were permitted to set up national networks, they could build up their deposit

bases without too much difficulty and be in a better position to cope with any loan losses they might have to endure, without being dependent on being rescued by the Fed or the FDIC.[83] Yet, dismantling this protection for the smaller state-centred banks, many of which already have significant risk exposure, through syndication or otherwise, on shaky prospects like oil exploration, real estate speculation or Third World debtors, is politically sensitive. So the regulatory authorities are once again in a bind about the course to take on deregulation. Permitting national networking will assist in limiting damage to some banks, but increase the failure rate of others, which may of themselves not be very important. However, ultimately, a spate of such failures will create some kind of uncertainty about the future of the banking system and lead to crises of confidence in states where such failures occur and in ones where there are fears of similar occurrences.

Compounding the problems of banking organizations are the difficulties of the so-called 'thrifts', such as the Savings and Loans Associations. Apart from those which have already gone under in spectacular style, an estimated 30% of them (916 to be precise)[84] are either in the process of failing or at risk of doing so, according to a study by Bryan (1987).[85] The main reason for their present position, in most cases, is an inadequate management of risk. Apart from the usual problems of credit risk, many of the 'thrifts' are now subject to interest-rate risk as well, since they are locked into a large number of long-term

fixed-rate mortgages and also hold large amounts of mortgage-backed securities, (an estimated $135.5 billion worth),[86] which have been declining in value on the secondary market because of rises in interest rates. This loss has been quite dramatic, with the value of these securities dropping 7% between mid-March and mid-April. On paper, this drop alone cost the industry $10 billion, a loss which is 59% of the its total estimated equity of $17 billion.[87] To make matters worse, the Federal Savings and Loan Insurance Corporation (FSLIC) is technically insolvent, with a deficit of $6 billion from its previous rescue efforts. Congress and the administration passed legislation in July-August 1987, for a $10.8 billion dollar bailout of FSLIC.[88] The structure of this bailout is somewhat puzzling. The money for the rescue is to be raised on the bond market, though no clear plan for repayment exists and there would be no way in which FSLIC's current and future sources of income from deposit-insurance premiums would be adequate to cover the new bonds. It can only be surmised that this is a stopgap, and that eventually Federal funds would have to be used to secure the position of FSLIC.

At best then, deregulation is a two-edged weapon. On the one hand, the financial sector should, in theory, become more and more competitive and flexible, and provide the kind of capital base that would assist in the regeneration of American industrial competitiveness, when the economy stabilizes. On the other, if not handled carefully, deregulation has the potential to create more problems than

it solves and to undermine the level of confidence enjoyed by the American financial sector, thus hurting future economic well-being.

Problems of Foreign Policy

The economic aspects of US foreign policy must take note of the ramifications of the debt-related difficulties encountered by many nations in the Third World, among them US client states or those in regions considered to be clearly under American hegemony. The major and minor debtors of Latin America and Southeast Asia generally fall into one of these two categories.[89] In these cases, the preservation of US influence is given a high priority, but the means for doing so are having to become increasingly more subtle and flexible.

In the last 5 years or so, Latin America has seen a marked shift to the restitution of democratically-elected governments, with a few exceptions like Paraguay and Chile. Throughout the continent, military rule is giving way to civilian administration, which is clearly in control. Argentina is perhaps the best example of this process.[90] Other civilian governments are installed with the tacit approval of the military, but as the experience of Brazil shows, attempts by the armed forces to get their nominees into key positions can, and do, backfire.

The debt question has had significant impact in

assisting this trend, because in many cases military governments have been responsible for running up the debt in the first place. The difficulties that ensued were sufficient to convince the broader population that the military was as incompetent, if not more so, than any civil administration. Since the avowed rationale behind many military takeovers was the promise of strong and sound economic management, the failure to deliver on this promise only strengthened demands for a return to barracks. Given the cyclical nature of politics, especially in developing countries, it is possible that at some point in the future, circumstances will change so that military rule is once again fashionable.[91] To stave this off, it is vital for civilian governments in Latin America to demonstrate a reasonable degree of competence in economic management. At the same time they are under pressure to produce rapid and sustained improvements in living standards for their people, especially the poorest. So far not many governments have been successful in combining these two objectives.

The move towards democracy has created a series of dilemmas for the foreign policy makers of the United States. They have to be seen to welcome such developments even though military or dictatorial regimes may be more amenable to US policy imperatives. Hence, the recent US moves to support progressive measures in the Philippines, South Korea etc.[92] The calculation must be that if 'moderate' progressives are not given support, they may be supplanted by hard-line, leftist groups. In taking this line, US

planners leave themselves open to various 'ambit claims'[93] which can be levied on them by the moderates, to demonstrate US support clearly. Among these are such things as aid and assistance in solving external debt problems. Inevitably, the US financial sector is also a tool of foreign policy and this has consequences which are far-reaching, especially at a time when there are more than enough internal problems. The chapter dealing with Argentina will show some of the difficulties involved here.

NOTES

1. This perception is reinforced by the relative lack of action by the governments of DCs to resolve the problems of global debt, either individually or in concert.

2. To some extent this is recognized by the administrations of the DCs - witness the number of US Congressional committees which have held hearings on the range of problems thrown up by Third World Debt.

3. A comprehensive account of the roles played by these two countries is given in Spindler, J.A., The Politics of International Credit: Private Finance and Foreign Policy in Germany and Japan, The Brookings Institution, Washington, D.C., 1984.

4. Mainly in Mexico, Brazil and Argentina, but also in some of the smaller states like Peru, Colombia and Costa Rica.

5. Delamide, D., Debt Shock, Weidenfeld and Nicolson, London, 1984, pp.207-211.

6. The prime example of this being the Philippines.

7. Dale, R.S., and Mattione, R.P., Managing Global Debt, Staff Paper, The Brookings Institution, Washington, D.C., 1983, p. 30.

8. Usually, this point is not explicitly acknowledged.

9. Allowing for the vagaries of the the US system of government which can result in a Congress dominated by one party and a President from the other, with uneasy coexistence as is the case at present.

10. The 'Fed' has sufficient autonomy to be able to set money supply targets nominally independent of administration economic policy.

11. Since 1982, the US Federal Reserve has operated a delicate balance on its monetary policies, with some measures of money being permitted to overshoot their targets when the threat of economic slowdown loomed and a tightening occurring when inflationary fears came to the fore.

12. This applied not just to prime rate borrowing but was spread across the board, including residential and personal loans and credit charges. For an indication of how the deficit distorted normal cyclical trends in interest rates see US Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, US Government Printing Office, Washington, D.C., December 1983, p. 26.

13. Rivlin, A.M. (ed.), Economic Choices 1984, The Brookings Institution, Washington, D.C., 1984, p. 21.

14. ibid.

15. ibid.

16. ibid.

17. ibid., p. 23.

18. ibid., p. 24.

19. Recent US military embarrassments, such as the inability to deal with mines in the Persian Gulf, lend weight to this argument.

20. It is argued that the defence programs have fallen into the old trap of trying to solve problems, not by coming up with innovative or creative solutions, but by throwing money at them. This is exemplified by the increasing revelations of malfeasance by many established defence contractors.

21. Until Congress belatedly began to reassert its authority, planning or the lack of it was left to the Pentagon and the rival services, who were all too often jealously guarding their empires.

22. At least not directly. Most of the new jobs created in the American economy in the past seven years have been in the service sector, and some of these would not have arisen if not for the massive military spending.

23. After some $4.5 billion dollars being spent on it, the DIVAD program is to be scrapped because the weapon is incapable of performing satisfactorily under even moderate test conditions. Existing guns are being retrofitted with Copperhead ground-to-air missiles, making the Sergeant York gun, the only anti-aircraft weapon to require another anti-aircraft weapon, to protect it from air attack!

24. This purchase delaying effect of recessions is well documented as is the disproportionate boost to demand which occurs at the end of them.

25. The IMF is presently engaged in being tough on Latin American and other debtors for doing exactly what the US is doing now.

26. Smaller Japanese manufacturers like Suzuki, Daihatsu and Fuji (Subaru) strenuously opposed these, on the basis that they would institutionalize the dominance of Toyota, Nissan, Honda and Toyo Kogyo (Mazda), but were overruled by MITI which was concerned at the consequences of not scaling back exports.

27. Japan is the main target of anger over trade, but increasingly some NICs and LDCs are also coming into the

firing line.

28. There is a minority view which argues that a) protectionism is not necessarily a bad thing, b) trade has never been truly liberal and never will be, c) the connection between lack of freer trade and economic depression only exists in the heads of advocates of trade liberalization. See Strange, S., "GATT and the Politics of North-South Trade", Australian Outlook, 38:2, Australian Institute of International Affairs, Canberra, August 1984, pp. 106-10.

29. ibid.

30. ibid.

31. These were the last two major rounds of trade negotiations held. The US has expressed a desire for a new round but has been stymied by France which wants to link the trade issue to that of monetary reform.

32. GATT, The Tokyo Round of Multilateral Trade Negotiations: II Supplementary Report, GATT, Geneva, 1980, p. 33.

33. These controls were on all exports and not just those which were technologically or militarily sensitive.

34. Bergsten, C.F., and Cline, W.R., Trade Policy in the 1980s, Institute for International Economics, Policy Analyses in International Economics 3, Washington D.C, November 1982, p. 16.

35. This 'random' effect of trade friction often harms players which it was never intended to impact on directly, e.g. the agricultural trade war between the US and the EEC has done a lot of damage to Australia, which tends to be a very efficient producer of many primary products and was never intended to be a victim of the conflict.

36. ibid., p. 46. See also Cline, W.R., "Reciprocity": A New Approach to World Trade Policy?, Institute for International Economics, Policy Analyses in International Economics 2, Washington D.C, September 1982.

37. Many of these NICs, such as South Korea, Mexico, Brazil and Yugoslavia are significant, if not major debtors to US banks.

38. See Collyns, C., and Dunaway, S., "The Cost of Trade Restraints: The Case of Japanese Automobile Exports to the United States", IMF Staff Papers, 34:1, International Monetary Fund, Washington, March 1987, pp. 150-175.

39. At least until 1986. It was argued that the Yen was being deliberately undervalued by the Japanese government to help exporters. This is patently no longer the case.

40. This is the Brazilian subsidiary of Volkswagen of West Germany.

41. Cohen, R.B., "The Prospects for Trade and Protectionism in the Auto Industry", in Cline, W.R. (ed.), *Trade Policy in the 1980s*, Institute for International Economics, Washington D.C, 1983.

42. Bergsten, C.F., and Cline, W.R., *Trade Policy in the 1980s*, --- p. 45.

43a. Saxonhouse, G.R., "The Micro- and Macroeconomics of Foreign Sales to Japan", in Cline, W.R. (ed.), *Trade Policy in the 1980s*, Institute for International Economics, Washington D.C, 1983.

43b. American Chamber of Commerce in Japan (ACCJ), *Report on 1981/82 Trade-Investment Barrier Membership Survey*, ACCJ, Tokyo, March 8, 1982.

44. This dispute arose because of a failed attempt by the US and Japanese governments to rig the market for this type of mass-produced chip. The Japanese were held to have violated the terms of the agreement, (which did little but raise the price of chips for all consumers), and were punished by having punitive levels of American customs duty levied on certain electronic imports to the US.

45. Apart from Japanese legal action against Toshiba for this breach, the corporation is also facing the possibility of a US Congressional ban on the import of its products into America.

46. The Japan-bashing in America has provoked a somewhat hostile response in Japan, especially in the press and the Diet.

47. A full-scale capital strike would be hard to organize, but even if only partially successful would have a devastating impact on the US. Perversely, it may be just this sort of sharp shock that may be needed to persuade the US to get its deficits into order.

48. Unless sanity prevails, and there is no clear sign that it will, battles over trade, particularly bilateral trade, will be a feature of international relations for years to come.

49. The mini-mill is a small-scale, high-technology plant operating very flexibly and with low cost of production.

50. There is also a substantial group of people who have benefitted from the booms in real estate, shares, artworks and other assets.

51. Professional Air-Traffic Controllers' Organization.

52. "Factory of the Future Survey", The Economist, London, May 30, 1987, p. 13.

53. ibid., p. 14.

54. ibid.

55. ibid.

56. ibid. See also, Jaikumar, R., "Postindustrial Manufacturing", Harvard Business Review, Cambridge, Mass., November-December 1986, pp. 69-76.

57. This problem of trying to find avenues to absorb surplus funds is going to be a long-term one, and the seeds of its solution may lie in longer-term development of LDC equity markets. See thesis conclusion.

58. Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1985, US Government Printing Office, Washington, D.C., February 1984.

59. ibid., p. 2.

60. ibid.

61. Taking into account only Federal spending. If state and local government spending is also included, the trend is even clearer.

62. See data in Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1985-1989, US Government Printing Office, Washington, D.C., February 1984, and the corresponding calculations in Bosworth, B.P., "Lowering the Deficits and Interest Rates", in Rivlin, A.M. (ed.), Economic Choices 1984, --- p. 28.

63. Rivlin, A.M. (ed.), Economic Choices 1984, The Brookings Institution, Washington, D.C., 1984.

64. ibid., pp. 88-107.

65. This reform did not have any overt social goals when first mooted, but has had some degree of redistributive effect because of the elimination of tax shelters largely used by the rich, in order to pay for broad-ranging tax cuts.

66. See Lawrence, R.Z., Can America Compete?, The Brookings Institution, Washington, D.C., 1984.

67. This bill, (or more correctly the last of this series of bills), is informally known by the names of its Congressional sponsors. The bill which finally passed Congress was fairly tough in its requirement for blanket cuts to the budget, but has since run afoul of Supreme Court

interpretation and other handicaps.

68. The lack of any significant pressure by foreign investors and the continuing international reserve currency role of the US dollar have also combined to allow the various arms of US government the luxury of inaction.

69. Pechman, J.A.(ed.), Setting National Priorities: The 1984 Budget, The Brookings Institution, Washington, D.C., 1983.

70. "Curing that deficit", The Economist (editorial), London, December 15, 1984, pp. 11-2.

71. This phenomenon is known as endaka in Japan.

72. "Slaying the dragons", The Economist (editorial), London, June 15, 1985, p. 16. Examples of such currencies are the Hong Kong dollar, the Korean won and the Brazilian cruzado.

73. Some of these are listed in "Factory of the Future Survey", The Economist, London, May 30, 1987, p. 16.

74. For example, serious banking collapses would strengthen demands for more and tighter regulation of the kinds of activities in which banks are allowed to engage.

75. It should be remembered that the fragmented nature of US domestic financial institutions means that a certain number of banks are expected to fail each year without any overt concern being voiced by most observers.

76. The heaviest drain was on the Federal Savings and Loans Insurance Corporation (FSLIC) which is now technically insolvent and is being temporarily rescued by Congress.

77. "Mending Midland Bank", The Economist, London, June 29, 1985, pp. 80-1.

78. ibid.

79. A substantial change in management, including the appointment of a former Deputy Governor of the Bank of England as Chairman, has slowed the rate of accumulation of losses, though the bank has so far not shown clear signs of a turnaround.

80. In theory, at least, such guarantees are not available to large scale depositors. Yet, in the case of Continental Illinois, the FDIC agreed to extend protection to big depositors who were not legally covered by it, in order to bolster confidence in the banking system.

81. The move by non-financial firms to become involved in financial services is a global phenomenon. For example, in 1986, many Japanese firms, (among them giants like Toyota

Motor Corporation), made more profits from _zaiteku_ (financial engineering) than from their main line of business.

82. The emerging concept of one-stop financial services has largely been pioneered by such non-banks, which are exempt from many of the restrictive legal stipulations which were written into US banking law as a result of the disastrous collapse of the Depression.

83. This strategy is also argued for in terms of the 'need' to build up American 'superbanks' to compete globally with the Japanese.

84. _The Economist_, London, August 15, 1987, p. 70.

85. This was an internal study performed for the international management consultancy, McKinsey & Co., by Mr. Lowell Bryan, one of their consultants.

86. _The Economist_, London, August 15, 1987, p. 70.

87. _ibid._

88. _ibid._, p. 68.

89. Many of the debtors in these categories also have their debt concentrated with US financial institutions, though not exclusively so.

90. The Alfonsin government has taken steps to demonstrate its ascendancy over the military by doing such things as bringing to trial the senior officers responsible for the excesses of martial law. It is noteworthy that most other Latin American governments, especially that of Brazil, have avoided such confrontation with their respective militaries. Even the Argentine government has backed away from prosecuting all of those involved.

91. If not military rule, then certainly a move back towards conservative politicians, an example being the electoral setback for the Radical party in Argentina's 1987 mid-term elections, with the Peronists gaining ground.

92. In the Philipines, the US was a late convert to 'People Power' and the Aquino candidacy, though it did play a useful role in 'helping' Marcos to leave. In Korea, the US got into the act earlier and probably exerted significant power on the Chun government for electoral and other reforms.

93. More correctly these are pressure points which are used to gain concessions from America, an example being the US bases (Clark Field and Subic Bay Naval Base) in the Philippines.

CHAPTER FOUR

SOUTH KOREA

"Credit is better than Gold"

- Slogan in lift at Hyundai headquarters in Seoul, Korea[1].

South Korea has been chosen as a case study for a variety of reasons, some of which already have been made apparent and others which will become clearer during the course of this chapter. To understand Korean economic policies it is essential to examine the history of the country and how this shaped economic thinking.

Japanese Colonialism

Korea, according to popular legend, was founded in 2333 B.C. by King Tan'gun.[2] From this time to the present, the Korean nation, or rather the social aggregate of the Korean people, has continued in one form or another and been known by a variety of dynastic names, including Chosun, Silla, Koryo and Hanguk.[3] Despite this lengthy period, formal organization of Korean society did not come about until the first century A.D. The influence of Confucianism, which had been introduced from China, on the society at large became quite pervasive and in so doing laid some of the foundations for successful colonization by the Japanese. The emphasis on such things as obedience to those of superior status, filial piety, unquestioning loyalty of subjects to the ruler and deference to the wisdom of elders were integral parts of the guiding philosophy which determined the development of

Korean social structure. Many of these attributes were and are shared with other Asian nations.[4]

While Japan formally annexed Korea as a colony in August 1910, the drive towards this colonization had started more than thirty years before. In 1876, the Koreans had been forced to sign a 'treaty of amity and commerce' with Japan and been deflected from their previous isolationist stance.[5] The issue of hegemony over Korea was a contributing factor to the Russo-Japanese war of 1904-5.

Japanese rule in Korea is divided broadly into two periods. The first lasted from the annexation until 1919. This was essentially a military occupation with Japanese armed forces and military police having control over the administration of the colony. The object was to pacify the country by force and prevent any challenges to the hegemony of Japanese authority. This necessitated, this involved quite a deal of brutality towards the civilian populace and proved to be counterproductive leading to an abortive uprising by a growing independence movement.[6] This, in turn, led to a shift in the thinking of the Japanese authorities. Coercion as a tool of control was rendered less important by a very determined attempt to assimilate the Korean people into Japanese language, culture and education. This was backed up by the gradual introduction of technology, services and goods which were ostensibly Japanese but had their origins, at least in part, in the West. The complexity of the Japanese approach to Korea in the second period of

colonialism which lasted until Japan's defeat at the hands of the Allies in 1945, must take some of the credit for laying the foundations for Korea's industrialization, even though it was largely unsuccessful in bringing about a Korean acceptance of Japanese overlordship.[7]

The Japanese educational system inculcated the importance of placing the group interest above that of the individual. The 'inevitable' nature of hierarchies and how there were two-way obligations in any relationship within these hierarchies were also stressed. The benefits of centralized authority and its ability to plan for the good of the whole of society were also dominant dictums of the value system learnt by Korean students in Japanese schools, among whom were many of Korea's post-war elite industrialists, politicians and administrators. It is not surprising, therefore, that there has been a significant emphasis on systematic planning and urbanization in the process of industrialization in Korea.[8] Even after the end of colonialism, Japanese influences have tended to persist, in spite of some frictions in governmental relations.[9] Many of the physical resources, e.g railways, that were to be useful in the process of industrialization were introduced by the Japanese. It seems quite logical that even after independence Japanese sources of technology, capital, production and marketing methods have been dominant.

American Neo-Colonialism

While the influence of Japan has been an ongoing one, the impact of the United States has also been very important since the end of World War 2, and during and after the Korean war. The partition of the Korean peninsula at the end of hostilities with Japan, into Soviet (North) and American (South) areas of influence, has created a complex relationship between the two Koreas. On the one hand, on both sides of the ceasefire line at Panmunjom, there is much national grief about the decades-long split in the country and a genuine desire for some form of reunification at an early date.[10] On the other there is a great degree of suspicion between the two Koreas and an unwillingness of one to bend to the will of the other. In Seoul especially, this has bred a kind of seige mentality, which has acted to some extent as a spur to greater economic efforts. The notion that, to resist Communism, the nation must be strong economically as well as militarily holds sway. Unlike many other US client states which espouse anti-Communism as a convenient nostrum to obtain benefits from their patron and expand the power of the ruling elite at the expense of other sections of society, the rulers and people of South Korea actually seem to believe firmly in the cause. It is strange, however, to observe the ways in which this national feeling is manifested. The national obsession with the threat of infiltration from the North, fuelled by such incidents as the destruction of Korean Air Lines Flight 007 and the bombing in Rangoon which killed many key members of the

Korean government, is somehow translated into greater economic effort to make the nation strong rather than into military action or moral indignation on the international stage. This is because such economic activity is considered a key component of national security.

The American influence in Korea was arguably greatest during the Korean War and soon after. The devastation caused by the war was extreme on both sides. The city of Seoul was literally razed to the ground and large parts of the countryside laid waste.[11] Reconstruction was an extremely demanding task, with little in the way of domestic inputs possible. Substantial foreign grants and technical assistance, predominantly from the United States, were the key to the rebuilding of much of the prewar Korean infrastructure, such as it was. Apart from such direct assistance, a United Nations Korea Reconstruction Agency (UNKRA) was setup to coordinate and direct reconstruction aid and to liase with the efforts made by the government of Korea itself. This was a logical enough step, given that US intervention in Korea took place under the banner of the United Nations. The setbacks suffered by Korea at the end of the 'police action' were therefore the concern of the UN.

The American response was widely justified in terms of building up a bulwark against Communism. The protection of the US military still is a vital factor in Korean life, with a sizable force of American troops stationed within the country, acting as a tripwire for any incursion from the

North, thus embracing Korea under the US nuclear umbrella. Korean troops are trained and armed in a manner that enables them to mesh smoothly with the American forces in a time of crisis.[12] The Korean Central Intelligence Agency is structured and run much along the same lines as its American namesake and counterpart. On a larger scale, Korean military resources are seen as an important part of the regional defence network that the Americans have been building up over the past decade or so, and within which they are currently having trouble trying to enhance the role of Japan. The most significant role played by the Americans, is arguably outside the military-strategic sphere. The gigantic US consumer market has been and will be more so, the key to much of Korea's prosperity, with its predominance as a destination for a high proportion of Korean manufactured goods exports.

Models for Industrialization

Korean industrialization did not begin to take off in earnest until the early 1960s. The first of a series of Five-Year Plans was drafted in 1962 by the Economic Planning Board (EPB). The EPB had been created the previous year by an amalgamation of the Bureau of Budget from the Ministry of Finance and the Bureau of Statistics from the Ministry of Home Affairs. The EPB took over planning responsibility from the Ministry of Reconstruction and absorbed the function of monitoring planning expenditures, including development

expenditures. This put the Board at the center of not only medium to long-term planning, but also short-term planning and policy making. To ensure EPB's primacy and power within the bureaucratic hierarchy, the head of EPB was given the title of Deputy Prime Minister and elevated in status above the other heads of ministries and departments.[13]

It is in some ways not surprising that these changes occurred under a military regime, that of General Park who had staged a military coup, since the provision of structure and order to the developmental and planning processes was arguably in keeping with a military mind-set. Yet, in other ways it is quite remarkable, given the broad failure of most military regimes to come to grips with the process of economic decision-making for the greater good, as opposed to the good of the military itself.

It is tempting to equate the EPB with Japan's Ministry of International Trade and Industry (MITI). However, even a cursory examination of the the two institutions reveals many differences in their roles. MITI, for all the mythical powers ascribed to it by hostile foreign observers, had a relatively limited number of instruments available to it as a means of influencing business behavior.[14] Some of these, such as the power to distribute export quotas, were quite useful and effective, but in general, the success of MITI's planning and implementation lay more in the economic and social pressures that the business community and government agencies could bring to bear on companies which upset the

inherent consensus within Japanese society and undermined a joint strategy that was seen as beneficial to the wider interests of Japan. This pressure to conform is so strong that activities such as hostile corporate takeovers which take place in most Western economies, where the interests of the individual corporation are paramount, are almost unheard of,[15] while mergers are often stage-managed by government agencies.[16]

Korean policy-makers are able to enforce their will by using a variety of blunt and sharp policy instruments. The EPB and other government agencies involved in the planning and development process, are often found to have dealt with fine detail in their interventions with business. The interventions are backed with a much greater variety of possible sanctions, including many which are not available to Japanese planners, such as the threat of witholding preferential loans. Not surprisingly, there is a high degree of compliance with policy directives. Indeed, the South Korean developmental model has been characterized as the epitome of the bureaucratic-authoritarian (BA) model, which interestingly is also the primary character of developmental economic policy in countries such as Mexico, Brazil and Argentina. Yusuf and Peters (1985)[17] have used a synthesis of the BA model and others, particularly the experience of Japan, as providing an exposition of a unique Korean model which arose in the rather special circumstances of Korean economic and political experience. However, they themselves acknowledge that any attempt to explicate this model runs

into problems with a 'paradigm soup' of different causes and effects all based on a series of assumptions which are perhaps not entirely valid in a 'real world' sense.[18]

What then are we left with? To start with, it seems quite valid to argue that the military coup of 1961 which brought President Park to power was a pivotal event in the economic development of Korea. In contrast to the regime of President Syngman Rhee, there was a much greater emphasis on building up the economy, particularly in the industrial sphere. The First Five-Year Plan established an ambitious target for annual growth (>7%), which was exceeded substantially, despite most Korean and American economic expert advice which argued that this was not possible.[19] The policy machinery was left largely in the hands of the quite competent civilian bureaucracy and still is to this day. It is difficult to say why the military in Korea resisted the temptation to get their fingers in the economic pie, and manipulate circumstances to their advantage, when almost every other military government[20] the world has experienced has done so to a greater or lesser degree. One explanation is that the constantly perceived threat of invasion from the North has served to enforce an urgency and priority to the notion of 'national strength through economic strength'. It may also be that with such a large US military presence, with which it is closely integrated, it is more difficult for the military to pursue self-seeking goals. On the other hand this US influence has not prevented factionalism within the Korean military and government, and the ruthlessness

with which it puts down perceived threats to its continuation, such as the Kwangju uprising. Interestingly, corruption, while hardly absent, is very similar to that in Japan. It has not had any demostrable negative effect on economic efficiency or performance. Indeed, it is almost an accepted part of the social and economic fabric as long as it is contained within certain limits. Once these boundaries are breached, especially in a public way that attracts a deal of adverse foreign publicity, the authorities ensure that they are seen to be taking action against those who are involved.[21]

Industrial Policies

Korea's industrial landscape is at first sight dominated by the increasingly globally recognized conglomerates known locally as _chaebol_. As names such as Hyundai, Lucky-Goldstar, Daewoo and Samsung become more widely recognised it is tempting to think of these as the new Korean _zaibatsu_,[22] Korea's equivalent of Mitsubishi and Mitsui. The reality is that the _chaebol_, while vitally important in many ways to the Korean economy, are by no means as dominant as the pre-war Japanese _zaibatsu_ were or their post-occupation successors are. There is not the same concentration of industrial effort or ownership of industrial assets. Many smaller, less well known Korean companies function alongside the _chaebol_ and are independent of them. Also, one key factor has always acted as a brake on the growth and influence of the major _chaebol_. Unlike their

Japanese counterparts, they are not centred on a banking group which functions as a primary lender to and lead-manager of funds for other parts of the conglomerate.[23] In fact, most of the Korean conglomerates still have no involvement in finance, except in restricted ways as providers of certain retail financial services to the Korean public. Indeed, the Koreans are restricted by the limitations of the financial system as it has been structured in their country, and the control exerted by the government on the raising of equity and more importantly, preferential loans. This straitening effect of the financial system in Korea is discussed at length later in this chapter.

The pattern of growth of Korean industry is closely identified with the sequence of Five-Year Plans since 1962. Korean planners, not unlike their counterparts at MITI, placed a heavy emphasis on the targetting of specific industries as areas of growth, particularly aimed at export markets or import replacement. This, coupled with high growth targets which have, till recently, inevitably been exceeded, has been the prime motivating force behind the astonishing rate of industrialization. Some examples would best serve to illustrate this point.

From about 1965 until the late 1970s Korea experienced extremely high levels of growth, primarily led by the export sector. This was in keeping with the strategy pursued about

a decade or so earlier by the Japanese. During the early phases of industrialization it was recognized that incentives, which included preferred access to capital and foreign exchange normally granted on the basis of proven performance, would be essential to the export sector.[24] Outside of this sector, the general pattern was for minimal government direct assistance, though indirect incentives such as tariffs, quotas, embargoes and high protection in both nominal and effective terms were provided. A major exception to this rule was the direct help given to selected firms in the heavy engineering industry, most of which were not involved in exporting.[25] The development of heavy industry, with its corollary of being able to develop infrastructure (roads, bridges, ports, power generation etc.), was seen as essential to both the economic expansion and the question of national security and defence, under threat from the north.

A key element of this heavy engineering capacity was the ability to produce basic iron and steel products at stable, internationally competitive prices. Not only was this capacity essential for the buildup of infrastructure, but also for such activities as shipbuilding, automobile production and other 'metalbashing' industries. It was not considered worthwhile to branch out into specialist, high value-added steel products, since local demand for these would be limited and a relatively high investment was required to produce them with sufficient quality. It was seen to be more rational to import such products from Japan

and other sources, but given the volume of basic steel and iron products used, it made sense to set up sufficient capacity domestically to produce most requirements. Korean planners opted for a strategy which involved setting up, from scratch, a modern, high efficiency steel mill of 8.5 million tonnes (mt) capacity at Pohang.[26] This one project alone, known as the Pohang Iron and Steel Company (POSCO), brought a fivefold increase in Korea's steel production. The plant was required to export a proportion of its output, mainly to ensure that its prices remained internationally competitive. Uncharacteristically for Korea, POSCO was State-owned, it having become clear that the private sector at the time did not have sufficient resources or capital outlay to take on the project. The Pohang mill was completed by Japanese heavy engineering firms in three stages over eleven years.[27] The location itself was chosen because it could be developed with associated deep water port facilities for the handling of large flows of bulk materials, both inputs and outputs. The level of technical advancement and economic efficiency is comparable with the more modern Japanese mills. This means that, in terms of containing labour cost per tonne, savings due to the lower costs of labour in Korea are not substantial, since the ratio of labour to capital is almost as low as in the Japanese mills.[28] POSCO and other corporations in Korea benefit, however, from lower corporate taxes (around 10% as opposed to around 50% in Japan),[29] and privileges like export finance at less than half open-market rates.[30] POSCO is now developing another 'greenfield' site at Kwangyang Bay

(another deepwater port). The mill which is being built there will have an ultimate capacity of 9 mt., thus more than doubling the company's capacity.[31] The strategy pursued in the case of steel production in Korea has, according to Edwards (1985), succeeded because of the emphasis on four vital points.

Firstly, production was efficient and large-scale, located at deep sea ports.

Secondly, there was concentration in basic steel products rather than an attempt to make a variety of steels in small uneconomical production runs, with imports of required special steels from efficient overseas producers being sanctioned.

Thirdly, there was a co-ordinated development of all aspects of steel production and distribution and the maintenence of tight construction and production schedules.

Fourthly, there was an export target, a requirement that meant the management of POSCO had to keep abreast of developments in the global steel industry and marketplace, were taking management decisions based on that 'finger on the pulse' and were supplying domestic consumers with steel at prices that did not put them at a competitive disadvantage globally.[32]

This integrated approach to establishing targetted industries also extended to shipbuilding. The expansion in capacity of the shipbuilding industry was also large scale. In 1973 this capacity was 0.2 million gross tonnes (mgt) but

this had increased to 4.0 mgt by 1980 (a twentyfold increase).[33] The current Five Year plan target was for capacity of 6.0 mgt by the end of 1986, but this has been revised downward to 5.3 mgt, because of the downturn of global demand for shipping. Shipbuilding is dominated by the chaebol. Hyundai, Samsung and Daewoo all have their own shipyards, with Hyundai's major operation at Ulsan being the largest, not only in Korea, but also in the world. Construction of this yard was commenced in 1972, again starting from scratch, with care being taken to locate it near the POSCO steel plant at Pohang, thus reducing cost and time in steel transport. The yard was designed originally to handle the construction of Very Large Crude-oil Carriers (VLCCs) of up to 1 million tonnes deadweight.[34] Unfortunately, this yard came on stream just after the First Oil Shock of 1973 spelt the end of the growth in the market for such large tankers. Flexibility has meant, however, that the yard has been able to turn its capacity to other types of ships, offshore oil platforms and so on, such that it has overtaken Mitsubishi's Nagasaki dockyard as the busiest in the world. In late 1984, for example, 55 ships were on the order books and it was not unusual for them to be built in identical batches of four in the docks designed to take one VLCC, something that no other shipyard in the world could hope to do.

There are problems with the shipbuilding industry, especially in the medium term. It cannot be assumed that order books will continue to be full, especially as shipping

itself remains a fiercely competitive business, with diminishing profitability, excess capacity and a relatively high rate of business failures. In the past the savings to be obtained from scrapping older vessels and replacing them with new, more fuel-efficient ones justified the cost of investing in new vessels. The drop in the price of oil has removed some of the incentive for operators to upgrade their fleets. It may very well be that as long as global recession continues and trade does not grow at healthy levels, Korean yards will have to survive as best they can. This is recognized at both the governmental policy-making level and within corporate management. The South Korean Ministry of Industry and Trade has pointed out the consequences of the Korean industry's dependence on orders for bulk carriers, roll-on roll-off ships, container vessels and tankers. Average price per tonne for these types had fallen from US$800 in 1982 (in '82 dollars) to US$500 in 1984 (in '84 dollars).[35] Orders were being won by tenders which were very low and were barely adequate to cover costs. Even so they only undercut Japanese yards by some 5-10%, despite labour costs being about 40% cheaper than those in Japan. This is partly because labour productivity is only about half that achieved in comparable yards in Japan.

Survival strategies for Hyundai's operation include bidding for available standard ships to keep the yard operating, while at the same time seeking to obtain orders for higher technology (chemical, liquified natural and petroleum gas tankers) and special (military) ships where

the profit margins are higher; measures to raise labour productivity and marry it effectively with the low-cost wages and modern production facilities; taking on repair, refitting and modification of existing vessels; placing an emphasis on research and development of new technologies in both the design and the construction of new vessels and their equipment to keep the technological quality of Korean product up to or close to world (and in particular Japanese) standards.[36] However, the huge appreciation of the yen over 1985-86, is bound to make Japanese yards less competitive on price. Korean orders should receive a boost from the decline of the American dollar, since the won is fairly closely tied to the US currency. As the cost of ordering Korean built vessels decreases for non-American fleet operators, production at Korean yards may begin trending upwards. Since many other governments are subsidizing their shipbuilders to a much greater extent than anything provided by the Korean government, the chances of a rapid Korean dominance of the industry emerging is not as likely as one might assume.

To digress momentarily on the question of wage costs, it is true that Korean wages and working conditions, and the flexibility built into the workforce by the almost total absence of restrictive work practices, would under normal circumstances constitute a comparative advantage. However, given the degree of capital intensiveness required to compete effectively with many industrial products in today's global market, the value of low wages is not necessarily very significant. For example, attention was drawn

previously in this chapter to the case made by Edwards (1985) who has pointed out that at POSCO's Pohang steel mill, savings from low wages are only marginal in calculating the cost of finished steel products.[37]

The integration of Korean industry and the emphasis on export oriented production is nowhere more clearly illustrated than in the sectors that produce consumer durables, such as motor vehicles and consumer electronics. The motor vehicle industry, for example, has had a great deal of success in an import sustitution role.[38] This is not surprising given the degree of protection accorded to it. However, the base that has been built up by using demand from the domestic market has set the stage for a major push on to world markets. Daewoo, Kia and Hyundai are all making moves to market Korean made vehicles and components on a global basis. In the case of the former two, their marketing linkups with, respectively General Motors and Ford,[39] will doubtless help them penetrate new markets. Hyundai is taking the harder route of trying to establish itself in its own right as a globally recognized manufacturer, with its own distribution and marketing network. So far, this strategy has been extremely successful, based as it is on two key competitive criteria - low price and durability.[40] Hyundai's vehicles slot into the lower price sector on all its export markets and cater to buyers who are seeking relatively basic transportation at reasonable cost. The ramifications of this strategy in the US market are discussed in the previous

chapter. Domestically though the market is distorted, in an attempt to discourage consumer demand for motor vehicles. For instance, a Hyundai Pony model which in 1984 had an export price of about US$3000, had a domestic price equal to around US$4500.[41] This is largely due to the 23 separate domestic taxes designed to discourage the local buyer. The effect of this is that by dampening down domestic demand, the government is able to conserve energy, maximize the available production for export, increase the level of saving in the community and ease the pressure on existing infrastructure.

Most of the technology that goes into Korean-built vehicles is imported, but this is done at a relatively cheap price because it is outdated by a few years and is not up with current world trends. Much of Hyundai's old Pony and new Excel and Stellar models depend on design, tooling and dies originated by Mitsubishi.[42] The cars are basic, but are seen as durable and very good value for money - the sort of qualities which originally enabled the Japanese carmakers to penetrate the global market. Body design has been contracted to an Italian studio, but will probably eventually become an in-house operation. To capitalize fully on the market niche that it is making for itself, Hyundai will gradually have to offer better technology packages and move upmarket if protectionism in other markets causes problems, because the profit margins on upscale motor vehicles are relatively higher.[43] So far the Korean motor industry has not been as successful as the Japanese, but it may only be a matter of

time before the industrial disciples outstrip the masters. With mutterings about this current and possible future success already being heard in Washington, the European capitals and elsewhere, it may not be long before the Koreans run afoul of protectionism, as the Japanese have already done. It is this fear that has driven the Korean government to reduce local tariffs and other import barriers before they become the ammunition in bilateral trade wars with its trading partners. Yet, unlike MITI in Japan, there has been no attempt on the part of EPB or other government agencies to restrict exports on a 'voluntary' basis.[44] This is partly because Korea's export volumes are not as threateningly high as Japan's. Also, it is probably a philosophy of making economic hay while the sun of comparative advantage shines before the protectionist clouds block it out. This explains why production in the passenger vehicle industry is expanding at a fast pace. Hyundai's new assembly plant at Ulsan, (again near POSCO's steel mill and the deep water port), has been wound up to full capacity and is working extra shifts, as the company moves to take advantage of new markets it is opening up, particularly in North America.

The combination of low wage costs and increasingly more sophisticated production and product technologies, is the perceived basis for future growth in Korean exports. The low wage costs are possible partly because unions in Korea are fragmented, weak and unable to mobilize their limited membership.[45] On the other hand, there is not as much

incentive for individuals to mobilize as a result of the forces that determine wages in Korea. Given the relatively recent transition of the bulk of available labour resources from being largely employed in the agricultural sector to being mainly employed by industry, there has been a large residual pool of workers, whose existence in theory would have retarded the rate of growth in wages, making the transition. In reality, agricultural wages experienced a period of rises and falls, some of which were quite sharp, between 1962 and 1975, at a time when wages in manufacturing increased yearly in real terms.[46] At times this rate of increase was almost double that experienced by wages of agricultural workers.[47] Given the low initial base, the impact of this increase in terms of comparison with other trading nations has been fairly small. Yet, on the domestic front it has meant a fairly consistent rise in the average Korean worker's purchasing power.[48] The government has consistently followed a policy of keeping domestic prices under a degree of supervision, and has been quite successful on this front, because it has been willing to tie things like import protection to the maintenance of a stable domestic pricing regime.[49] This useful anti-inflationary measure could, of course, be reinforced with the wide variety of instruments available to the government in its interventionary role in the economy. So, domestically at least, wages were seen to be consistently rising and no real pressure existed for larger adjustments. Also, the won being tied to the dollar at a consistently undervalued rate has helped further with the competitiveness equation. All this

parallels the experience of Japan. Till quite recently, a combination of similar factors, including an undervalued yen, gave a global perspective of Japan being a low-wage nation.[50] The lessons to be drawn from the Japanese experience are that, ultimately wage increases will become exponential in their (international) price effects, that pressures will be brought to bear by trading partners on the exchange rate, and that these along with other factors will conspire to diminish advantages that currently exist. This is why it is imperative that Korean manufacturing continues to move up the technology and market sector ladders, investing as much as possible in areas such as research and development, quality control, production engineering, marketing and coherent, efficient distribution networks, along with the ongoing requirement for more and more capital investment in production facilities. The logic of these necessities is that the current demand for capital, in the form of equity and more so in the form of credit will expand rather than decrease. The ultimate prize for success in carrying through this strategy is that Korea will one day acquire a substantial capital surplus, the careful management of which enables cushioning of the effects of being less competitive as a manufacturer and exporter.

In broad terms, these are some of the determinants that drive the Korean economy, its financial markets, the broad thrust of government and corporate policies and ultimately Korea's need to maintain and extend its external debt.

Financial constraints

Given potential domestic demand, the inability to acquire adequate and reasonable finance, in the form of equity or borrowings, would seem to be the key restraining factor in the expansion of most enterprises in Korea. To understand the reasons for this it is necessary to understand the structure and functioning of the financial system in Korea and the nature of its domestic capital markets. As stated previously, Korea's financial system has been very much under the influence of governmental policymakers. Most students of the country's experience in regard to the development of its financial system argue that it has gone through two cycles of growth and diversification.[51] The first of these occurred under the Japanese between 1910 and 1940, and the second began in the mid-1960s and continues today. The system created in the first cycle was specifically designed to assist Japanese interests in Korea and did not provide any lasting benefit to Korea itself or to the relatively few Koreans who were involved to any large extent in the colonial economy. The end of colonialism saw a period of repression, inflation and disruption with the financial system reverting to the chaos of pre-colonial times. This disruption was exacerbated by a variety of political factors and the effects of the Korean War.[52] The belated attempts to set up a viable financial system have also demonstrated the fallibility of Korea's otherwise quite competent planners. In June 1962, the

government, alarmed by a substantial increase in the money supply (about 50%) and fearful of the potential inflationary consequences carried out a poorly thought out and hastily executed currency reform. Despite there being no significant effects on prices at the time, government fears of inflation in the near future overcame common sense.[53] There was also a perception that money was being hoarded by large speculators who would soon act in ways that destabilized the economy. The reform consisted of demonetizing the old hwan currency and replacing it with the won, limiting the amount that could be converted, requiring registration of all cash and instruments such as money orders and cheques, and finally trying to force all "surplus" funds into a new "Industrial Development Corporation" that was meant to finance new investment in industry.

The immediate effect of these actions was to bring the Korean economy to a halt, literally overnight, with widespread panic breaking out among the populace. Given that the total money supply amounted to less than 12% of GNP,[54] there had not been a great deal of scope for hoarding, especially in an economy where cash surpluses were often in the hands of expanding businesses which were reinvesting them with a fair degree of efficiency. Stopping the flow of funds halted the economy in its tracks. Within a week the authorities were forced to begin rescinding the measures they had brought in and in little over a month all that remained was a currency with the new name (won). The ultimate effect of this particular effort at intervention

was a weakened currency, an undermining of confidence in financial institutions and a shift away from holding surpluses as money towards holding them as goods, thus stimulating the very inflation the government had sought to avoid.[55] The officials involved suffered tremendous loss of face and planners in Korea were to learn a lesson that they have rarely forgotten since - that it is essential to think through very carefully all the possible effects of any intervention before acting and to adopt the longer-term view in any policymaking.

To some extent, however, Korean government financial policy was dictated by the circumstances in which the country found itself. Contrasting these circumstances with those of Japan is a useful way of understanding the primary constraints on the Korean financial system. The private sector in Japan has consistently relied on capital raised through debt rather than equity, especially in the postwar period when massive investment was being undertaken on a scale which outstripped the ability of the equities market to keep up.[56] This demand for credit was satisfied by tapping into the large and increasing pool of private savings. A group of factors explain this growth in savings, including a personal tax structure which rewarded savings and investment and discouraged consumption and inadequate welfare provisions for members of the workforce who retire, thus providing strong incentive for self-motivated saving for old age. In recent years the rate of saving has been around 20% of disposable income, which is much more than the

rate in most industrialized countries.[57] The tight regulation of Japan's financial markets, which are only now being slowly and cautiously deregulated in a piecemeal fashion, meant that there were few avenues in which this money could be invested, other than in time deposits with the private banks and other financial institutions. This was especially so since most Japanese small investors were neither overly familiar with nor very confident in the equity markets and did not as a rule trade actively in shares.[58] This could be due to a desire for absolute security for their capital, given the experiences of many who lost their investments during and after the war. Over 80% of savings on a national basis have been invested in traditional time deposits[59] with financial institutions. With time, as the Japanese public becomes more familiar with the opportunities that are opening up, both domestically and overseas, this level can be expected to fall markedly. Irrespective of this, the fact is that during the crucial phase of their development, Japanese corporate enterprises were able to rely on a cheap, domestic and relatively large source of financing which was channelled to them by their banks, either the big commercial, 'city' banks or their own in-house group banks. The cost of this credit was quite low because of the restrictions on maximum rates of interest offerable by financial institutions,[60] barriers on Japanese investors moving their money offshore for other than direct investment in projects being taken up by Japanese firms, and also because the government kept its borrowing requirements quite low till the mid-1960s, by following a policy of

balancing its budget. It was able to do this because it did not invest in other than essential infrastructure (e.g. power generation but not large scale housing redevelopment), had minimal defence expenditure (because of the self-imposed 1% of GNP ceiling on funds expended on the military),[61] and was not a significant provider of social welfare services. Lately, however, it has become a significant borrower in the securities markets and currently accounts for some 30% of outstanding bonds.[62] Yet, at the same time it is a significant lender to the private sector, not so much in direct terms, but through various govermental financial agencies and institutions which draw their funds from the deposits made by the public in the Post Office savings bank system.[63] As can be inferred, the main consequence of these circumstances was that private corporations, particularly the large-scale zaibatsu-type conglomerates, had a certain amount of priority in borrowing from the captive, low-interest marketplace. Yet, in periods of rapid industrial growth, this dependence on investment funds from banks of one sort or another, led to a condition of excess borrowing. The impact of this 'overborrowing' is that the banks, particularly the 'city' banks (the largest type of commercial banks) then have to cover their shortfalls on the short-term money market which is quite active in Japan.[64] Yet, there are many gaps in the Japanese financial system when compared with most similar systems in the West and especially in relation to the prime centres of New York, London and Hong Kong. Strict controls on the levels of deposit interest that may be offered, the rate of expansion

of banking operations (e.g. every two years no more than two new branches of a domestic bank may be opened, though the Ministry of Finance may veto even this rate of expansion),[65] requirements that individual banks specialize in different aspects of banking (e.g. short-term finance, long-term finance, foreign-exchange banking etc.) all help to restrict the development of Japanese finance, though recent years have seen a gradual lessening of regulation.

The situation in Korea was somewhat different. In the early 1960s when both the industrialization strategy and the financial system to drive it were being put into place, per capita GNP was so low, and consequently also the level of savings within the domestic economy, it was apparent that financing from domestic sources would be too small to be adequate for most developmental strategies, let alone the very ambitious plans being laid. The Korean bureaucratic response was to ensure that firm and detailed control of the financial sector remained in government hands.[66] This control was exercised by both direct and indirect means via such agencies as the Ministry of Finance (MOF) and the Bank of Korea (BOK - the central bank), and extended deeply into the commercial banks and other private financial institutions, such as finance companies and insurance offices. Primarily, there are five nationwide 'city' banks in Korea, along with six special purpose banks, ten regional banks, several branches of overseas banks, and an assortment of other types of financial institutions.[67] The special

purpose banks such as the Korea Exchange Bank (KEB) and the Korea Housing Bank (KHB) were established to fulfil specific functions, such as handling all transactions related to foreign exchange or raising capital for housing construction. While business enterprises were permitted to deal directly with banks regarding their financial requirements, government agencies almost always became actively involved in the processing of any deal that was negotiated. For instance, an enterprise wishing to use a foreign loan, initially arranges the loan, perhaps through one of the many foreign banks represented in Korea.[68] Before an agreement can be concluded, the loan has to be approved by the EPB. After this, approval from the BOK or KEB is required so that these institutions may extend a guarantee to the overseas lender. This explains why almost all Korean foreign debt is ultimately considered to be sovereign risk.[69] In turn the BOK or the KEB would receive guarantees from a commercial bank or from the Korea Development Bank (KDB). These guarantees are advanced passively, on the basis of EPB approval, with the individual organizations doing little in the way of critical project evaluation. It is not usual for the banks to go against government directives, even on commercially sensitive matters. This control exercised by government, which usually also has the dominant shareholding in most of Korea's domestic banks (on average around 30%) with restrictions on the amounts of shares held by others, explains the poor profitability of Korean banks in general.[70] It also explains the relatively slow growth of the banking sector in relation to the rest of the economy.

This ability of government to control almost all the main sources of credit, domestically and also from overseas, gives it the ability to offer credits on highly favourable conditions to some of the enterprises in the economy, usually the chaebol or some government agency. It is also able to underwrite its own large-scale infrastructural programs at concessional rates of interest. It is mainly the small to mid-size firms which are left out in the cold in regard to their financing requirements.[71] They are then often forced to resort to the unregulated money market (UMM) or, as it is more popularly known, the curbside or street financial market.[72] This UMM can be found to some extent in many Third World countries, particularly where formal institutions do not adequately serve rural production and the seasonal needs of farmers and landed peasantry. They arise from diverse origins, but in Korea the progenitor of the UMM, is something called the kye; a form of rotating credit association.[73] The workings of the kye itself are not of interest here, but it was through them that the curbside market originated. Organizers of kye, who also acted as credit agents in the curb market, usually had access to the large amounts of cash that circulated through them. Since there were often lapses of time before the next settlement in the chain had to be made, it was possible to lend these out on an informal basis to businesses that had to maintain ongoing liquidity. Interest rates on these loans were comparatively very high and generally above the legislated maximum (30% per annum) under the law on usury.[74] Typically

interest was paid at between 2.5% and 5.0% per month.[75] This technical illegality of the street market and its shadowy connections with the officially sanctioned market, made it an unusual creature. On the one hand, participants tended to maintain a fair deal of secrecy about the transactions they made, even when they were quite respectable businesses. The government has made a few attempts to crack down on the UMM, including a Presidential decree in 1972 that made it illegal for Korean citizens to be involved in the curb market.[76] On the other hand, all those involved, including government policymakers in the EPB realize that the UMM acts as an important safety valve in ironing out short-term liquidity crises in the Korean economy caused, in part, by the inadequacy of the official financial markets, the unsatisfied demand for credit that is generated by the rapid growth of the economy, and government controls on overseas borrowing.[77] The ambivalence of the governments attitude to the UMM was demonstrated most clearly in 1983, when fraud on the part of certain participants in the curb market threatened its complete collapse. The government stepped in behind the scenes, and extended considerable financial support to businesses and creditors who were threatened by the scandal. It would have been the simplest thing to let the market collapse under the weight of its own miscalculations and force the underground savings that it taps to enter the official market. This action on the part of the government belied its official stance of hostility to the UMM.[78]

Economic conditions in Japan have tended to encourage its businesses to borrow very heavily in relation to their capital base. Gearing (debt/equity) ratios of 10:1 are not uncommon,[79] and there is a reluctance to expand capital by issuing new equity. The trend in Korea is for these characteristics to be exacerbated even further, with even higher levels of borrowing and even narrower capital bases. Surprisingly perhaps, many of the large scale private enterprises are still largely under family ownership of one sort or another, even when they have issued shares on the relatively small Korean stock-exchanges. (Hyundai, for example, is still very much in the hands of the various branches of its founding Chung family, with different family members holding sway over different divisions of the group). Part of the reason for this lack of willingness to travel fully the joint-stock company route is perhaps a fear that giving up control to those who may lack personal loyalty to the objectives of the company, would ultimately lead to its downfall. It may also be sheer unwillingness to give up power and influence. Arguably, such elements of apprehension could be mitigated by examining the history of family-based companies in Japan. There the transition from control by members of the family to control by professional managers has been fairly smooth. (In some cases in Korea, such as Hyundai, members of the family have themselves become the professional managers by acquiring the necessary qualifications, experience and expertise). Also, those who would retain the bulk of shares within the family would do well to examine cases like that of Konosuke Matsushita,

founder of the Matshushita group of electronic companies, the world's largest consumer electronics manufacturer, which started as a small repair shop. The only shareholding in the group still maintained by the founder is 2.7% of Matsushita Electric Industrial, the group flagship. At the end of 1986, this asset alone was worth over US$800 million.[80]

Another aspect of this lack of emphasis on equity is the absence of deeply traded stockmarkets within Korea or indeed markets for Korean stocks overseas. Investors are wary of putting their money in enterprises which do not always publish accurate and precise balance sheets and other standard reports.[81] The extreme influence of the government may also be a factor in dissuading widespread interest in share-ownership. The legislatively imposed Korean stock-valuation system was unrealistic, with prices not being related to operating performance. Most investors tended to perceive stock prices in relation to par, not as equilibrating mechanisms, and dividend rates were fixed as a percentage of par.[82] In recent years, the government has moved to change the system to reflect more closely a true market value for shares, but reform in this area, as in many others, has been slow. This may explain why the Korean stock market has developed so poorly in comparison to markets in other LDCs, such as Brazil, and has not served the interests of Korean enterprises, in their attempts at capital formation.

The absence of key banking groups within the <u>chaebol</u>,

unlike in the Japanese conglomerates, has led to further difficulties in raising loan funds. Of course, under the present system, the role that these could play in directly tapping into financial markets is limited, but if reforms do go ahead at a significant pace, it may be essential for the Korean conglomerates to develop such financial arms.[83] In the meantime it is clear why external debt plays such a vital part in the Korean economy and is likely to continue to do so in the foreseeable future. In the past, Korea's external debt was owed largely to Japanese[84] and American institutions and syndicates, though sources of finance are increasingly diverse with the growing presence of banks from Europe and other parts of Asia.

The pegging of Korea's currency (the won) to the US dollar has also been of benefit in handling the external debt situation. This connection with the largest export market, enables a fairly steady rate of expansion of exports without concern about a currency risk. Over the years, there have been a series of slight upward revaluations of the won relative to the dollar, but still the perception outside Korea is that the won is undervalued.[85] In trading and debt repayment terms, however, the current policy makes a great deal of sense assuming it is not derailed by irate trading partners.

External Debt Implications

At present, there is no apparent problem with the repayment of external debt, and certainly no evidence of any difficulty, such as government-originated requests for rescheduling of payments. However, there are possible problems on the horizon which may upset the equanimity with which this is viewed by the Korean government and its creditors. 1984 proved to be somewhat of a setback in terms of the export drive, with targets not being met for the first time since the early 1960s.[86] The cause of this was the general slowdown in world trade due to the global recession, which impacted more heavily on exports from many of the NICS. In Korea's case this was compounded by other factors taking effect at the same time. The slowdown in demand and the consequent operational problems facing many employers led to an effective wage freeze which saw rises in the levels of industrial disputation and strikes. Of the chaebol, Daewoo in particular was hit by a series of stoppages, with workers demanding improved wages.[87] Apart from undermining the myth of a docile workforce, the workers formed links with dissident student groups and other activists thus adding further muscle to the opposition to the Chun government, especially in the wake of the bloody suppression of Kwangju. This alliance was instrumental in bringing about the recent concessions granted by the government on the method of electing the next president and on the release of political prisoners. There is evidence of rising anti-American sentiment, partly due to tacit American

approval of the methods used at Kwangju, which at this stage is confined largely to the more active elements of society, but may widen if there is a general perception that the US government and Congress are penalizing the Korean people for their success and rewarding US industry for its failure by imposing protectionist measures. Already measures have been taken against some Korean exports, for instance anti-dumping duties have been imposed on colour televisions[88] and quotas on steel.

This protectionism is also creeping incrementally further into the, already heavily protected, textile, clothing and footwear industries. The MultiFibre Arrangement (MFA) set up several years ago as an interim measure, steadfastly refuses to die and has been supplemented in many developed nations by other means, technically illegal within the rules of GATT.[89] This was a contributing factor to the collapse of the Kukje Group, the sixth largest <u>chaebol</u>, which had diversified interests centred on construction, textiles and clothing. Kukje, along with others like Hyundai, had construction as a core business and depended very heavily on turnkey and piecemeal contracts from the Middle East.[90] The oil glut and its consequences on the spending power of its customers, drastically slashed the profitability of these ventures. Hyundai had to cope with slowdowns in demand for new shipping as well as in construction. Its automobile business however has been doing relatively well, though management have decided to preempt any attempts by the US International Trade Commision (ITC)

to get them to accept 'voluntary' restraints, by announcing plans to set up a Hyundai plant in Canada which will be turning out 100,000 cars per year by 1990.[91] In this regard it is noteworthy that Korean manufacturers are being forced to take such steps at roughly the same time as their Japanese counterparts,[92] before they have had a chance to really make their mark on the global marketplace and consolidate their positions. Already, they have to worry about competition from other emerging producers, not just the Taiwans, the Hong Kongs and the Singapores, but also the Chinas, the Indias and the Indonesias. It seems reasonable to expect that Korea will have to maintain its lead by emulating Japan and relentlessly pushing upmarket in terms of quality, technology and value-added, while keeping a step (or preferably, two) ahead of the protectionist lobbies in the countries with which it trades most.[93] In theory, there is an upper limit to the degree to which this strategy can be pushed. Even the Japanese have been unable to persuade global consumers that Honda and Toyota models are the equal (in price and quality) of Mercedes-Benz or BMW. They may never succeed in doing so, but at least by then they will have consolidated their multi-billion dollar surpluses to provide a comfortable cushion with which to absorb the shocks of re-orienting their industrial strategy.

Another recent factor that has hurt Korean business badly is the shakeup of the financial system. The government has wholly or partly privatized its holdings in the major private banks and ordered them to operate on a more

commercial basis.[94] This move does not take into account the impact of the large number of non-commercial loans, already on the books, which were issued under government decree and have now turned bad, but which are being sustained by government guarantees. Also, the largest of their customers have not yet adjusted to the new rough and tumble that this implies. Some have responded to the cash squeeze in which they find themselves by selling off assets and businesses or property which they are unable to utilize fully. Others, Kukje among them, took on unacceptable levels of short-term debt which they have had difficulty servicing. The result was an acrimonious debate between business management and government planners about the rate at which the financial landscape was being changed.[95] Opposition was strong enough for the government to reverse or modify some of its plans. The stockmarket too has been changing with more private firms going public, often under strong pressure from government on resistant management. For example, Hyundai Engineering and Construction Co., resisted the government's instruction to go public for five years before finally making the move in November 1984.[96] During the year from October 1985 to October 1986, the total value of shares in the Korean market more than doubled.[97]

The Korean government coped fairly well with the problems that it found itself facing on the economic front. It demonstrated a willingness to be flexible and change direction as and when the need to do so became apparent. There were alternately, tightening and loosening of monetary

policy, a re-evaluation of infrastructure projects, a willingness to take hard decisions and the sense to see when these harsh measures were doing too much harm.[98] This distinguishes it from many governments in the West and elsewhere, which tend to develop an ideological stake in their economic policy, in the style of Reagan or Thatcher, and are consequently less flexible. Many of the infrastructural projects which are being pursued are designed to soak up the spare capacity in construction, but the really expensive projects, such as the very ambitious nuclear power program,[99] have been delayed. A large commitment is being made to housing, water supply, road and rail construction and similar civil engineering projects. A major revamping of the laws and administrative procedures governing foreign investment has taken place, with the avowed aim of making it easier to turn external debt into foreign-owned equity.[100] This is seen as vital to stop the possiblity of the external debt burden getting out of control.

Perception of Korea's future prospects are extremely positive in global financial markets. The slowdown in growth is viewed as a temporary phenomenon, which will be rectified by either a revitalization of demand for Korean exports or even a change in policy by the government leading to the stimulation of domestic demand for consumer durables.[101] It is acknowledged that excess capacity in some industries, e.g. shipbuilding, will persist for some time, but the view

is that the inherent strengths of the Korean economy will be sufficient to overcome any problems within certain sectors. Overseas investors do not seem to be as worried about the rise of lower-cost competitors, as Korean government and business elements seem to be. For example, the Korean government's recently launched Korea Growth Trust (offering foreign investors the chance to invest in Korean securities) had no problems in obtaining subscribers.[102] The New York investment bank Scudder, Stevens & Clark launched its Korea Fund in August 1984, at the height of the slowdown.[103] The Fund was backed by the Korean government and listed on the New York Stock Exchange (NYSE). The NYSE's full disclosure requirement meant that for the first time a document (the prospectus) issued by the Korean government had a detailed account of the workings of the curbside market. It had always been easier for Korean officials to pretend to the outside world that the market did not exist, as they preferred not to lose face because of their inability to control it. The Korea Fund eventually created financial history by trading at a premium to its net asset value.[104] A second issue in May, 1986 was sold at an amazing 78.5% premium to its net asset value,[105] so the indications are that international investors seem to be very bullish on South Korea.

At present the management of Korea's external debt is concentrated on converting the larger part of outstanding short-term debt to medium or longer-term committments. This is seen to give a greater degree of flexibility in decision

making and strategic planning, both within private enterprises and government agencies, which are all being encouraged to undertake this restructuring, especially since it often leaves them with a more favourable interest rate regime, good risks being relatively rare on international capital markets these days.

The future of successful external debt management lies in the successful management of the economy. The Koreans have had to compact their process of industrialization and their entry on to world markets into a far shorter time than the Japanese had. They now face time constraints in trying to consolidate themselves. For example, Korea has had overall trade deficits, with 1986 expected to produce the first ever surplus.[106] This is partly due to the heavy reliance on Japan for parts and machinery. It will need to have visible surpluses in merchandise to service its debt. It will take quite a while for a comfortable capital surplus to be built up, yet Korean firms are increasingly having to move offshore, as the Japanese have done, particularly by setting up manufacturing and assembly operations in main markets. This is ultimately bound to produce pressure on domestic employment and industrial relations, and certainly on inflows of receipts that would help service foreign debt. The planners would appear to have erred in building up such an excess of capacity in particular sectors which on present indications do not have much in the way of future demand.[107] The gamble is that at some stage in the next few years there will be a dramatic boost to the global economy that is

sustained over four or five years giving the Koreans a chance to consolidate the gains they have made so far and turn to using their domestic economy as the main engine of growth.

In the interim the main challenges come from domestic political opposition to the Chun government and the way in which these challenges are resolved. So far, there has always been a valid perception that Korea's economy is distinct from any political crises that may be faced by the government of the day. The bureaucrats are seen to be relatively independent in their decision-making. This is one of the reasons why political unrest has not deterred investment by domestic and foreign capital interests.[108] Yet, if the economy shows signs of going off the rails and the alliances between disaffected workers and radical students become stronger, there is every possibility that confidence in the Korean model will be eroded. Depending on the degree of such a crisis of confidence, there is potential for some very difficult situations in the future. This is especially so in the light of a growing internal debate about the value of foreign debt and the questioning of the large amounts of money required to service it, especially when it is argued that this money could be better spent directly in improving the living conditions of the people of Korea, rather than in being used to build up excess capacity that cannot be used. The scaling down of many of the more ambitious developmental projects is, in part, an admission of the validity of this argument.[109]

Given the Korean bureaucracy's willingness to admit to its mistakes and face up to reality, one has to assume that the situation will be kept under review. Meanwhile, Korea is one of the few countries in the world which has continued to expand its external debt burden sizably[110] in recent times.

NOTES.

1. Smith, M., McLoughlin, J., Large, P. and Chapman, R., Asia's New Industrial World, Methuen, London, 1985, p.41.

2. Kim, K.T., Industrialization of Korea Under Japanese Rule: A Case Study, Unpublished Ph.D. Dissertation, University of Maryland, Baltimore, 1974, p.14.

3. ibid.

4. The emphasis on these values was so marked that even a US Army handbook on Korea, from the early 1960s sets out to explain carefully the complexity of these cultural values. See The Department of the Army, US Army Area Handbook for Korea, US Government Printing Office, Washington, D.C., 1964, p.94.

5. Kim, K.T., Industrialization ---, p.69.

6. Mason, E.S., Kim, M.J., Perkins, D.H., Kim, K.S., and Cole, D.C., The Economic and Social Modernization of the Republic of Korea, Harvard University Press, Cambridge, Massachusetts, 1980, pp. 60-75.

7. There appears to have been less resistance to the processes of industrialization and modernization but rather, most opposition was to the imposition of Japanese language and culture.

8. Smith, M. et al, Asia's New ---, pp. 42-44.

9. These frictions are centred largely on the long-standing refusal by the Japanese to admit to error in their colonizing Korea. The recent formal apology by the Emperor of Japan to President Chun Doo Hwan is seen as going some way towards redressing this.

10. It is hard for an outsider to gauge the strength of this desire, much as it is in Germany. Relations between the parties tend to oscillate from good to bad.

11. The impact of partition was also damaging to the economy given that it had been built up as an integrated whole which was then rent in two on an economically irrational basis. See Mason, E.S. et al, The Economic ---, pp. 86-89.

12. Korean and American forces in Korea are under a joint command structure.

13. Mason, E.S. et al, The Economic ---, p. 252.

14. The role played by MITI is described in great detail in Johnson, C., MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975, Stanford University Press,

Stanford, California, 1982.

15. The only recent example which comes to mind is the attempt by Kyocera, an industrial ceramics company run by an American-trained Japanese chief executive, to take over a group of businesses which proved unwilling. The attempt failed when Kyocera's bankers refused to become involved financially, for fear of alienating the government and other customers.

16. For example, the recent rescue of Sanko Shipping.

17. Yusuf, S., and Peters, R.K., Capital Accumulation and Economic Growth: The Korean Paradigm, World Bank Staff Working Papers No. 712, The World Bank, Washington, D.C., 1985.

18. ibid, p.45.

19. It was a feature of all of Korea's Five-Year Plans, until the reversals of 1984, that they generally exceeded their high targets.

20. The current government of Korea is more correctly a military-backed regime rather than a military government per se, though the author finds it hard to distinguish between the two.

21. There seems to be a greater willingness to confront the issue of corruption head-on in Korea than in Japan. The Park regime put several businessmen and others who had been shown to be corrupt, in jail when it first took power. In 1984 exposure of corrupt dealings by the ruling party's chairman, forced his withdrawal from politics. Compare this with the poor record of Japan's ruling party.

22. Since the Zaibatsu were 'tainted' by being involved in the mobilization of Japan's war effort, their latter-day successors are not referred to by this name, though sometimes the term Keiretsu is used.

23. As a matter of course, the group bank and other companies in the group have interlocking share ownership and directorates, resulting in a somewhat incestuous situation.

24. Edwards, C.T., Heavy Industry in South Korea: Development, Current Situation, Prospects and Policies, Working Paper No.30, Bureau of Industry Economics, Canberra, 1985, pp 3-4.

25. ibid, pp. 14-19.

26. ibid, p. 7.

27. During the latter years of construction there was a greater emphasis where possible on utilizing locally produced components. For a summary of the criticisms that

gave impetus to this process of adding local content see Korea Institute for Industrial Economics and Technology, The Heavy Machinery Industries of Korea: Problems and Prospects (Final Report) (English Language) Seoul, Korea, 1982, pp. 121-192.

28. Edwards, C.T., Heavy Industry ---, p.7.

29. ibid.

30. Referring here to the rates on the official financial markets and not the unregulated money market (UMM).

31. Though currently development of the plant has been delayed and its completion date put back.

32. This approach has got the Korean steel industry into trouble with the US, which has slapped quotas on Korean steel supposedly because it is being subsidized.

33. Along with this rise in capacity, a major investment was made in ancillary facilities like R&D facilities and testing tanks.

34. Smith, M. et al, Asia's New ---, p.55.

35. Edwards, C.T., Heavy Industry ---, p.11.

36. Such measures would maintain a competitive advantage over other low-cost producers such as Yugoslavia and Brazil.

37. Edwards, C.T., Heavy Industry ---, p.7.

38. Albeit largely with imported technology, designs, machinery and parts.

39. Both these American companies hold equity in their Korean partners.

40. These two criteria are those on which the Volkswagen Beetle in the 1950s & 60s and the Toyota Corolla in the 1960s & 70s were extremely successful.

41. Smith, M. et al, Asia's New ---, p.48.

42. This is an example of how, in many sectors, many of the inputs that go into Korean exports are imported. This is not unlike Japan in its early days, but would be a worry if it continued to be the case.

43. The Japanese response to quotas imposed by the US was to pursue this strategy, such that even though the number of units exported to the US declined, profitability was increased.

44. So far, there has not been any sustained pressure for this measure brought to bear on EPB or the government's

trade negotiators.

45. There has been occasional industrial action in the past, but this has had limited scope and effects.

46. Hasan, P., and Rao, D.C., Korea: Policy Issues for Long-Term Development, (Report of World Bank Mission), Johns Hopkins University Press, Baltimore, Maryland, 1979, p.181.

47. ibid.

48. It is argued that, given the disparities in pricing of goods and services and the distortions of exchange rate fluctuations, a more valid comparison of income in different countries can be made using purchasing power parity (PPP) of the currencies. The methodology for this is described in Kravis, J., Heston, C., and Summers, A., World Product and Income, Johns Hopkins University Press, Baltimore, Maryland, 1982.

49. The effect of this policy in the past has been that, as people's incomes improved, given the relative price stability, they were able to afford more consumer products and services, even though the initial cost of these was fairly high when they first came on the market.

50. For instance, it was not uncommon for domestic protectionist rhetoric in Australia to argue as recently as three or four years ago that the reason why Japanese goods were relatively cheap was because of the 'exploitation' of Japanese labour. Any comparison of the relative wage rates in Japan and Australia on PPP grounds would have demonstrated that this was nonsense.

51. Cole, D.C., and Park, Y.C., Financial Development in Korea 1945-1978, Council on East Asian Studies, Harvard University, through Harvard University Press, Cambridge, Massachusetts, 1983, p.35.

52. Without finance to drive it there was no possibility of economic growth. A study by Adelman and Morris produced results showing that the degree of improvement in financial institutions is the strongest index of dynamic economic performance. See Adelman, I., and Morris, C.T., "Performance Criteria for Evaluating Economic Development Potential: An Operational Approach", Quarterly Journal of Economics, Vol.82, No. 2, May 1968, pp.260-280.

53. Cole, D.C., and Park, Y.C., Financial Development in Korea ---, pp. 58-60.

54. ibid., p. 59.

55. ibid., pp. 59-60. Also see, Kim, B.K.,Central Banking Experiment in a Developing Economy: Case Study of Korea, The Korean Study Series, Vol.12, The Korean Research Centre,

Seoul, 1965, pp. 45-61.

56. Ishi, H., "Financial Institutions and Markets in Japan", in Skully, M.T. (ed.), Financial Institutions and Markets in the Far East, MacMillan, London, 1982, pp.87-92.

57. ibid., p.88.

58. This situation has changed somewhat, not that significant numbers of small Japanese investors are entering the stockmarket directly, but that they are investing more in unit trusts and other mutual funds which are involved heavily in the current Japanese bull market.

59. Ishi, H., "Financial ---", p.108.

60. This ceiling was imposed by a combination of informal means and legislative fiat, e.g. by use of the Temporary Interest Rates Adjustments Law.

61. This figure, often quoted in Japan, assumes that service pensions and other welfare benefits for military personnel and their dependents are not taken into account. If these were included, as is the practice in most other OECD countries, the true figure would be closer to 1.6% of GNP.

62. Ishi, H., "Financial ---", p.89. See also Patrick, H.T., "Financing of the Public Sector in Postwar Japan", in Ohkawa, K., and Klein, L. (eds.), Economic Growth: The Japanese Experiences since the Meiji Era, R.D. Irwin, Homewood, Illinois, 1968.

63. To understand how this interacts with the banks' deposit system see the account in Suzuki, Y., Money and Banking in Contemporary Japan: The Theoretical Setting and Its Application, Yale University Press, New Haven, Connecticut, 1980, pp. 179ff.

64. It is no accident that short-term money markets have become quite prominent in Japan and Korea, given their very useful role in ironing out liquidity crises that are a result of the restrictions placed on financial markets generally.

65. This control is mainly in place to prevent banks from taking deposits away from the Post Office system, especially outside the main cities.

66. Hasan, P., and Rao, D.C., Korea ---, p. 365, 370.

67. ibid., p.374.

68. At last count there were 52 foreign banks represented in Korea. See Far Eastern Economic Review, Asia 1986 Yearbook, FEER, Hong Kong, 1985, p.176.

69. While there are different precise definitions of sovereign risk, the term essentially means that the government of the country concerned is liable for the servicing or repayment of a loan which it has guaranteed, even though the loan may be to a private entity.

70. There is a problem when evaluating profitability in the East Asia region, given the propensity to take investment decisions based on the long term returns, rather than immediate profits. Yet, even by these standards the returns on capital from Korean banks are poor.

71. Some of these firms are key suppliers to the _chaebol_ of various components and services, yet their survival is a precarious business.

72. Many of the transactions literally happen in the street, thus the name.

73. See Geertz, C., "The Rotating Credit Association: A 'Middle Rung' in Development", _Economic Development and Cultural Change_, April 1962, pp. 241-263.

74. Cole, D.C., and Park, Y.C., _Financial Development in Korea ---_, p.119.

75. Nam, S.W., and Park, Y.C., "Financial Institutions and Markets in South Korea", in Skully, M.T. (ed.), _Financial Institutions ---_, p.159.

76. Presidential Emergency Decree of August 3, 1972.

77. In this regard it functions much like a deeper (and more expensive!) version of the short-term money market.

78. This is tempered with pragmatism in permitting the UMM to operate relatively freely when the need for it is perceived to be vital. Yet, till recently, the government avoided acknowledging its continued existence, and maintained the fiction that the UMM had been eliminated by the Decree of 3/8/1972.

79. Suzuki, Y., _Money and Banking ---_, p. 14.

80. "Richer than Croesus-san", _The Economist_, November 29, 1986, p. 72.

81. Accounting standards that are acceptable to the 'Big Eight' international accounting firms are rare in East Asia, with Japan and Singapore being the major exceptions. On the other hand, the accountants Arthur Andersen & Co. have shown that if the American government had adopted generally agreed accounting standards for its federal budget deficit in 1984, the US deficit would have been US$ 333.4 billion rather than the stated figure of US$ 185.3 billion.

82. In addition to this, the government placed a cap on the amounts by which share prices could move each day on the market, thus helping to slow down trading even further.

83. It must be recognized that the Japanese conglomerates do not necessarily deal only with their group bank, which acts as a lead manager in putting together syndicated deals with other banks, some of which are from other groups. Yet, the 'special relationship' that exists between group bank and group enterprise is vital to optimizing financial conditions. See Wallich, H.C., and Wallich, M.I., "Banking and Finance", in Patrick, H., and Rosovsky, H. (eds.), Asia's New ---, pp.293-298.

84. Often in the form of trade credits.

85. This is largely due to the increasing visible trade surpluses in merchandise. The surplus with America has widened to an estimated US$5.6 billion in the first ten months of 1986, an increase of nearly 70% over the same period in 1985. See "Supercompetitive Currencies", The Economist, December 6, 1986, p.17.

86. As the previous footnote indicates this was not because of lack of growth in external demand for Korean products, but because demand did not grow as fast as the ambitious goals demanded.

87. Far Eastern Economic Review, Asia 1986 ---, p.173.

88. ibid., p.176.

89. The MFA was originally set up under the guise of being a mechanism by which an orderly transition could be made from the very high protection enjoyed by these sectors in most OECD countries to a less protected regime which permitted NIC competition to be relatively unfettered.

90. Particularly in Saudi Arabia. At one stage the presence of Korean construction companies was so widespread that this joke was reportedly circulating around Riyadh, at a time of tension with Israel - "Have you heard the Saudis have declared war on Israel? The South Koreans have won the contract!"

91. Far Eastern Economic Review, Asia 1986 ---, p.175.

92. Toyota, Nissan, Mitsubishi, Honda and Mazda are all setting up assembly plants in the US to circumvent opposition to Japanese imports. Mostly, they have managed to negotiate labour contracts with their relatively non-unionized workforces that should give them a competitive advantage against GM, Ford and Chrysler which are dependent on higher-cost heavily-unionized labour. The Canadian option should give Hyundai a relative cost advantage and fairly unfettered access to the US market, given the relatively free trade between the US and Canada.

93. An interesting set of strategies for managing this challenge are described in Rhee, Y.W., Ross-Larson, B., and Pursell, G., Korea's Competitive Edge: Managing the Entry into World Markets, Published for the World Bank by Johns Hopkins University Press, Baltimore, Maryland, 1984.

94. This is part of a growing recognition within EPB and other agencies that more dynamism within the Korean financial sector is essential to future plans, especially if the magnitude of external debt is to be contained.

95. This display of public dissension was unheard of in the Korea of days past. The fact that it occurred was an indication of the depth of feeling on both sides.

96. Far Eastern Economic Review, Asia 1986 ---, p.176.

97. Mainly due to the listing of new companies on the exchange.

98. Examples of this are given in Westphal, L.E., and Kim, K.S., "Korea", in Balassa, B., and Associates, Development Strategies in Semi-Industrial Economies, Published for the World Bank, Johns Hopkins University Press, Baltimore, Maryland, 1982, pp.270-274.

99. The original plans called for the completion of a network of 39 nuclear power plants by 2000, each with a capacity of at least 950 MW. These would feed into an electrical grid already supplied by other, largely thermal means.

100. This is part of a trend being followed by many other debtor nations, including Argentina, though one suspects that Korea will be more successful than the others.

101. The Korean market, unlike the Japanese one, is not yet affluent enough to take up much of the slack created by an export downturn.

102. Far Eastern Economic Review, Asia 1986 ---, p.176.

103. "South Korea's Premium", Investment Management Survey, The Economist, November 8, 1986, p.19-20.

104. Usually closed-end funds like the Korea Fund trade at a 20-30% discount on their net asset values.

105. "South Korea's Premium", ---, p.20.

106. "Supercompetitive Currencies", ---, p.17.

107. Examples of this would be shipbuilding and basic steel production.

108. Compare the growing interest in investment in South Korea at a time when student riots, worker dissatisfaction and opposition to the existing political regime are all on the increase, with the effect on investment that these would have in almost any other developing country.

109. However, economic factors are cited as the primary cause for the decision to delay or cancel these projects.

110. None of this, as far as can be ascertained, was tied to any rescheduling arrangement and was 'new' lending. Compare with the major Latin American debtors whose total debt has remained fairly static, with a squeeze on 'new' lending.

CHAPTER FIVE

ARGENTINA

"The government is not offering miracles ---. A country with a weak economy overrun by inflation is a country that cannot defend its national interests ---."

- Juan Sourrouille, Minister of Economy, Argentina.[1]

Though they are, nominally at least, both Newly Industrializing Countries (NICs), economically South Korea and Argentina have had very different experiences, in terms of the utility of their external debt and the consequences of having entered into that debt.

Argentina is, of course, along with Mexico and Brazil, one of the 'Big Three' Latin American debtors.[2] In terms of the magnitude of their debt, these stand out even on a global scale, with South Korea being one of the few other countries to match them. There are some reasons for selecting Argentina, in preference to Brazil or even Mexico, as the example of a NIC unsuccessful at managing external debt. Certainly the scale of its debt makes it a worthy example, as do the problems involved in servicing this debt. More importantly, however, Argentina has been a pioneer of the move back to democracy in Latin America. From a political perspective, in Mexico, the institutionalized one-party state[3] has elaborate, and highly effective, mechanisms to stifle popular dissent, while its writ runs sufficiently for it to be able to, as a matter of course, provide largesse to those who support it. In Brazil, the

military still wields substantial power from behind the scenes, and President Sarney's government rules with the acquiescence of the generals, if not with their unqualified support.[4] Argentina is the best example of a repressive military regime being displaced by a popularly-elected government with a notional program of social and political reform. From an economic perspective, Mexico still has some advantages due to its physical proximity and political closeness to the United States, even if much of its oil wealth has been squandered. Brazil is able to fall back on the sheer size and depth of its economy[5] and its resilience. Argentina, more so than the others, has to survive on its wits as a supplement to its income from primary production. In sum, Argentina is a test case. If it is possible to find comprehensive ways of managing external debt problems and still maintain a commitment to internal democracy and social justice, the Argentina of Raul Alfonsin would be the prime candidate for success. If these goals are incompatible, Argentina's failure to combine them would be the most spectacular.

Superficially, Argentina's history does not give grounds for much optimism about its future. Throughout most of its independent existence the country has been dominated by some form of autocratic and repressive regime. The pinnacle of this was probably reached by the virtual dictatorship of Juan Peron.[6] Yet, the harshness of these regimes has often been tempered with a heavy dose of populism and appeals to patriotism. This has led to such phenomena as the

near-worship of the Perons and the popular support for the military misadventure in the Falklands-Malvinas.[7] The current civilian administration is a sharp contrast to its recent predecessors. The election to government of President Alfonsin and his Radical Party, was a major step forward in terms of breaking the run of authoritarian regimes.[8] The military junta which the Radicals replaced, was largely responsible for the policies which led to Argentina running up its present external debt. In common with many other military regimes in Latin America, this one was very heavily committed to squandering resources on keeping up a large military machine, which hardly ever dealt with external threats to the country.[9] More often, its role was to assist in a policy of internal repression, culminating in such excesses as the 'disappearances' of thousands of Argentines who were critics of the regime or suspected of being opposed to it. Alfonsin and the Radical Party were swept to power with a popular mandate because of a combination of circumstances. There was widespread disquiet concerning the way in which the military was running the country. After the severe loss of face engendered by the defeat over Falklands-Malvinas, it was impossible for the military not to concede civilian rule. This was compounded by the realization that economic mismanagement was rife and the external debt burden was out of control. Furthermore, there was a perceptible change in political outlook throughout Central and South America, which has seen the replacement of most military and dictatorial regimes by those which have been democratically-elected.[10]

The Economic Picture

Argentina's economy was founded on primary production and is still heavily reliant on income from the export of various agricultural products. In this regard, it is not as advanced as the more industrial economies of Brazil and even Mexico.[11] While a significant degree of industrialization has taken place, the base is still not particularly large, and there is a lack of depth in the patterns of such industrialization. Private sector industrial conglomerates, such as Brazil's EMBRAER or ENGESA or Mexico's Grupo Alfa are quite uncommon. However, as in much of Latin America, the state sector is quite sizable and dominant, especially in those areas deemed to be of vital interest to the public. For example, in the energy sector, a virtual domestic production and marketing monopoly over all oil-based products was vested in the state oil company Yacimientos Petroliferos Fiscales (YPF).[12] This policy was similar to Mexico's attitude towards Pemex. Other LDCs also had central state-owned oil companies which dominated their domestic production, but not many had such a monopoly over the product from well-head to final point of sale.[13] The size of the, allegedly grossly overstaffed, state sector and the unwillingness to reduce it, have been running sores in the relationship between the IMF and a succession of Argentine governments. One of the things which really irritates the Fund and commercial banks is the way in which some of these Latin American state monopolies have been buying back their

outstanding debt at substantial discounts in the secondary market, by using hard currency earned from their international activities.[14] Since these companies have been able to hide behind their state ownership as a means of avoiding the nastier consequences of not servicing the debts, the Fund and the banks feel this to be unfair. This is especially so in the case of the state oil companies, such as YPF, Petrobras and Pemex, which are quite solvent and stable entities. So it appears that all is fair in love and debt! On the point of state ownership of enterprises, it is unlikely that there is much domestic support in Argentina for a major denationalization of industry.[15] Certainly, the unions, many of them controlled by the Peronists, violently oppose the notion. In spite of this, there have been recent moves by the Radicals to consider engaging in a limited amount of privatization of state-owned companies.

Some of the reasons for the paucity of secondary industry are tied up with the country's continuing role as a primary producer. Argentina is not the only large-scale exporter of agricultural, or even mineral, products, which has had trouble establishing a strong domestic industrial base. Australia also has had this problem. Saudi Arabia, which is in the midst of a fairly ambitious industialization program, is likely to face the same difficulty. Until the latter part of the last century, Buenos Aires was little more than an administrative centre for overseeing the extraction of wealth from the agricultural lands of the Pampas.[16] Even now, the importance of beef, wheat and other

primary products as export income earners cannot be underestimated. At the turn of the century Argentina achieved prominence as an exporter of frozen and canned beef, as the impact of these new technologies made it easier to ship more palatable beef to European markets.[17] (Previously the majority of exports consisted of salted or dried meat, which may have been suitable for feeding armies,[18] but left something to be desired by the average consumer). The ability to produce high-quality agricultural products was to stand Argentina in good stead, especially at times when global shortages loomed, as was the case during the Second World War. Argentina emerged from the war, with its balance of payments in substantial surplus, high foreign exchange reserves, and wealth generally increased.[19]

Unfortunately, post-war economic history in Argentina has been of cyclical fluctuations around a path of relatively low growth, double-digit inflation in practically all years, and recurrent balance of payments crises.[20] The persistent imbalance between the rates of growth of the primary and secondary sectors has not helped with the latter. Part of the problem was that for too long, industry relied on imported inputs, while agriculture remained the principal source of foreign exchange.[21] Growth in industry was directly dependent on agriculture. Planning was strongly oriented towards import substitution, with a corresponding strong bias against the export of industrial products.[22] In hindsight, given this policy mix, it would seem that balance of payments crises were inevitable.

This feature of the Argentine economy meant that periodic stabilization measures have been a feature of its landscape since the war,[23] and are not just an IMF plot of the sort so beloved by some of the more nationalistic, often right-wing,[24] Argentinian politicians. Typically, stabilization implied a resort to devaluation (to promote primary exports and contain imports) and a tight monetary policy (allegedly to prevent inflation). In general, the manner in which these measures were implemented, and the extremes to which they were taken, resulted in recession and inflation.[25] There was usually a temporary improvement in the balance of payments as economic activity declined. However, given the export bias of the domestic food producing industries, the price of food to Argentinian consumers inevitably rose following a devaluation.[26] Compounding this difficulty was the fact that there was no attempt to even experiment (by means of an incomes policy) with the notion of maintaining wages at acceptable, but reasonable, levels until the late 1960s.[27] The experiment failed and entrenched a system by which the cyclical nature of increased external demand for Argentine exports is matched by similar increases in real wages, but with no corresponding falls at times of recession, (at least for those who remain employed). There are strong political factors which explain this phenomenon and these are dealt with later in this chapter.

The pattern of periodic balance of payments crises and

accompanying problems such as substantial domestic price inflation, remained a feature of the Argentine economy during the past forty years. Before Argentina was to become a major debtor, clear major crisis points could have been easily identified in 1950-54, 1958-60 (the first in which the IMF became involved), 1961-63, 1969-73 and 1975-76.[28] In theory at least, the economists of the banks which were to lend so lavishly to Argentina should have had sufficient grounds for sounding cautionary notes about potential future problems. Unfortunately, in the best traditions of international banking, most of the analysis of risk, both financial and political, was performed only _after_ the risks had been taken on.[29]

Anomalies in Taxation

The standard response of most Argentinian governments to the crisis points was almost predictable. It consisted of some mix of devaluation, increased foreign borrowings to meet the shortfall in external reserves with which to fund consumption, and a general aversion to any tightening of fiscal policy by means of tax increases, either nominal or real.[30] The question of effective taxation is a serious problem in Argentina as it is elsewhere in Latin America and the rest of the developing world. The problem is not with rates of taxation or with taxation policy as a whole, since these are usually stated and have clear direction and substance, if not always economic rationality. The difficulty arises with _enforcement_ of the chosen regime of

taxation. Tax avoidance, and more often blatant tax evasion, are rife and, apart from endemic problems of corruption within the public service organizations charged with collecting tax receipts, there is a lack of political will to confront this head-on.[31] A large part of this tolerance of tax evasion is connected with a desire not to offend the powerful urban middle class which has had tremendous political influence ever since the Peronist era. Not only do the members of this group keep much of their assets abroad (in Swiss bank accounts or Florida condominiums), but they also declare ridiculously low values for their domestic real estate and other assets. Of 770,000 contributors to the revenue in 1985 in capital and wealth taxes, 730,000 paid an average of US$ 170 for the whole year.[32] It is not uncommon for highly-paid professionals to declare that their luxury flats in the better Buenos Aires or Sao Paulo suburbs are only worth US$7,500 and that they earn only US$150 per week.[33] Since 95% of politicians and the judiciary come from an urban middle class background,[34] swindling the state is considered wholly acceptable.

On the other hand, the rural sector does not have the kind of political clout that one would expect it to have, given its massive contribution to both the balance of payments and the economy as a whole. Current treasury policies fall most inequitably on rural landowners and, in particular, arable farmers, in the form of huge export taxes.[35] (These export taxes also affected larger local firms which were seeking to expand their operations to other

parts of the continent or even the world). Collecting these taxes at the point of shipping is a fairly easy exercise and one not likely to cause too much political fallout. Yet, this has a serious effect on the producers of the exports. For example, in 1986 the average soybean farmer had to hand over 36% of the port price in export and turnover taxes: from the remaining 64% another 15% went towards transport and the payment of middlemen, and then from what was left the government received, on average, another 22% in capital, personal wealth and land taxes.[36] The upshot of this was that arable farmers in 1986 made no money, even if they funded their own working capital. If on the other hand, as most did, they borrowed this capital at very high interest rates, they are now hopelessly in debt. With little new working capital it seems likely that areas under cultivation will decline. In a country where arable crops and their by-products account for almost two thirds of the value of exports, this sort of policy is sheer economic stupidity. Yet, it is relatively risk-free in terms of short-term domestic politics, since it does not offend the key political constituencies, such as the urban middle class.

The Political Picture

The extreme degree of political influence exercised by the urban middle class is only one of many artefacts of the Peronist era which continue to bedevil Argentina today. The early 1940s was a period of confusion in Argentine

politics.[37] Quite early in the Second World War, Argentina had been enmeshed in a serious diplomatic row with the United States over trade, something which gradually spilled over to affect all relations between the two states.[38] The trouble hinged on Argentine attempts to find new markets for its agricultural products which could no longer be sold to occupied Europe. Attempts to expand sales in America ran headlong into the provisions of the Smoot-Hawley Tariff Act of 1930, one of the most protectionist pieces of legislation ever devised.[39] This friction over trade seriously affected the relationship of the US with many countries in Latin America and damaged the progress of policy initiatives such as the Pan-American defence alliance. (Only later in the war did Argentina profit from global shortages of the products it had to sell). Domestically, the growing economic crisis damaged and severely weakened the standing of the coalition Castillo government that was then in power.[40] By the end of 1941, the government was reduced to using the Japanese attack on Pearl Harbor as an excuse for the imposition of a state of siege, and rule by decree. As some of its coalition partners deserted it, and its popularity plunged, the government became more and more dependent on the goodwill of the military for its survival.[41] However, when it became known that President Castillo was about to step down in favour of another politician who was unpopular with the military, even this support evaporated and the armed forces staged a bloodless coup.

The new government which resulted was in theory a

civilian one, but actual power was in the hands of an unlikely group of political bed-fellows, including two elements of the army (the 'moderates' and the 'nationalists'),[42] and some sections of the Radical Party which provided the new president Ramirez. The nationalists held the whip hand in the Ramirez government and were bent on pursuing a policy of confrontation with the US and with Brazil, which was viewed as the American puppet in the region. This led to baseless fears about the possibility of an invasion by Brazil and wild talk about invading Brazil first.[43] Throughout all of this the government, such as it was, slowly but surely destroyed its authority over the Argentine people. Ever on the lookout for a cosmetic change to fix deep-seated problems, the army dismissed Ramirez and appointed Farrell in his place.

At the time, Peron was an army colonel who was appointed as an aide to the new president. However, he very rapidly finessed himself into being appointed, firstly, the minister of war, and then the vice-president.[44] Peron's origins were immigrant middle class, like those of most of his contemporary military nationalists. His strong background in military politics was a distinct advantage as was the major role he had played in making and breaking a series of governments. Arguably, Peron's early attempts at populism were motivated by a desire to mollify rising discontent with the government he served. However, his attempts to woo organized labour were so successful that they provided him with what was to be his most powerful and longest lasting

constituency.[45] Peron turned to labour in the latter half of 1944, as a wave of strikes hit major portions of agriculture, industry, transport and other essential services. From the outset Peron portrayed himself as the defender and protector of the working class, something which an objective observer, would have had difficulty taking at face value, given his brutal purge of communist union leaders only the year before.[46] Yet, the union movement itself felt under threat and was keen to increase its own political influence, which had been only slight for the preceding quarter century. Peron and the unions needed each other.[47] Peron's bid for working class support hinged on enacting a variety of improved workers' conditions - pay, vacations, pensions, housing, accident compensation - and establishing new labour courts. In combination with a generous social security system, this was a powerful lure to a working class which had previously been treated with a degree of contempt by almost all preceding governments. Having abrogated to himself the power to intervene in strikes and impose binding solutions to disputes, which inevitably were very much to the advantage of the workers involved, Peron was able to portray himself as 'Argentina's Number One Worker'.[48] It was a fairly easy task to recruit support from key union leaders and eventually to turn the major unions themselves into agencies of Peronism, something which they still are today. Together, the *Peronistas* set about conducting their failed experiment in building the 'New Argentina'.

Even at the best of times the Peronist political philosophy, if one could call it that, was a rather contradictory and muddle-headed view of the world. Its guiding doctrine was something called *justicialismo* - a mixture of justice, sovereignty, welfare, emancipation, harmony and progress. *Justicialismo* was, according to Peron, a complex mix of "Christianity and humanism" along with "the best attributes [of] collectivism and individualism, idealism and materialism".[49] At best it was a misguided venture to become all things to all people. At worst it was simply baffling gobbledegook. Yet, the times in Argentina were such, that it worked. It helped make Peron president, and elevated his wife Eva, who portrayed herself as an indefatigable worker for charity and a friend of the poor, to the status of a semi-religious icon, even more so after her death.[50] The appeal of Peronism still persists to this day. It survived the exile of Peron in 1955, and a variety of other events of national significance. It still has strong roots in the union movement, a strong political party (which is currently the main opposition to the Radicals) and an emotional appeal to many Argentines of all ages.

The legacy of Peronism is one of the worst things that today's Argentina has to cope with. To begin with, it has effectively neutralized the working class as an instrument of decisive change.[51] The working class is now very much aligned with the interests of middle class Argentines. Kirkpatrick (1971) noted the absence of any widely perceived conflict between bourgeoisie and proletariat.[52] She points

to surveys of the time which clearly indicated that among others, the middle classes, rural workers and trade unionists were all widely approved of and held in high regard, while landowners (even those with smallholdings), communists and "foreigners" were perceived with a great deal of hostility and suspicion.[53] It would be a brave theoretician who attempted to apply the standard Marxist model of class relations for modern industrial societies to Argentina, even today, since it seems that little has changed. There is much identification with the middle class which is reinforced by a relatively high degree of upward social mobility for the lower-middle and working classes. Peronism was hardly a doctrine of austerity and sacrifice.[54] 'Nation-building' was supposed to happen without the people having to endure any special trials and tribulations or even having to defer consumption. As a result, it has bred a political culture that makes it extremely difficult for any government to demand sacrifice from the people. Indeed the key to winning politically is to promise that such sacrifices are not necessary for the restoration of economic wellbeing. The Peronists, and indeed most other Argentine political parties, are great planners. A five year plan of some sort is always in the wind. However, it is rare for these plans to be entirely coherent economically, and even rarer for them to be carried out successfully.[55] It is not as if the Argentine people do not critically evaluate the performance of governments. They do, and the evidence is that they are quite harsh critics of governments that have failed them. The problem is that the criteria that they use

for making their judgements are very different from those of external observers. The people, and their representatives such as union leaders or even elected members of the national and provincial assemblies (deputies), only judge a government's economic performance by the degree to which they themselves gain from or lose by it.[56] How then does any Argentine government have a reasonable chance of implementing the sorts of stabilization measures so beloved of the IMF and the international banks? The rising expectations which have persisted since Peron are not about to yield to calls for national sacrifice, especially if the proceeds of that sacrifice are to be sent overseas to line the pockets of some *Yanqui* banker.[57] In a sense the people cannot be blamed. For most of this century they have been subject to varying degrees of economic mismanagement, interspersed with short periods of fortuitous economic booms, followed by harsh recession-inducing measures when the booms have finished. They have probably had as much stabilization as they can tolerate.

Political and Economic Management Under Alfonsin

Initially, the Alfonsin government seemed to have a clear notion of how it was going to tackle the severe problems of external debt and economic stagnation which it had inherited. At the outset it had a substantial reserve of goodwill from the Argentine people.[58] This was predicated on three factors. Firstly, there was disenchantment with the previous military regime for reasons of economic

mismanagement and general incompetence. Secondly, even those Argentines who had ignored the Galtieri junta's atrocious record on human rights were forced to confront the issue of the 'disappearances' of suspected 'terrorists', by the actions of courageous groups such as the Mothers of the Plaza de Mayo. Alfonsin and his government promised to bring to justice all those in the military who had committed murder, torture and other repressive acts in the name of the state. Thirdly, the badly botched Falklands-Malvinas misadventure cast the armed forces of the Argentine Republic in a very unfavourable light as far as carrying out their primary role was concerned, and made it unlikely that they would try to take over government again in the near future.

At the outset, the Alfonsin government was preoccupied with more political issues such as ensuring that its hold on power was secure and that it did not give the military a chance to stage a coup before it had firmly grasped the political initiative. By early 1985 however, it became quite apparent that the economy was out of control. Inflation was estimated to be of the order of 350-400%, capital flight was rife, debt repayments had ceased, tax receipts had lost most of their value by the time they arrived in treasury hands, and the public sector deficit was financed by printing pesos.[59] It was imperative that something be done to contain the damage before it undid the still fledgling democracy, by destroying the government. Alfonsin appointed the respected economist, Juan Sourrouille to the post of Minister of Economy and instructed him to come up with a plan to

stabilize the economy. Sourrouille's response was the so-called 'Austral Plan'.[60] The elements of the plan were dramatic rises in the price of fuel and public sector services, a statutory wage and price freeze, a devaluation so severe that it even left behind the blackmarket value of the US dollar, the imposition of high real interest rates, a huge increase in taxation (mainly imposed on the export sector), and a promise not to finance any budget deficit by printing money.[61] The peso was demonetized and replaced by a new currency called the Austral, which was exchangeable for old pesos or dollars.

Argentina had experienced statutory freezes before and more seasoned observers in and outside of the country were highly sceptical of the chances for the latest plan's success. However, a general public fed up with inflation, took it to be an instant success and overlooked the inadequacies of the Radicals' economic policies which had allowed the situation to deteriorate so badly in the first place.[62] The plan was hailed as a saviour of Argentina and the general euphoria surrounding it helped the Radicals win the November 1985 congressional elections which previously they had seemed certain to lose. Among those who admired the 'success' of the Austral Plan was President Sarney of Brazil, who soon came up with his own version of anti-inflationary shock tactics, dubbed the 'Cruzado Plan'.[63]

Indeed, in its early stages in both Argentina and

Brazil, these shock tactics seemed to be working. For about eight months the Austral Plan continued unchanged, with the government able to ignore special pleading from vested interest groups because of the general level of support from within the community.[64] Unfortunately as the plan began to bite, some of the political gilt began to wear off. Some aspects of the plan had unexpected side effects. For example, most manufacturers had already factored future expectations of inflation into their pricing regimes and the freezing of costs left very substantial profit margins. As a result these manufacturers were perhaps the only sector of society who could afford to continue investing, given that annual effective interest rates on short term deposits were soon over 100%.[65] The government was forced to begin giving ground, sparingly at first and then with ever increasing speed. Some things, such as the surreptitious price rises resorted to by small retailers and suppliers of services, it had never really been able to control because it lacked effective mechanisms to do so. It could have stood its ground on others, but chose not to for reasons of political expediency. Ultimately, the Austral plan slowly fell apart during 1986 (and was soon followed by the Cruzado plan of Brazil). The Argentine government then had no recourse except to return to the basic strategy which is now followed by most of the major Latin debtors. In essence, this consisted of managing the ongoing chronic crises in economic policy and external debt servicing on a day to day basis, trying to maintain a semblance of reasonable relations with creditors, agreeing targets on a variety of indicators,

(with the IMF), as a prelude to obtaining the next rescheduling or even the occasional injection of promised new money, and working out the best ways of fudging the issue when these targets were not met.

Debt Management

Managing Argentina's external debt poses several dilemmas for its current Radical Party government. Part of the problem is that there are no votes at home for taking steps which are deemed necessary by creditors. Indeed, on the contrary, blind obedience to the dictates of the international banks and the IMF would be a fairly certain way of committing political suicide. Arguably, the Argentine government can find the political will to take hard decisions and move decisively to restructure its economy, but only if it can point to tangible gains from doing so. For this to happen, those outsiders who wish to see such change in Argentina have to offer something more than good intentions and words. For example, despite Argentina being one of the 15 countries covered by the Baker Plan, it has precious little to show for its tacit endorsement of the strategy involved.[66] The Baker Plan, enunciated at the 1985 Bank/Fund meeting in Seoul, was a welcome change from the previous chorus of calls for debtors to implement ever harsher, more contractionary domestic policies. It was perhaps the first time that an officially-endorsed plan explicitly argued a strategy of maintaining growth in the debtor nations which had serious debt-servicing problems.

This was the first tacit acknowledgement by any OECD government official that squeezing the debtors in the traditional IMF style had its limitations.[67] The Baker Plan was dependent on four critical assumptions. Firstly, it was taken for granted that the additional debt taken on board as a result of the plan would of itself boost growth and export revenues to levels high enough to cover both existing and new debt service obligations.[68] Secondly, it was assumed that multilateral institutions, particularly the IMF, would be able to force debtors to adhere to politically painful adjustment programs and see them through. Thirdly, it was thought that commercial banks would provide the required amounts of new funds, especially if encouraged to do so by a moderate boost to multilateral lending.[69] Lastly, the global trading environment was presumed to be flexible enough to accommodate substantially greater volumes of net exports from major debtors without triggering further protectionist sentiment in the OECD countries.

It is now becoming clear that these assumptions were, to varying degrees, unfounded.[70] Additional debt, even when it has been forthcoming, has not been as productive as had been imagined. In the face of deteriorating domestic political situations many debtor governments have resisted pressure to push through tough adjustment programs. The commercial banks involved have avoided significant further input into debtor nations. Instead they have been seeking avenues for disengaging themselves as far as is possible from lending to many of the debtors. The Baker plan is slowly coming

unstuck, though it is far from being officially declared dead and buried.

The only other significant plan which has any chance of official sanction is commonly referred to as the Mistry Plan (after its author Percy Mistry, who was until recently, a senior financial adviser to the World Bank).[71] Mistry marries some of the better ideas of Baker with others from Congress and a relatively old proposal of the investment banker, Felix Rohatyn, for something approximating the mechanism engineered to rescue New York City from bankruptcy. Mistry's centrepiece is something he calls a debt restructuring facility (DRF),[72] quite similar to the Municipal Assistance Corporation (MAC) organized by Rohatyn at the time of New York's fiscal crisis. Mistry himself has a fairly clear idea of how the DRF would be set up and administered (as a special programme of the World Bank).[73] Among the key advantages of this plan would be:

* Reversal of the recent trend towards large net transfers of real resources from developing to developed countries.

* The accelerated removal of a large portion of outstanding LDC debt from the books of commercial banks, this debt being then taken on board by the DRF.

* The securitization of much of this debt into more easily managed parcels, which are then widely distributed

throughout the global securities markets, thus leading to a dispersal of credit risk, with the accompanying liquidity advantages.

* LDCs which wished to avail themselves of the DRF would have to agree to resident monitoring teams from the IMF/World Bank which would oversee compliance with much more specific economic, monetary and fiscal targets than are presently set in IMF endorsed reschedulings.

* The _quid pro quo_ for this greater intervention would be that all targets would be set with significant levels of growth in mind, so that the LDC governments concerned would be able to use this tangible gain to stifle domestic political opposition.

* The DRF would have a substantial level of leverage, in terms of its capacity to issue commercial paper, and would be largely financed from private sources of funds in the financial markets.

As Mistry sees it, the gearing ratio of the DRF would be as high as 10:1, i.e. it would borrow 90% of its funds from the markets.[74] Furthermore the 10% which constitutes initial capital would mainly be in the form of callable capital or capital guarantees from OECD countries. So if US$ 3 billion was the paid-in (cash) capital, and the total guaranteed capital resources were US$ 30 billion, the DRF would be able to raise something like US$ 300 billion of funds with which

to 'purchase' the sovereign debt held by the world's major commercial banks. Of course, since this debt would be purchased at a discount of at least 25-30%, this would enable the DRF to take on board US$ 400 billion-450 billion of LDC debt over a period of 3-5 years.[75] This kind of capability would make a real dent in the overall debt problem instead of nibbling at the edges. In theory at least, and allowing for unseen pitfalls, the Mistry plan would provide a reasonable outcome for most participants. However, it has been steadfastly ignored since its debut in April 1987, by the World Bank hierarchy and the key OECD governments. The will even to consider such sweeping action seems to be missing, and may not be found soon.

The Mechanics of Current Strategies

The waves of financial innovation which have swept through global financial markets have had spin-offs for LDCs which are seeking to manage their debt. A variety of instruments are now available to enable certain debts to be offset, at least to a degree. In common with many other recent financial innovations these techniques rely on the fact that most problems arise from a uneven global distribution of liquidity. In a sense, most of the innovations, especially those which are most profitable, have been based on circumventing this problem in a variety of creative ways. Yet, the one common feature of almost all of these innovations is that they create little in the way of new lending or new resources to LDCs. They are a way of

easing the debt problem rather than solving it.

The new market in swaps,[76] for example, which is a favoured tool of many corporate treasurers, has spawned a group of innovations which are particularly useful to hard-pressed LDCs. Swapping debt for equity is the most popular technique. The mechanism for this is quite simple, especially in comparison to some of the more complex currency and interest swaps which have been engineered in recent years. A debtor country's financial officials, or its bankers, may identify a loan or group of loans which would be amenable to such treatment. This is by no means an easy task, since a range of criteria may have to be satisfied for the swap to be successful.[77] At a very basic level, a swap is nothing more than trading an asset for an asset, or more correctly debt for debt. However, the motivation for engineering them is often related to their implications for taxation and liquidity.

The most common form of LDC swap is exchanging debt for equity. In a typical debt/equity conversion, a prospective investor, (for example, a multinational corporation which is seeking to expand its production facilities in the debtor country in question), purchases an eligible debt, (usually meaning it has been rescheduled at least once). The financial institution which holds title to the debt, is paid in the appropriate _foreign_ currency such as US dollars, but with a discount from face value which reflects an assessment of the likelihood of repayment.[78] The multinational is then

able to redeem the debt from the debtor government at full face value, but in local currency. The proceeds of the swap are then available for use within the debtor country for the purpose originally intended, the multinational having saved a substantial amount of convertible currency in its investment program.[79] The bank or other institution holding the debt is able to retrieve at least a part of its money in foreign currency, and the debtor government has been able to retire a portion of its debt without dipping into precious foreign exchange reserves.

Debt/equity swaps have already taken place in quite a few countries, including Chile, Costa Rica, Ecuador, Mexico, the Philippines, Brazil and Argentina.[80] The authorities in Colombia, the Dominican Republic, Uruguay, Venezuela and Peru are debating the merits of using these instruments.[81] This reflects the fact that there are reservations even about the limited use of swaps. The US banks involved are concerned about the implications of the transaction from an audit perspective. Debtor governments and central banks are unhappy about having to redeem their debts at full face value, even if in local currency, when the secondary markets have generally written these down to a substantial discount. In 1986 only about $ 2-2.5 billion of assets is estimated to have been involved in conversions of one sort or another.[82] Ultimately debt/equity swaps are a second-best way of dealing with debt problems. Indeed they have been described as being synonymous with a man buying a dog for $ 1 million dollars, realizing it was a bad deal, and swapping the dog

for two cats.[83]

Another type of swap in which LDCs are participating, though on a very minor scale, is the conversion of debt to export commodities. The government of Peru, which has been a very vocal critic of orthodox debt management strategies, is one of the pioneers in this area, especially since it suspended the servicing of much of its debt.[84] A debt/export swap is basically a form of barter, or to use the fashionable terminology, 'countertrade'. As such it has all the limitations of barter as a form of trade. Most governments which agree to depend on countertrade to any extent usually do so when under financial pressure. Inefficiencies abound in trying to work out parities between the goods being traded. When many parties are involved, as is sometimes the case, negotiations can become hopelessly convoluted and inflexible.

When financial institutions are at the receiving end of the exports, special problems arise. As a rule, they do not have the expertise to become traders in physical commodities, unless they have a trading company subsidiary.[85] Even then, they do not usually receive easily negotiable goods such as oil. They are more likely to be expected to take things which do not have ready world markets, or have markets which are depressed, with little likelihood of an early upturn. In the case of Peru the commodity that fits this description is copper. Peru has spent quite some time trying to engineer this sort of deal

with a variety of banks but has so far been turned down by all except First Interstate. There are traps for debtor governments too in such a deal. In times of high-inflation and wildly fluctuating commodity prices, they could be locked into deals which undervalue their exports and prevent them from enjoying windfall profits at some future date.[86]

Another market-oriented mechanism which seems to be gaining in strength is the direct selling-off by banks of certain debt obligations at a discount. This is a technique which appeals most to banks with limited exposure to a particular debtor. It may be in the bank's best interests to sell off the title to the debt at a discount to another institution or even to private investors.[87] The particular loan, or set of loans, is subject to a discount depending on the apparent likelihood of it being redeemed by the debtor. The theory is that if this were to happen eventually, the new owner of the security would receive payment at full face value and thus make a capital gain. In the meantime there are tax advantages and other accounting benefits. This mechanism is popular enough for there to be an emerging global secondary market for these debt instruments. A limited number of brokers are able to quote prices for them which fluctuate on the basis of marginal improvements or deteriorations in the financial health of the debtor. In a sense this is a prelude to wider securitization of this type of LDC debt.[88] Yet, until such securities are available in large quantities and traded in large blocks, the market will remain limited because of fears about liquidity of the

instruments. This too, is not a solution but only an ameliorative measure.

Future Trends in Financing

Looking beyond the present stasis in LDC funding, there are a few other possibilities which could prove useful in breaking through the barriers to financing growth in the Third World. The huge Japanese surplus and the large amounts of savings tied up in the Japanese financial system are an obvious place to look for new financing. Japanese banks and financial institutions have relatively low exposure in terms of direct lending to the LDCs as a whole, though they do have particular concentrations of loans in certain debtor countries.[89] The picture as far as Latin America is concerned is at least somewhat encouraging. Firstly, more and more Japanese industrial companies are liable to look to the region for new manufacturing bases as the unusual effects of the phenomenon known as endaka[90] work their way through the system at home and make manufacturing offshore much more attractive. As they move to increase their manufacturing capacity in Latin countries, their banks are following them in much the same way in which the US banks followed US multinationals in the 1950s and 1960s. As these banks spread their operations, they are likely to begin servicing the needs of companies domiciled in their new markets. Secondly, some of the key Japanese financial institutions themselves, such as the 'city' banks and the major securities houses, are keen to break free of the

restraints imposed on them by authorities in their domestic market.[91] As business opportunities within Japan decline, it is logical for them to move overseas because of the greater scope for profits, especially in developing countries. Lastly, the Japanese government is itself committed, in principle, to providing substantial funds to LDC debtors and other developing countries. As part of its attempts to deal constructively with hostility aimed at its record trade surplus, and as a means of ridding Japan of its reputation as one of the most parsimonious of the the big industrial countries, the government is taking several measures.[92] Currently, these commitments exceed US$ 30 billion. Notably, Japan's contribution to multilateral official development assistance (ODA), mainly through agencies such as the World Bank, the Asian Development Bank, the Inter-American Development Bank and the African Development Bank, will double to about $ 8 billion. Another $ 9 billion is earmarked for direct bilateral aid and trade credits which are <u>not</u> tied to purchases of Japanese goods and services. In addition Tokyo has agreed to launch a $ 43 billion domestic spending package to stimulate the economy and promote imports.[93] Part of this import promotion is to be the drastic lowering of trade barriers. Assuming that all of these actions occur, Japanese financial institutions would feel a measure of home government support for lending to the debtor nations.

Yet, there are some lingering doubts concerning how deeply the Japanese are willing to get involved, even

assuming that their government keeps all its promises. In March 1987, 28 Japanese commercial lenders, primarily some of the leading banks, put into action a scheme which helped offload some $ 30 billion of risky loans in Latin America and Asia.[94] The strategy, which involved a holding company in the Cayman Islands, (and is described in an earlier chapter of this thesis), enabled them to offset book losses against taxes. It is not clear whether this will be a future incentive or disincentive to lend more to debtor countries.[95] As Japan's financial institutions become more internationalized, they have to acquire the new skills which are necessary to succeed in a very different environment from that which they are used to. Breaking free of the supervision of the Ministry of Finance and the Bank of Japan, also means losing some of the protection that these offered them at home. Would they not be more cautious than usual? So, in the short-term at least, there has to be a question mark about the free flow of funds from Japan.

In the meantime, other fairly promising avenues are being explored. The World Bank's International Finance Corporation (IFC) is actively canvassing the concept of 'emerging markets'.[96] The IFC believes that there is substantial scope for the development of equity capital markets in the Third World. It has been pointed out that the network of international capital markets is similar in size to the banking system.[97] While the global banking community is heavily involved in Third World debt and trying to extricate itself, capital markets have, by comparison,

hardly any exposure in LDCs. Global capital markets are estimated to have something of the order of $12-15 trillion dollars worth of funds under management.[98] This is a substantial pool of liquidity into which the IFC hopes the emerging markets can tap.

The variety of 'country funds' that have been floated of late are a means of testing the water for the promotion of more direct investment in LDC equities. These funds have invested in the obvious NICs like Korea and Taiwan and the not so obvious near-NICs like India and Thailand.[99] The idea is that these markets have good growth potential and the price/earnings ratios for many of their leading companies is low by developed country standards. Also, entry in the form of a unit fund is not as threatening to LDC governments as concentrated investment by MNCs, especially those with a good deal of political leverage. For this reason they are more acceptable to some governments, such as Korea's, which otherwise forbid foreign equity investment.[100] The country funds have generally performed reasonably well, with some trading at a substantial premium over their issue price.

A logical extension of the single country fund is one which is more diversified throughout many emerging markets. The IFC itself gave the lead here by setting up an Emerging Markets Growth Fund (EMGF) which attracted substantial backing and is capitalized at $ 50 million.[101] EMGF invests in eight different markets. Its unit price increased by 38% in the first 18 months after its launch. EMGF and other

funds are structured in such a way as to assuage the fears of host governments about 'hot money' and its destabilizing effects. The stress is on long-term investment rather than speculation. EMGF has been followed up by a variety of other, private sector, fund managers. IFC itself has been underwriting or lead managing some of these deals. Country funds for Brazil, Mexico and Argentina have been either put into place or are in the pipeline.[102] Indeed interest is so strong that, in Mexico, for example, there has been a substantial boom in the stockmarket. Mexican country funds do not have a major direct effect on this boom. However, they are a vote of confidence from foreigners, which encourages local investment and attracts back flight capital from its havens in Florida and Switzerland with the lure of substantial profits.

Why is there interest in buying equity in LDCs which until recently were considered beyond the pale by the international investment community? There are a few factors which explain this:

* The rise of new Euromarkets specializing in equity rather than the more traditional bonds. IFC estimates that by the end of the century, some 2,000-3,000 stocks will be owned and traded internationally, a four to six-fold increase on the current number.[103] Depending on the scale and speed of deregulation, it is not inconceivable that international equity markets will begin to rival international bond and money markets in size and importance;

* The impact of moves by governments in many OECD countries to encourage their citizens to make their own pension provisions, by offering tax concessions for superannuation payments. This has meant that pension funds in most DCs have grown at a faster rate than the global economy, over the past ten years. Most estimates of the aggregate size of worldwide pension funds are in excess of $2 trillion, which makes them the second largest pool of investible funds after the international banks.[104]

* Increasingly, pension fund managers are seeking two things - performance and diversification.[105] In the US in particular, changes to legislation governing pension funds permitted them to seek these two goals by allowing managers to invest overseas for the first time. The growth of European and East Asian equity markets, which generally delivered very good returns, accelerated this shift overseas. Moving into emerging markets is just an extension of this.

A further step forward along this path, and one which may have the greatest amount of positive impact if it succeeds, is something that the IFC calls an 'Emerging Market Debt Fund' (EMDF).[106] At present, EMDF does not actually exist, except as a concept. The reasoning behind it is that the equity road itself has eventual limitations, mainly to do with the natural reluctance of LDC governments to see ownership of choice assets pass into foreign hands on

a large scale. Even if this were to result in the development of a domestic equity capital market, which ultimately was the vehicle for their own nationals to buy back control or even expand overseas, there would be a great deal of reluctance to permit foreign influences which are seen as 'destabilizing'. It is this sort of thinking, even today, that makes it difficult for foreigners to invest in Japan, and almost impossible for them to do so in Korea. This is not to imply that LDC governments do not see the advantages of developing their own domestic capital markets.[107] There is ample evidence that such markets can be developed successfully, given adequate time and input of liquid funds. Many of the LDC debtors already have stockmarkets established which, though varied in size and turnover still make significant contributions to the GDPs of the countries in which they are located. Consider, for example, the new Brazilian financial futures market in Brazil, the Bolsa Mercantil & de Futuros (BM&F). This was only set up in February 1986, but is already the second largest financial futures exchange in the world, after the Chicago Mercantile Exchange.[108] Certainly, the volume of contracts being traded through the BM&F would not be so high if not for Brazil's hyperinflation, economic instability and the level of national uncertainty. Yet, organizing and operating such a market requires a substantial level of skill and expertise, and the indications are that Brazil is not alone in being able to find nationals capable of taking on the task of developing domestic capital markets in conjunction with domestic and overseas investors. However,

for a substantial takeoff of these markets to occur, they would have to follow the lead of the markets in the advanced capitalist countries and become more integrated into the global financial trading system.

EMDF would, assuming it comes about and is successful, bring the power of the international capital markets to bear on the problem of LDC debt. The idea is to induce pension and other fund managers (such as insurance companies and investment trusts), to invest a small portion of their available cash, even as little as 1%, in LDC debt through the EMDF. If the IFC's sums are correct, this should eventually put something of the order of, at least, $80-100 billion at its disposal,[109] though the immediate plan is to begin with a much less ambitious $ 500 million during the early stages to demonstrate the concept's workability.[110] EMDF would be a long-term fund, with all that such a strategy implies for the creditors and debtors involved. Debtors would be able to refinance themselves on longer maturities and, probably, with fixed servicing costs. The short-termism of the banks could be avoided. Creditors would get assets which are currently undervalued by the market, but have the capacity to be worth substantially more in 20-30 years time.[111] In the meantime they produce a reasonable return. The degree of predictability that this would introduce would have a very beneficial effect on economic growth in the debtor countries. Indeed, it is possible that pension funds which invest in EMDF would see it as a part of their investment strategy in emerging

markets.

For EMDF to work successfully, IFC would have to engineer a large degree of liquidity and flexibility into it. This means that an active secondary market to deal in EMDF and like securities would have to develop. If the IFC, with World Bank support, were to lobby for the expansion of the present secondary market, it should achieve what is necessary. After all, given the ideological predilection of the Bank's senior leadership, including its president, for 'private sector' involvement, such a market-oriented strategy should be very popular in Washington.[112] It is tempting to think of the plan for EMDF as a private-sector equivalent of the Mistry plan. Certainly, while it is far smaller in size and narrower in scope, the essential elements are all there. Presumably, debtors approaching EMDF for funds would have to submit to rigorous monitoring of their economic performance.

So far, the indications are that a great deal of effort will have to be put into marketing EMDF to all the parties involved. Yet, it probably has a higher chance of coming to fruition than the Mistry strategy, for the simple reason that fewer governments, institutions and individuals will be involved. Agreement may be easier to reach, especially since most OECD governments, which are often the most difficult to deal with, will not have more than a marginal role to play.[113] As long as they feel that there is no threatened blowout of their tight-fisted budgets as a result of the

plan, they may be happy to stay out of the way and only contribute the odd bit of ideologically dogmatic, gratuitous advice. In spite of this there is a long way to go before the Fund becomes a reality. It may or may not be successful in reaching its stated goals. In the meantime the debtors and the creditors are left to struggle along as best they can. This task is not made easier by some changes which are unexpected. Paramount among these is the fact that, of late, net transfers of financial resources have been moving <u>from</u> the LDCs to the DCs, rather than <u>vice versa</u>.

Potentially, the most destabilizing factor in the present dynamic equilibrium of debt is this problem of negative transfers. Since the squeeze on new lending which followed the Mexican rescheduling of 1982, it is becoming quite apparent that the flow of financial resources from North to South has turned around. Debtor nations of the poor South (for example, Mexico, Argentina and the Philippines) are now redirecting something of the order of 2.5% of their GDPs annually in such transfers.[114] True, this is about half the level of GDP which was required to sustain debt servicing when the crisis first erupted, but it is becoming an ongoing drain on the LDCs which they can afford less and less. The danger is that eventually, debtor nations may decide to test the degree of muscle that they have, in a sense, recently acquired.[115] The banks recognize this and strategies such as making added provisions against bad loans are a part of their pre-emptive response to this potential threat. It is possible that a shift in the current stance of

debtor nations could be brought about by a set of factors, including the fact that creditors are becoming more and more divided among themselves. Official and private creditors no longer see eye to eye, and the differences of interests which began to surface in 1985-6 are now out in the open.[116] At the start of the crisis, commercial banks, Western governments (especially their central banks), the IMF, and (to a lesser extent) the World Bank, all banded together to form a strategy to protect the banking system and stabilize Third World economies.[117] Now, as attention has turned to longer-term questions of adjustment and recovery, their policies are less synchronized.

The government of Argentina, like that of many other heavily indebted LDCs, is at a crossroads. It has to recognize three things. Firstly, that the present state of affairs cannot go on for ever. At some point drastic changes are going to have to be made to the way the question of debt is handled, before the internal economic and political fallout from the present path becomes irreversible.[118] Secondly, such a change may involve it having to seek some accommodation with its key adversaries within the domestic polity, but only if this were sought under 'realistic' terms, which permitted it substantial freedom of action in trying to come to grips with the issue of external debt.[119] Thirdly, generations of thinking about the way in which the domestic economy should be run would have to be overturned, but only in a manner in which clear, unambiguous advantages are sought and received from creditors, so that the benefits

can be used to quell domestic opposition. Can Alfonsin and his Radical Party do what is necessary? Can anybody else? Can Argentina change?

NOTES

1. The Plan of Economic Reform, Speech given by the Minister of Economy of the Republic of Argentina, Juan Sourrouille, in Buenos Aires, on June 14, 1985, pp. 12-13. (Official translation provided by the Embassy of the Republic of Argentina, Canberra.)

2. Also referred to as the MBA countries (M - Mexico, B - Brazil, A - Argentina).

3. The party, the somewhat perplexingly named Institutional Revolutionary Party (PRI), has held effective power in Mexico ever since the revolution that freed it form Spanish rule.

4. The Brazilian armed forces would have disliked the people's choice for president, Tancredo Neves, even more. Fortunately for them, he died before taking office, leaving Sarney to succeed him.

5. Brazil has also been described as the most centrally-planned economy outside the Soviet bloc. See Hurtado, M. E., "Sarney Opens the Investment Floodgates", South, September 1987, p. 35.

6. It is strictly not correct to term the Peron era a dicatatorship, given the level of populist support that Peron enjoyed until a few years before his exile. However, many of the repressive features of dictatorial regimes were present.

7. This form of referring to the islands is adopted to avoid seeming to endorse the claim of one side over the other.

8. The Radical Party itself used to have a reputation for being interventionist and strongly in favour of state control of industry.

9. Though Argentina has had a few other ongoing territorial disputes, including one with Chile over the Beagle Channel, none of these had resulted in it going to war.

10. Argentina's change of government occurred before this trend became established.

11. As an index of industrialization, consider the market capitalization at the end of 1986, of the Brazilian, Mexican and Argentine stock exchanges - US$ 43 billion, US$ 6 billion, and US$ 1.6 billion respectively. See Lapper, R., "Latin America Rings the Fiscal Changes", South, June 1987, p. 71.

12. Bekerman, M., "The Impact of the International Environment on Argentina", in Griffith-Jones, S., and

Harvey, C. (eds.), World Prices and Development, Gower, Aldershot, England, 1985, p. 209.

13. Even OPEC members did not have control over their products once they had been shipped.

14. de Svastich, P., "A Market Approach to Debt Reduction", The Banker, Setember 1986, p. 35.

15. So far no political party has dared to include privatization in its official platform.

16. Rock, D., Argentina 1516-1982: From Spanish Colonization to the Falklands War, University of California Press, Berkeley, California, 1985, p. 173.

17. ibid., p. 171.

18. ibid.

19. Randall, L., An Economic History of Argentina in the Twentieth Century, Columbia University Press, New York, 1978, pp. 222-3.

20. Berlinski, J., and Schydlowsky, D.M., "Argentina", in Balassa, B., and Associates, Development Strategies in Semi-industrial Economies, Johns Hopkins University Press, Baltimore, Maryland, 1982, p. 83.

21. ibid.

22. ibid.

23. ibid., pp. 83-87.

24. These are mainly from the Peronist movement and the Justicialist party, but there are Marxist and other leftist elements also opposing the present government.

25. ibid., p. 83.

26. ibid.

27. ibid.

28. ibid., pp. 83-87.

29. Nisse, J., "The Benefits of Hindsight", The Banker,, London, July 1987, pp. 35-39. See also Kobrin, S.J., "Assessing Political Risk Overseas", The Wharton Magazine, Wharton School of Business, Philadelphia, Winter 1981-82, pp. 25-31.

30. See "An Analysis of the Budget", The Review of the River Plate (Revista del Rio de la Plata), July 31, 1985, p. 74.

31. This is partly because the Peronist unions would consider this a challenge to their authority, and become more troublesome than they are already.

32. Emerson, G.A.D., "Can Argentina Turn the Corner?", The Banker, August 1986, p. 41.

33. ibid.

34. ibid.

35. ibid., p. 40.

36. ibid.

37. Rock, D., Argentina 1516-1982: ---, pp. 231-245.

38. ibid., pp. 242-3.

39. ibid., p. 242.

40. ibid., p. 245.

41. ibid.

42. ibid., p. 247.

43. ibid., pp. 243-253.

44. ibid., p. 252.

45. Kirkpatrick, J., Leader and Vanguard in Mass Society: A Study of Peronist Argentina, The M.I.T. Press, Cambridge, Massachusetts, 1971, p. 32.

46. Rock, D., Argentina 1516-1982: ---, p. 253.

47. Kirkpatrick, J., Leader and Vanguard ---, p. 32.

48. Rock, D., Argentina 1516-1982: ---, p. 254.

49. ibid., p. 264.

50. ibid., p. 307.

51. There is some debate about whether this was one of Peron's key goals, or whether it was just a convenient rationale invented to placate the Americans who were starting to get very uncomfortable with his worker-oriented policies. See ibid., p. 292.

52. Kirkpatrick, J., Leader and Vanguard ---, pp. 150-4.

53. ibid., p. 151.

54. Compare this with the kind of philosophy which has guided the development of Korea.

55. One of these, the 'Austral Plan' is discussed later in the chapter.

56. This is not unique to Argentina, but the degree to which the phenomenon exists seems extreme.

57. American banks and the IMF are the most hated of overseas institutions.

58. Emerson, G.A.D., "Can Argentina Turn ---", p. 39.

59. _ibid._

60. The plan was officially known as the 'New Economic Plan for Argentina'. See "Full Text of Speech by President Alfonsin, on 14.6.85, announcing the New Economic Plan for Argentina" (Texto del Discurso Pronunciado por El Presidente Alfonsin, el 14.6.85, Para Anunciar El Nuevo Plan Economico Argentino), Telex obtained from the Embassy of the Rupublic of Argentina, Canberra.

61. Emerson, G.A.D., "Can Argentina Turn ---", p.39.

62. _ibid._

63. After the new Brazilian currency which replaced the cruizero.

64. _ibid._

65. _ibid._, p. 40.

66. The others were Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia.

67. Mistry, P., "Third World Debt: Beyond the Baker Plan", _The Banker_, September 1987, p. III.

68. _ibid._, p. I.

69. _ibid._, p. I-III.

70. _ibid._, p. III.

71. Mistry actually left the Bank before the messy, morale-damaging cuts which were made by Conable to reduce the Bank's staff numbers.

72. _ibid._, p. VII.

73. _ibid._

74. _ibid._

75. _ibid._, p. VII-VIII.

76. The innovations in swaps were originally devised to help firms which operated internationally, minimize their exposure to fluctuations in exchange rates and interest rates, without having to pay out the costs required for traditional hedging instruments.

77. "Asset Swaps: A Quiet Success", The Banker, May 1986, p. 37.

78. In February 19887, these discounts ranged from 92% for Bolivia to 40-43% for Mexico and only 18-20% for Colombia. See Schubert, M., "Trading Debt for Equity", The Banker, February 1987, p. 18.

79. This can be a major consideration, especially if there is a barrier to the free convertibility of local profits into a currency that can be remitted to the MNC's country of domicile.

80. Schubert, M., "Trading Debt ---", p. 18.

81. ibid.

82. ibid.

83. Nisse. J., "Trade Finance: Dogs or Cats?",The Banker, August 1987, p. 18.

84. ibid.

85. Few banks are in this position. First Interstate, one of Peru's lead bankers, is one of these. It specifically set up First Interstate Trading (FIT) under the US Export Trading Company Act of 1982, to handle these debt/export swaps.

86. ibid.

87. It is not uncommon for small private investment banks to invest in these securities.

88. Given the trend towards turning all forms of debt into easily marketable, negotiable securities, it is probably just a question of time before this starts happening to LDC debt.

89. Some of these loans are in countries with fairly good prospects, such as Taiwan and Korea, while others are in places with worse prospects, such as the Philippines.

90. The term is used to describe the complex effects on the Japanese economy of the post-Plaza (Baker-Miyazawa) depreciation of the yen.

91. Japanese finance houses are moving offshore in a very

significant fashion to take advantage of the increasing pace of deregulation within Japan itself, since profitability overseas is generally higher.

92. Friedland, J., "Tokyo Splurges on a US$ 20-Billion Halo", South, July 1987, p. 24.

93. ibid., p. 25.

94. ibid.

95. ibid.

96. See Westlake, M., "The Bulls Head South", South, June 1987, pp. 65-69.; Cohen, E., "Emerging Exotica", The Banker, July 1987, pp. 50-52; Shreeve, G., "A True Believer", The Banker, September 1987, pp. 24-25.

97. Shreeve, G., "A True ---", pp. 24-25.

98. ibid., p. 25.

99. Westlake, M., "The Bulls ---", p. 68.

100. In Korea's case, there is a possibility that this stance may be reviewed, and a decision made to open up investment in the stockmarkets. See ibid., p. 65.

101. Cohen, E., "Emerging ---", p. 52.

102. Westlake, M., "The Bulls ---", p. 68.

103. Cohen, E., "Emerging ---", p. 51.

104. ibid.

105. ibid.

106. Shreeve, G., "A True ---", p. 25.

107. House, R., "Sarney Opens the Investment Floodgates", South, September 1987, pp. 35-38.

108. House, R., "Sao Paulo Shortens the Odds", South, June 1987, p. 70.

109. Shreeve, G., "A True ---", p. 25.

110. ibid.

111. For fund managers to invest such a small portion of their cash reserves on such a long term basis would not be inconsistent with current practices, even in the light of worries about short term performance.

112. There does not seem to be any reason why the Bank should not support the proposal. Also, it should be popular

with both Congress and the Reagan administration.

113. In view of the current level of friction between some of the key OECD governments, it may be better to avoid involving them as far as possible, lest they turn EMDF into a political football amidst their own squabbles.

114. Feinberg, R., and Williamson, M., "Whose Finger on the Trigger?", The Banker, September 1987, p. 40.

115. ibid. See also Mendelsohn, M.S., "Wrong Way to Tackle Debt", The Banker, March 1987, pp. 30-33.

116. Feinberg, R., and Williamson, M., "Whose Finger ---", p. 43.

117. ibid., pp. 43-4.

118. The danger is that the damage being done by internal policies will preclude any movement on the external debt front.

119. To some extent, this would involve having to stress the idea that successful debt management requires an internal consensus about policy. Populist appeals may be better directed at 'selling' useful policies, rather than stirring up resentment of 'foreigners' and the IMF. This is easier said than done of course, since the debt crisis is the sort of thing that opposition parties dream about as an ideal stick with which to beat the government.

CONCLUSION

Over the past five years or so, all participants in the 'Debt Crisis' have done little more than muddle through. While this approach may lack intellectual appeal and dramatic effect, it has proved to be useful in a rudimentary way. It is not hard to make a reasonable case for assuming that the next few years will bring more of the same. This is predicated on two factors. Firstly, the complexity of the problems encountered, and the diversity of the players involved, would mitigate against any neatly planned solutions. If anything, the past few years have shown conclusively that, as time passes and panic lessens, it has become more difficult to organize collective actions. Certainly, it is true that, as a general principle, there is a common interest in not taking actions which cause serious instability. Yet, this does not mean that there is an automatic imperative for the participants to act in concert, while subjugating their individual interests to the common good. Secondly, so far, no great calamity has taken place. Thus, there is no impetus to shake global policymaking, as it relates to the debt problem, out of its current drift.

The one phrase which seems to sum up economic policymaking throughout the world today is 'near-paralysis'. Many of the key Western governments, especially that of the United States, are unable or unwilling to come to terms with the limitations of their current policies and move forward to implement those which would be more appropriate. The structure of the global economy dictates that this penalizes even capable governments, particularly those of successful

NICs like South Korea, which have shown a degree of competence in managing their domestic economies. Ultimately, the small are hostage to the big. As threats emerge on a variety of fronts, among them trade and finance, governments are hard-pressed to come up with coherent, coordinated responses which enable a viable framework within which economic activities can take place.

The Plaza Agreement of 1985 (also known as the Baker-Miyazawa Pact) was one of the few instances in recent economic history where an agreement to coordinate policy was adhered to and carried out, more or less fully, by the participants. Based on the success of this largely bilateral deal between Japan and the US, plans have come to be laid to attempt wider economic policy cooperation. In February 1987, a meeting of the Group of Seven (G7) finance ministers in Paris broadly agreed to the notion of permitting exchange rates between the major currencies, to remain roughly at prevailing levels, (the agreement being known as the Louvre Accord).[1] By June, at the Venice economic summit, the G7 governments were moving further towards a stance of cooperating on exchange rate policy. The latest attempt to overcome the inertia in policymaking is the nominal agreement to coordinate exchange-rate policy which emerged from the 1987 World Bank-IMF joint meeting in Washington in September.[2] The foundations for this agreement were laid in discussions both at the previous meetings and in other international forums. However, it must be stressed that the aims of this coordinated approach are fairly modest. Given

the common difficulties being experienced on the exchange-rate front by most of the G7 governments, it is not so difficult to organize coordination of attempts to deal with these problems. Coordinating trade policy or fiscal policy could prove to be a much tougher agenda.[3] Furthermore, the agreement to seek to stabilize exchange-rates within certain target zones has not been tested under stress. It is quite conceivable that under the right circumstances, the agreement could easily break down. At the moment, only very brave or very foolish speculators would take on the combined might of the central banks of the G7 countries, though this could change depending on the market perception of the strength of cooperation between central banks.

Irrespective of the outcome of this attempt to synchronize policy on exchange rates, the fact remains that it is much more difficult to come to terms on coordinating domestic economic policies. The inability to do this has become another irritant to relations between the United States, Japan and West Germany. The thrust of US demands thus far seems to be centred on requiring a reflation by the other two, especially Japan, in the belief that this would help take pressure off its own current account deficit. At the Venice meeting, the Japanese conceded a major boost in domestic government spending, but are yet to begin to implement it substantially.[4] West German policymakers, who in any case have a dread of inflation which is greater than the norm, have avoided making any real commitment to

reflate. This type of cooperation is still in the balance, though some factors may assist its eventual *de facto* establishment. For example, given the increased mobility of capital, governments are finding that they have an incentive to synchronize policies on corporate taxation and nominal tax rates. This effect is seen most clearly in the moves being made by many OECD governments to match the new, lower scales of US taxation.

Why is all of this important to the resolution of the debt question? Quite simply because so much of the resolution of debt problems rests on the ability of the key players in the global economy to come up with acceptable methods for managing the diverse difficulties currently being experienced. If these 'managers' are unable to handle protectionism, if they cannot find acceptable means of reconciling the needs of debt-ridden LDCs with their own interests and those of their banks and industries, then these debt problems can be expected to become more acute. Ultimately, the resolution of the Debt Crisis rests on the resolution of the crisis of economic management. Without some clear indication of where the global economy is headed, it is very difficult for any long-term strategic planning to take place on the debt front.

In the meantime though, crisis management is proceeding in a fairly unstructured manner. In fact, as time passes it is becoming clearer that individual interests are becoming less subordinate to the common good. For instance, Mexico's

stocks are currently riding high. The Mexican government has, in the past, tended to meet or come close to meeting agreed targets on key economic indicators, under the terms of its rescheduling arrangements. In spite of setbacks because of softening and unpredictable oil prices, the economy is doing well enough to trigger a boom on the Bolsa de Valores, the Mexican stockmarket. Indeed, the bourse in Mexico City has outperformed every other market in the world during 1987.[5] Though foreign investors are constrained, there is substantial demand for Mexican shares, particularly from Western mutual funds. In such an environment, what advantage would there be for Mexico to join a debtor's cartel or declare moratoriums? Why jeopardize its own relatively comfortable position for the good of Brazil or Argentina? Similarly, there has been a minor falling out between banks. One of the outcomes of the 1987 Bank/Fund meeting has been a public split between Deutsche Bank and Citibank. The former has very limited exposure in Latin America and has, in any case, made substantial provisions to cover its bad debts. Its chairman has indicated that Deutsche Bank is considering forgiving a significant part of its Latin debt and pulling out of the debt rescheduling process altogether.[6] The feeling is that the German bank has little to gain from pursuing the current course of collective action. Naturally, this approach does not sit well with Citibank and other American banks which are heavily exposed in the region and which, despite recent moves to make provisions, still do not have adequate reserves to offset possible losses. Yet, the question

remains, if a leading German bank is willing to take such action, is the Debt Crisis as big a threat to the global financial system as previously imagined? Presumably, Deutsche Bank would not take this step without the concurrence of the <u>Deutsche Bundesbank</u>. If the German central bank is not too concerned about this, does this mean that the Debt Crisis is under adequate control?

It is apparent that the Debt Crisis has now reached a state of equilibrium, and that, all other factors being equal, it will take quite some effort to force it one way (towards resolution) or the other (towards default and financial collapse). Indeed, as long as all players act in predictable ways, it seems unlikely that the present stasis will be disturbed. The chronic problems of indebtedness will become another feature of the global economic landscape. So, barring major recessions, trade wars or problems with liquidity, no major debt calamities should occur. Even if this were to generate a degree of complacency, it is unlikely that future upheavals would cause a collapse of the international financial system. Now that all participants are sensitized to the threat, they seem to be capable of responding in a fairly cohesive manner when the need arises. The main problem will be to individual debtor nations, whose internal economic and political processes will continue to suffer from the negative consequences of the debt overhang.

What then of the individual cases under study? Are these likely to drift along their present paths or are they likely

to undergo major changes to their individual situations?

Firstly, consider the United States. There have been some recent developments in the US economy which give cause for concern, particularly in relation to inflation and interest rates. Further disquiet is emerging because of the persistence of the trade deficit and the non-appearance of the expected J-curve effect, even though it is almost two years since the dollar began depreciating from its previous high levels.[7] Despite these problems and the clear need for a significant reform of current administration thinking, nothing much is likely to happen in the US, in the near future, which would be a major change in policy direction. It seems implausible that the Reagan presidency will see any significant effort to come to grips with the budget deficit either by an increase in taxation or cuts in the defence budget. Is there hope that a change to a Democratic administration in 1988, if it happens, might mean a new willingness to tackle these 'hard' questions? Frankly, no, because the Democrats themselves have doubts about the political wisdom of such moves. Historically, they have been perceived as a high-taxing, high-spending party with a fondness for intervention.[8] Since that sort of philosophy is no longer popular, with small government, low taxes and deregulation currently holding the political high ground, it seems likely that the Democrats also may avoid politically unpalatable decisions. If so, there would be no incentive for Congress to change its current thrust on economic and trade policy.

However, some issues are likely to be forced. The drive to have the Glass-Steagall Act repealed is building up. If Glass-Steagall goes, McFadden may not be far behind. With these twin legislative restraints swept away, it is likely that there will be a period of major reorganization of the American finance industry. The much-vaunted 'superbanks' may eventuate as the healthier enterprises, (financial or otherwise), take over those in poorer health, and consolidate themselves across the nation. Could this be the way in which the banks which are heavily exposed in the Third World are eventually 'rescued'?[9] Would the troubled entities of today become part of large financial/industrial conglomerates which attain unprecedented global economic influence and dwarf their Japanese competitors? After all, acquiring a bank with substantial accumulated losses is a convenient tax write-off for a cash-rich corporation.

The signs seem to be that there will be little change in the US until the political will is found to push through necessary, unpalatable adjustments. There is a great deal of scepticism about the probability of that happening soon. For example, the recent attempt by the Reagan administration to tout the notion that the budget deficit is being reduced substantially is being treated with disdain by financial markets, which view the new figures as little more than an exercise in 'creative accounting'. It is true that the US is perhaps the only country which can afford the luxury of such inaction. Indeed, it may be able to persist with inaction as

a substitute for policy for some considerable time. The danger is that, if given enough financial rope, it may one day hang itself.

Next, consider South Korea. There are no overt signs that this country has any problems with its debt, and given the success of its economy at present and the prudence of its policymakers, it would have been surprising if there had been any. Potentially, however, there could be difficulties in the future. A priority for the Korean policymakers would be to replace a significant fraction of external debt with either domestic savings or equity held domestically or internationally. This would achieve a reasonable spreading of the inherent risk which the government runs in guaranteeing foreign borrowing. Unfortunately, it will be quite some time before domestic sources of finance can make a major contribution, even if significant reform of the internal financial system is carried out soon. Also, domestic savings would only be gained at the cost of less domestic consumption. If the international trade situation were to go against Korea, the country would have to place a greater reliance on domestic consumption to sustain its economy, even partially. It would be very difficult to maintain savings if such a boost to demand proved necessary. Korean policymakers, for a variety of reasons, would prefer to avoid having foreigners holding substantial equity investments within the country. For a start, such foreign involvement would probably dilute their ability to control tightly economic events within the country. However, they

may ultimately have no option but to encourage such investment. Otherwise they run the risk of getting into a very difficult situation on the debt front if resistance to Korean exports builds up.

Only recently has Korea been running a trade surplus, its deficit with Japan having absorbed more than its surplus with the US and other trading partners. The key question is whether Korea will be able to consolidate its trading position or whether it will run afoul of disputes over trade. Several years of surpluses will be necessary if Korea is to go down the Japan road. What would happen to a successful, albeit much-indebted, economy which is heavily dependent on and geared to exports, if it were suddenly denied reasonable access to its key markets? Would this not do serious damage to its debt-servicing profile and creditworthiness?

Finally, consider Argentina. Unlike the other two cases, there is almost universal agreement that Argentina is a 'problem debtor'. The challenge for any government in this country, particularly a civilian one with a commitment to a degree of democracy, is to find a policy mix which secures the economic fundamentals and satisfies creditors, without alienating or depriving significant sections of the community. Often, this can be an impossible task. The current government also has to contend with a union movement controlled by its political opposition and a discontented military which is just waiting for an opportunity to take

over once again. Under the circumstances the Alfonsin administration is not doing too badly. However, there is a limit to the time over which its current balancing act between the demands of opposing forces in society, can continue. Ultimately, something may have to give, thus throwing its external debt management into disarray.

Argentina's administration has bought time, not only for itself to get its domestic economic policies into line, but also for its creditors to get their own houses in order. The threat is that, having found it to be successful for so long, it may decide that the continuation of ad hoc decision-making is sufficient. True, other governments, especially in the OECD, do little more than make economic policy on the run. However, Argentina's economy is far more vulnerable than any of these. Avoiding having to face up to its external debt problems will only provide a temporary respite. Eventually, some Argentinian government, at some time, is going to have to take some very hard decisions and implement even harsher economic measures. Unless the notion of intractability is broken, it will not be possible to come to grips with the debt problems. A few interesting options for future financing are opening up, especially under the guidance of the IFC. Argentina may well have to begin considering these seriously as it looks for alternatives to break the impasse.

This thesis has concentrated on the contrasts between the three cases, but what of the similarities? Answering

this question is difficult. On a very general level, it is easy to say that all three share a common interest in maintaining the global economy broadly in its present state. None of them has any particular long-term advantage in having disruptions occur to global trade or financial flows. They would all benefit from continued global peace and relative stability. Their governments are all, to varying degrees anti-Communist. (They also all run sizable budget deficits!) As nations, all have at different times taken, and continue to take, actions which preclude the likelihood of strongly Socialist or Communist ideologies taking root. Each is a fertile ground for capitalism, albeit somewhat different forms of capitalism, to thrive in. Each has a sizable military which has sufficient influence to be able to lay claim to a significant portion of national resources. All three are aware of the advantages of being an industrial power and have made efforts in the past to become such a power, with varying degrees of success. Beyond such generalities, it becomes more difficult to make comparisons which bring out a common experience shared by the three nations. The differences are what make them worthy of study. Ultimately, it will be the differences in the approach of each nation's policymakers which decide whether they succeed or fail in the management of their external debt.

Analysts of the global economy today are fond of the image of an abyss or precipice. Often this metaphor is related to the policy decisions of governments. Strategies which are risky are seen as leading to the edge of the

abyss, while those that promote stability are viewed as helping to draw away from the edge. The three governments in question can be seen as being on the edge of the abyss for different reasons - America because of inaction, South Korea because of over-reliance on exports and Argentina because of domestic political constraints. Sometimes they seem to recognize the risks which they are running. At other times they seem oblivious. To all intents they are dancing on the edge. If they are not careful they may fall down the precipice. Are there unseen safety nets upon which they could rely? Perhaps. Is the drop not as steep as one would imagine? Perhaps not. Why else would America, Korea and Argentina continue to dance on the edge?

The one factor to stand out clearly from the case studies is the different way in which external debt isperceived in each The authorities in the United States, South Korea and Argentina have very different notions of the importance of external debt in the policy making process.

In the United States there has been for too long an indifference to the implications of a large external debt burden. In keeping with the tenets of Reaganomics and the lack of concern about the mounting budget deficit during the past eight years, no concrete policy has been put in place to begin to address the external debt question. This has had negative implications for fiscal and monetary policies, as the government has relied on foreigners, initially private investors and the central banks, to continue to fund the

twin deficits of trade and budget. As such, the necessary adjustment to economic management policies are impeded by being subsumed to political goals; in this case the Reaganite insistance on reducing taxation levels and running a fairly loose fiscal policy, thereby placing the onus on monetary controls to contain inflation.

In South Korea, on the other hand, the government has not perceived itself as having the latitude to indulge its constituency in such a fashion. Monetary and fiscal rectitude have been a norm of policy despite the likelihood that South Korea is fairly well placed to take advantage of the goodwill of foreign investors. Indeed the government has embarked on a quite large debt reduction program which even encompasses the private sector. In one way the buyback does not make sense. As the won inevitably is revalued against the currencies of most trading partners, the longer the redemption of debt is delayed, the cheaper it will be in Korean currency. Indeed, the government has met some resistance from private sector firms that wish to profit from this one-way bet. Despite this, the government lineis that debt reduction is essential to maintain credibility in global financial markets. While this may be true, it seems strangeto be worrying about such credibility when South Korea is more intent on withdrawing from international financial markets and concentrating on raising investment funds from local sources.

Argentina does not have such an option. The same sort of

inadequate political will, as in the United States, seems to have paralyzed economic policymaking. Certainly, economic factors outside of the policymakers' control do play a very significant part here. Yet, those which could be dealt with at a local level, such as the efficient implementation of fiscal policy measures, are not carried through because of a lack of political courage. Despite its much more precarious position vis-a-vis external finance, Argentina has so far been able to avoid internal adjustment much like the US has done. In spite of the ever present threats of default, and the consequent withdrawal of funds, Argentina has been able to avoid politically unpopular decision-making in much the same fashion as the US administration has been able to. Certainly, some adjustment has taken place in Argentina, but this has mainly impacted only on the effectively disenfranchised poorer parts of the population. The electorally important middle-classes, (and those who aspire to be middle-class), have not been harshly dealt with. This explains the shelving of plans to control inflation, privatize government enterprises and restrain wages and prices.

What then of the theoretical frameworks and the implications of the case studies for their validity or otherwise? Consider the liberal perspective and the related line of thinking adopted by the World Bank/IMF. The case of Korea lends some credence to this but the theory itself makes some fairly idealistic assumptions. The degree of Korea's centralized decision-making that is made abundantly

clear in the case study is not taken into account in what is a 'free-market' theory. Furthermore, in the United States, the freest market of the three cases, the fundamental assumptions of the liberal school are challenged. Equilibrium between debt servicing and export earnings, and the primacy of economic over political reality are seen to be false notions. Political cowardice about raising taxes, and the inability of domestic industry to capitalize on favourable economic conditions, stand out in the case study. When looking at Argentina the major conclusion is the inappropriateness of applying the liberal perspective to an economy with such a high degree of state centralization. The resulting failure of the IMF and World Bank to make much headway with policy prescriptions is not surprising in this context. None of the case studies provides real support for the liberal perspective.

The mercantilist view naturally would lead to adversarial relations between debtors and creditors. Argentina's relations with its creditor banks clearly demonstrate this at certain times. Yet, the Argentine case study shows how the relationships tend to oscillate between cooperation and conflict. The responses of the two sides are based on the combination of forces and pressures that exist at any particular time. Cooperative debtors tend to find they can overcome some of the conflict if they are willing to meet the debtors halfway. In America, though, government has been able to largely ignore pressures from creditors in formulating policy, perhaps an example of the relative

nature of power. South Korea, being almost a model debtor, does not have adversarial relations with its creditors, though relationships are strained by Korea's unwillingness to open up its financial markets to foreigners. On balance, the mercantilist view is also not satisfactory as a theoretical framework.

Structuralist/world systems explanations begin to take the debt debate out of the realm of current 'reality' and into a more idealistic framework. Certainly the Argentine case study demonstrates the need for such a view in the context of a fairly rigid domestic economic structure and the long history of populist politics. Yet, while this may work internally, when it comes to dealing with outside agencies, such as the IMF, Argentina has to drop this framework. Hence, despite much talk of the creation of debtor cartels to negotiate more favourable terms, none has ever been set up. Another complication with this is the way in which a form of this argument has been adopted in the United States by those who wish to blame the US trade deficit on Japan. At its best, this line is essentially a structuralist argument - i.e. Japan has so come to dominate world trade, by 'unfair' means, that the US cannot compete because the terms of trade are stacked against it, and the 'playing field' is not level. Unfortunately for this contention, it is not supported by the material in the case study.

The Marxist/Radical perspective on external debt has the

luxury of postulating policies, which in all probability will never be tested. Outright debt repudiation is one of these strategies which is not seriously considered as an option by any debtor government. The reasons for this are canvassed in the Argentine case study, with the clear implication that such a strategy would have disastrous consequences for any debtor who attempted it. Furthermore, the notion of withdrawing from the global economy and trying to create an internally self-sufficient development program seems even less of a viable option, at a time when the closed economies of the Soviet Union, China and other communist countries are opening to the West.

Overall, the thesis has demonstrated that current theoretical frameworks are inadequate to clearly explain the fashion in which external debt management is carried out. Certainly, there is a strong political aspect to the formulation of policy, or more often, the lack of policy. Yet, the difficulty is in finding a theoretical explanation that does more than just state the prerequisite nature of political will. The need is for a theory or perspective that adequately explains the quite different attitudes and actions of the governments concerned. The challenge is to find such a theory, which can then be applied across a range of countries without being tripped up. Otherwise, all we are left with is the rather mundane observation and quite obvious conclusion that governments only formulate economic policy according to the <u>political</u> circumstances in which they find themselves.

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The above figures are based on data from International Monetary Fund, International Financial Statistics, IMF, Washington, D.C., Monthly. Various Issues from 1980-1987 were consulted. The main purpose of including the statistical appendix is to provide, in effect, a sketch of each country's economic position, without having to devote space to this in the text. As such, the appendix should be treated as a adjunct to the thesis and not an integral part of the arguments put forward.

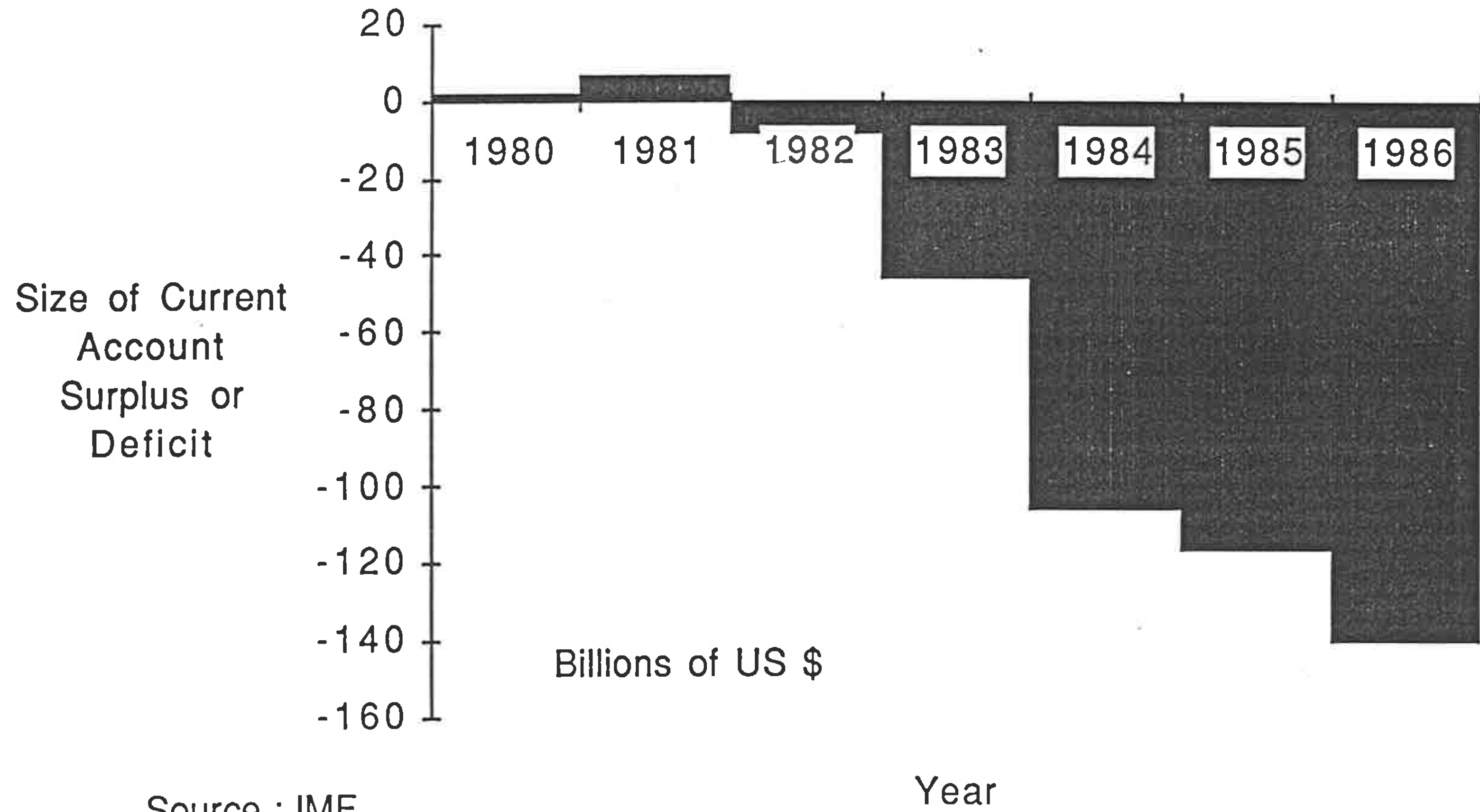


FIGURE 1

UNITED STATES - EXPORTS

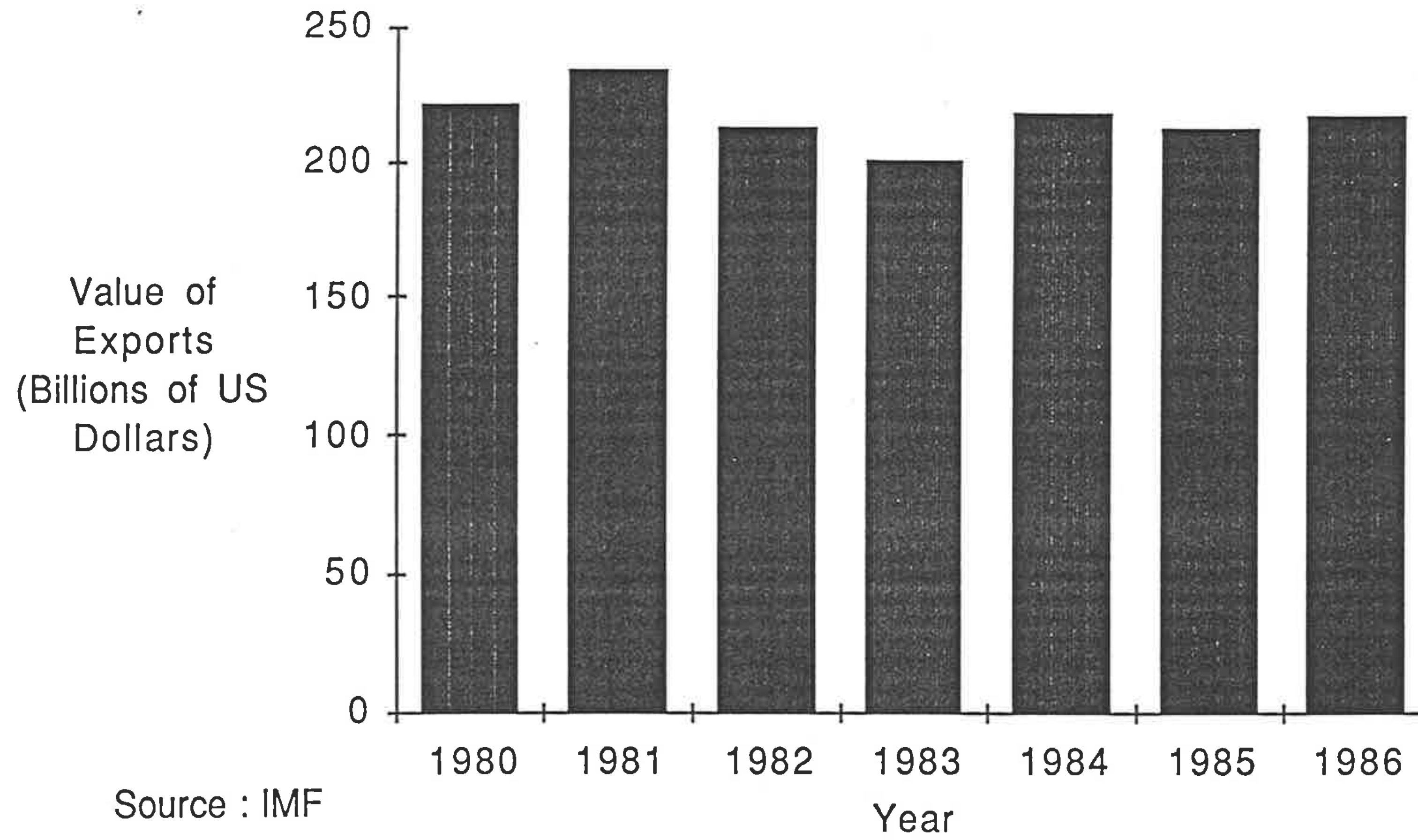


FIGURE 2

UNITED STATES - VOLUME OF EXPORTS

1980 = 100

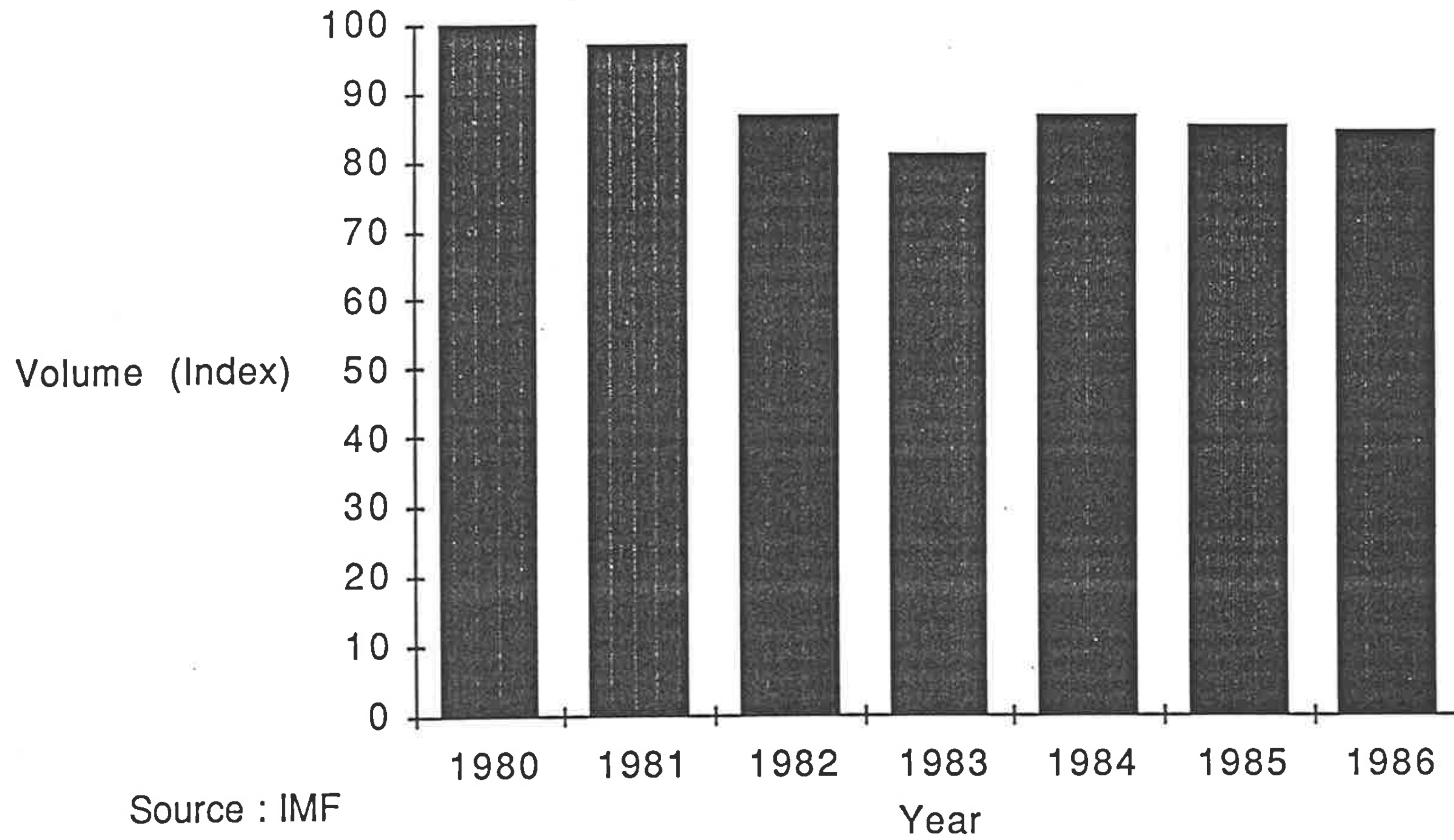


FIGURE 3

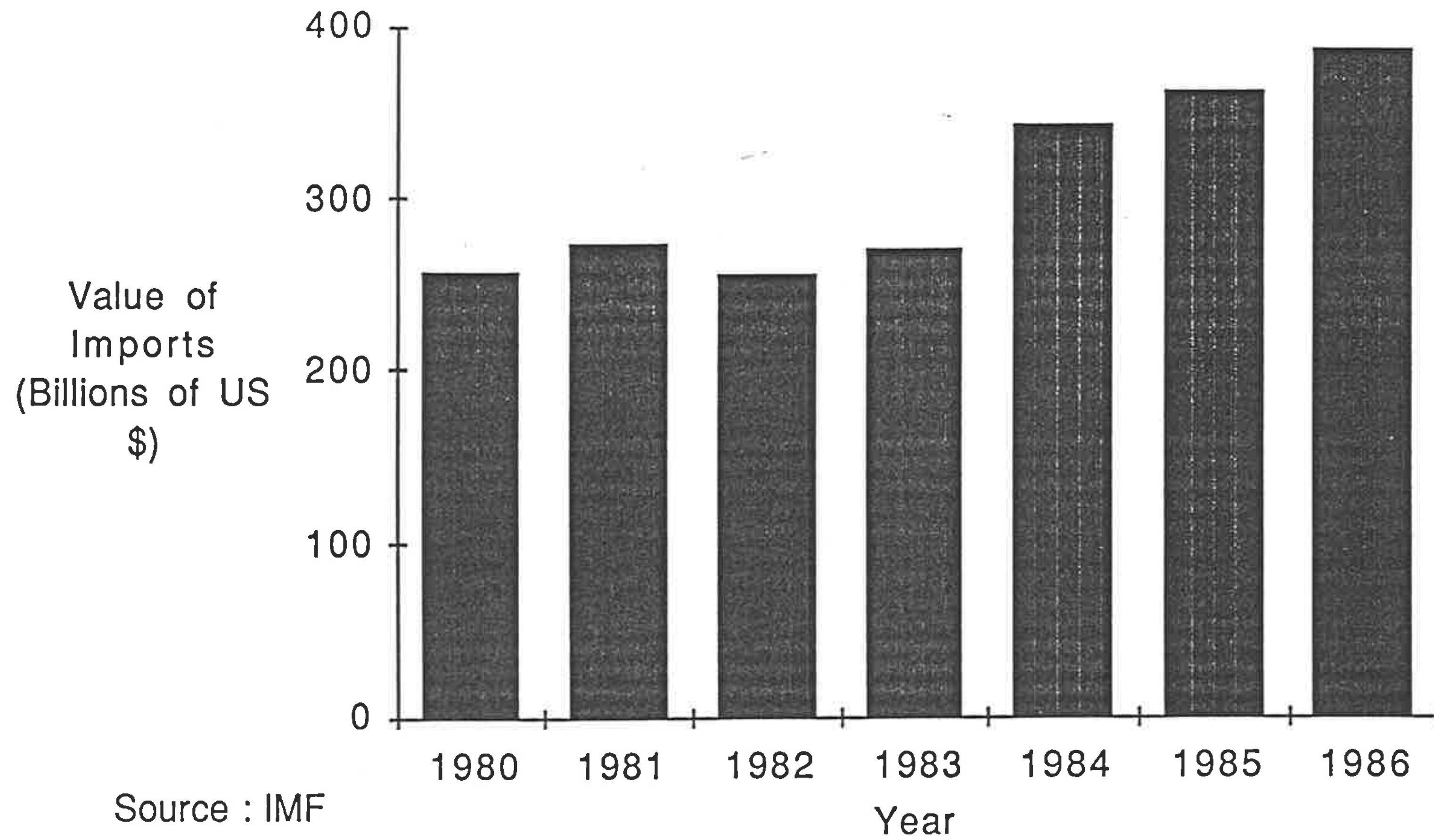


FIGURE 4

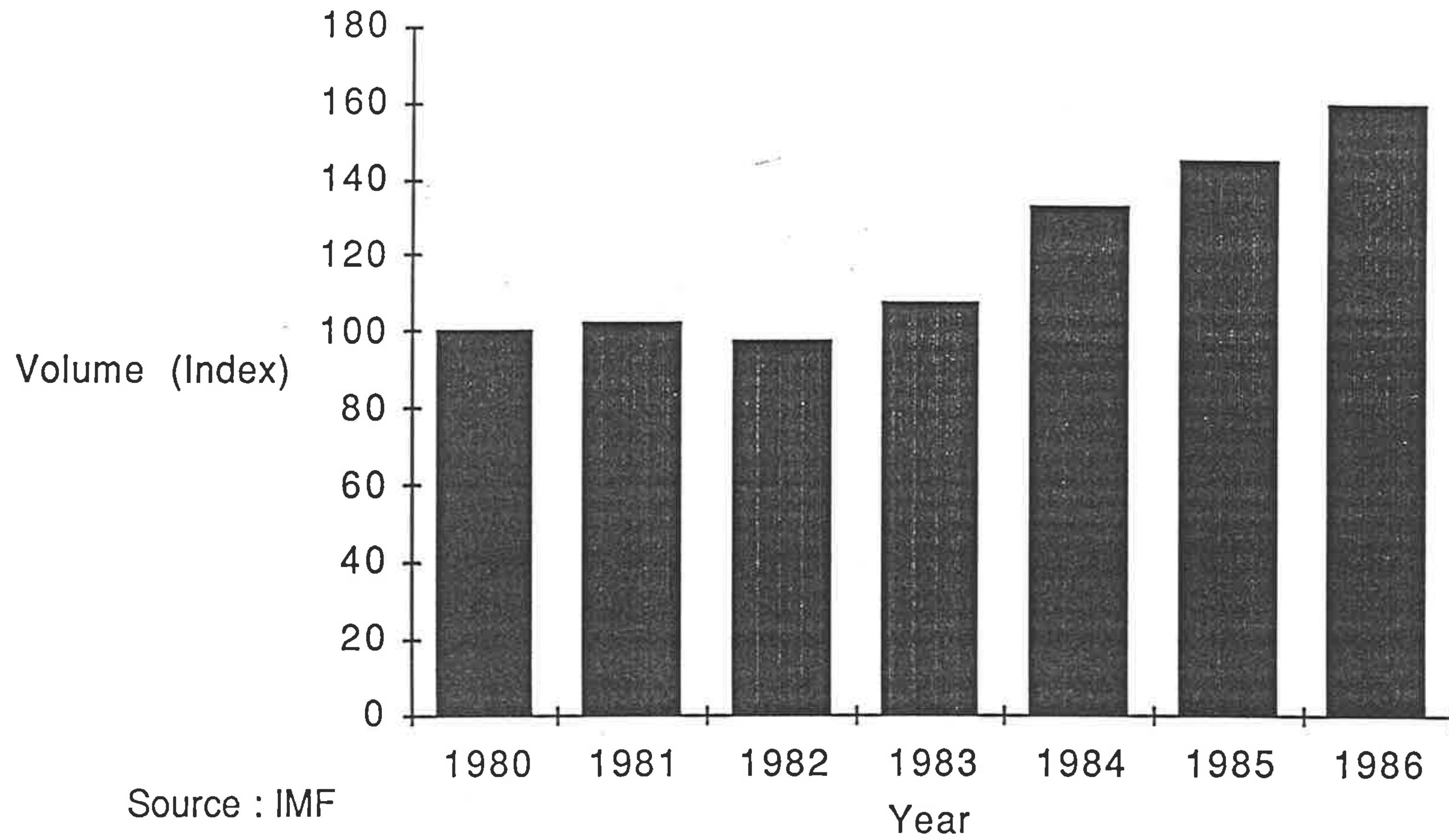


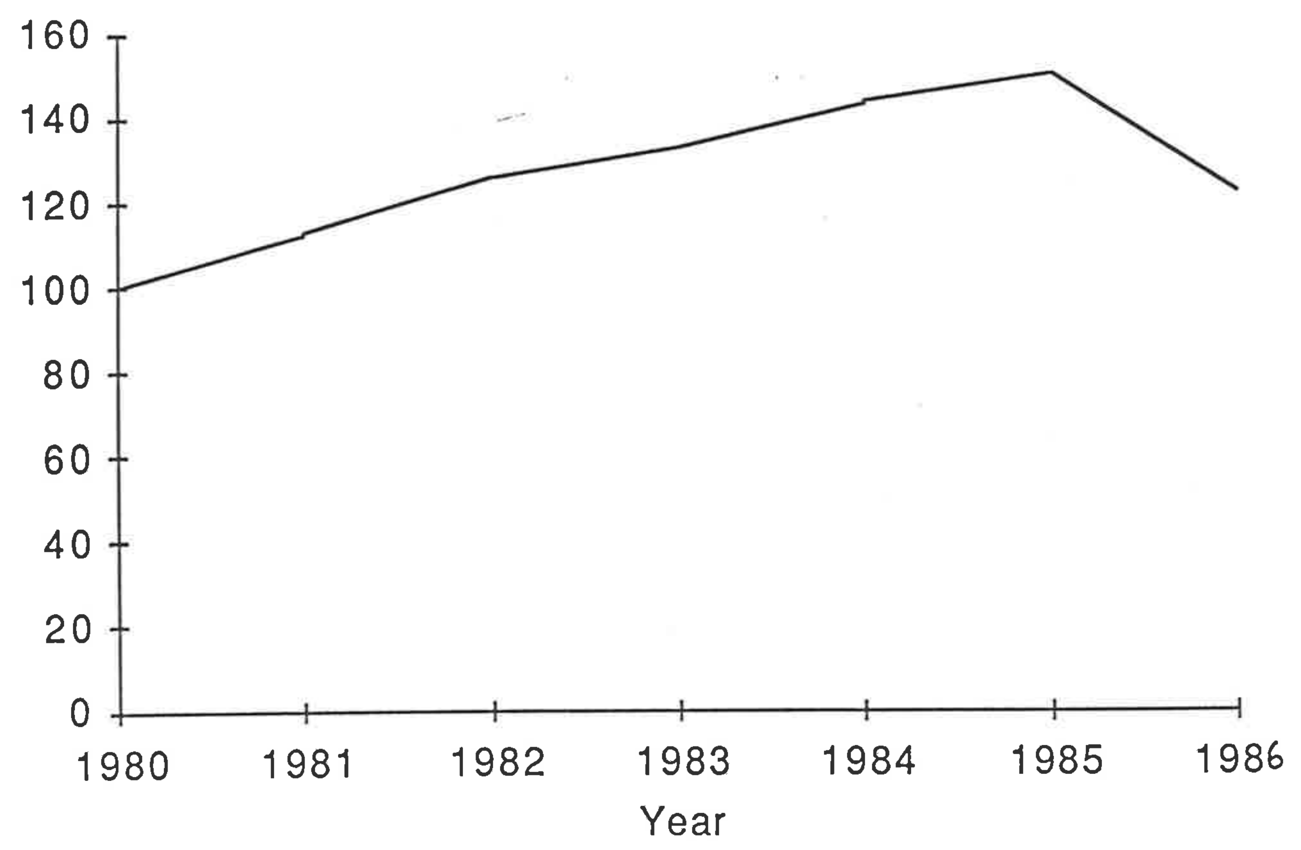
FIGURE 5

1980 = 100

UNITED STATES - EFFECTIVE EXCHANGE RATE

(Trade Weighted Index)

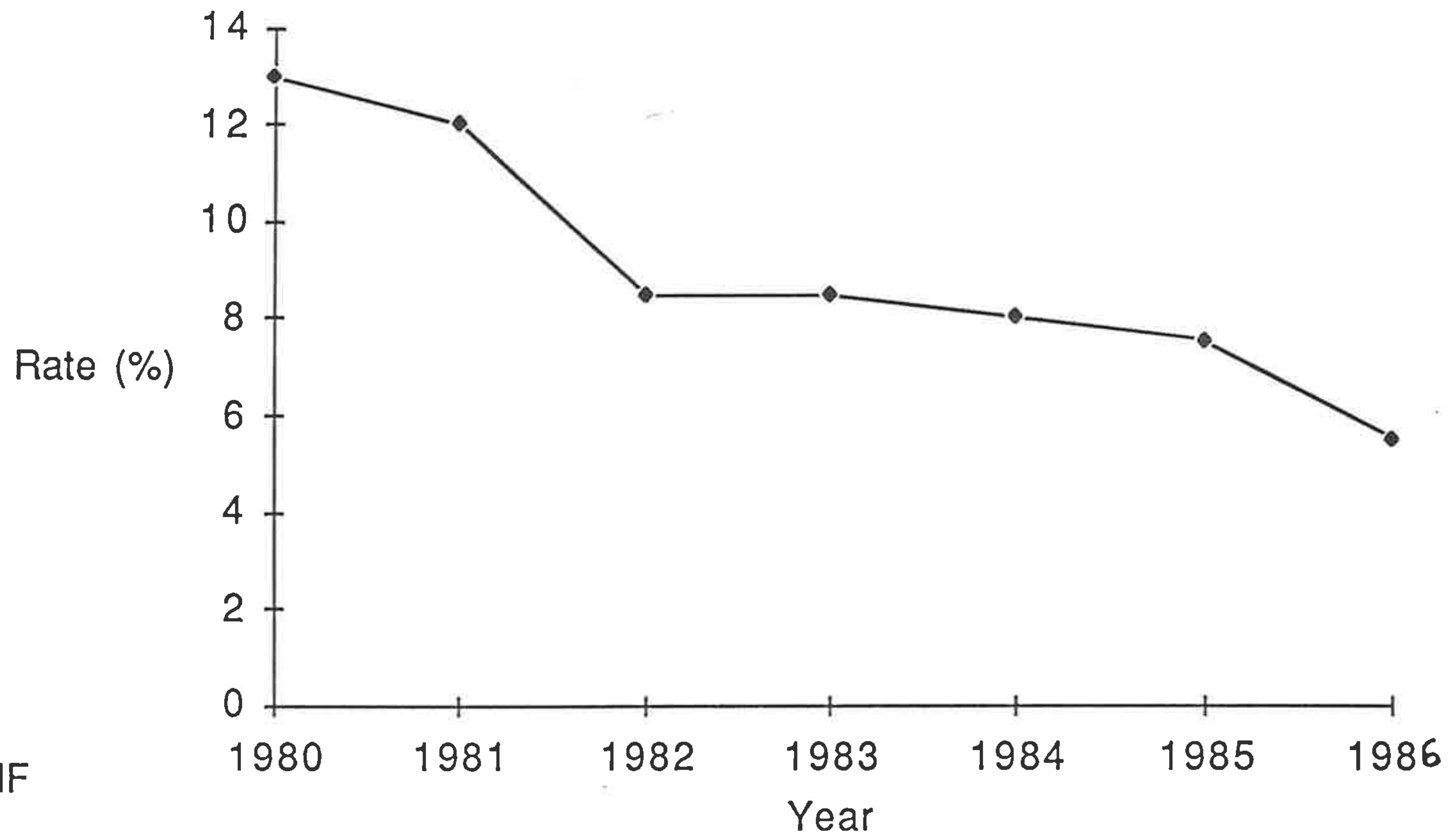
Average Exchange Rate



Source : IMF

FIGURE 6

UNITED STATES-INTEREST RATES
(Discount Rate)

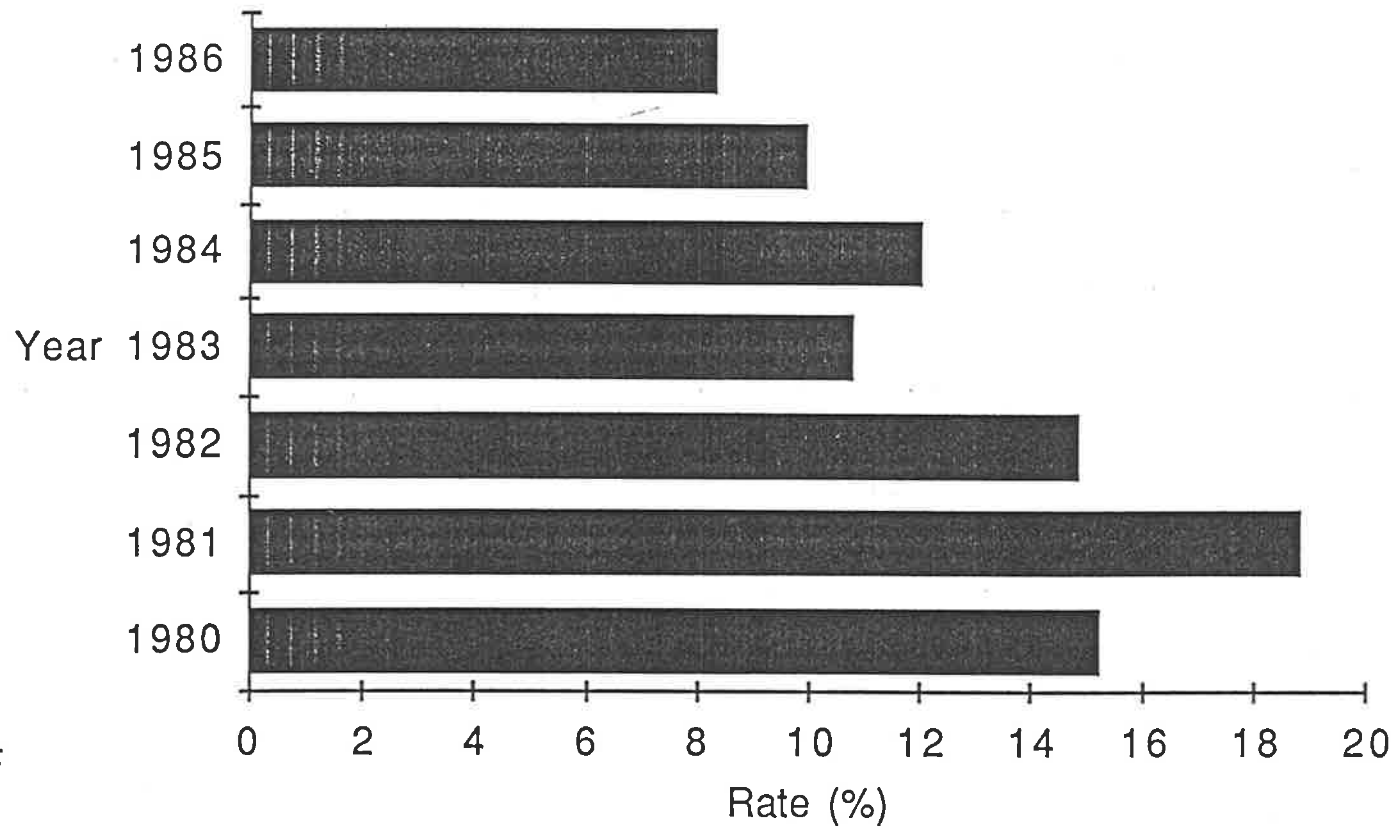


Source : IMF

FIGURE 7

FIGURE 8

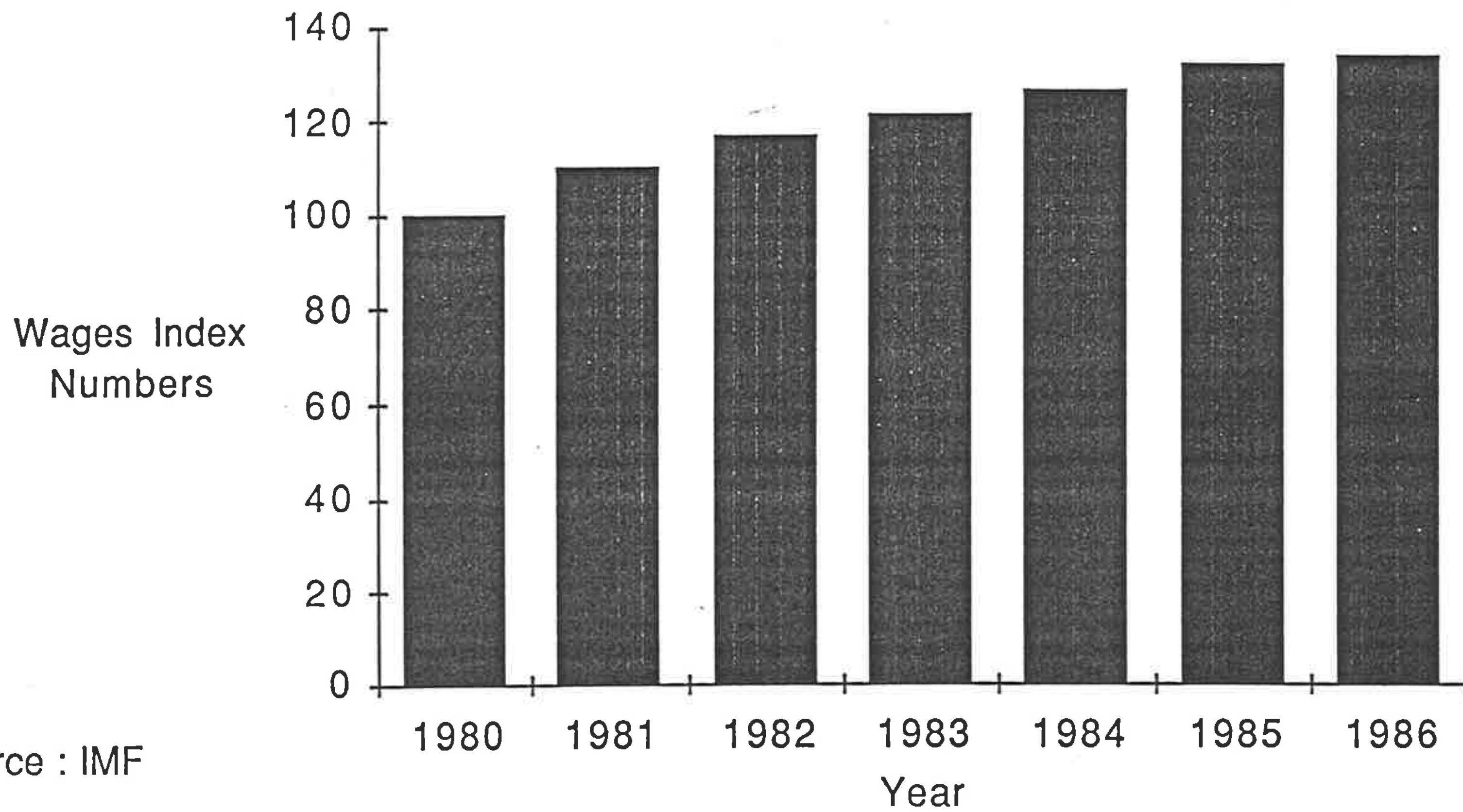
UNITED STATES - INTEREST RATES
(Prime Lending Rate)



Source : IMF

UNITED STATES - WAGES (Hourly Earnings in Manufacturing)

1980 = 100



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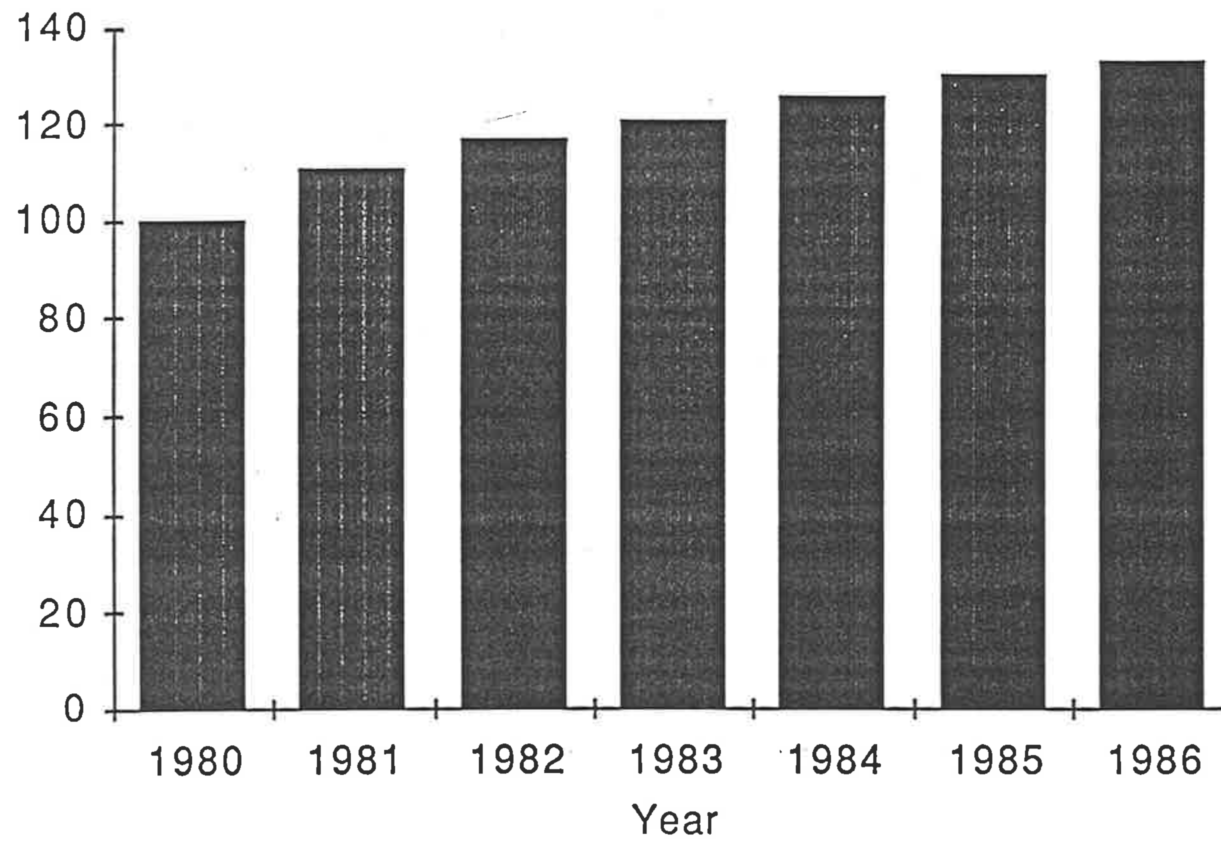

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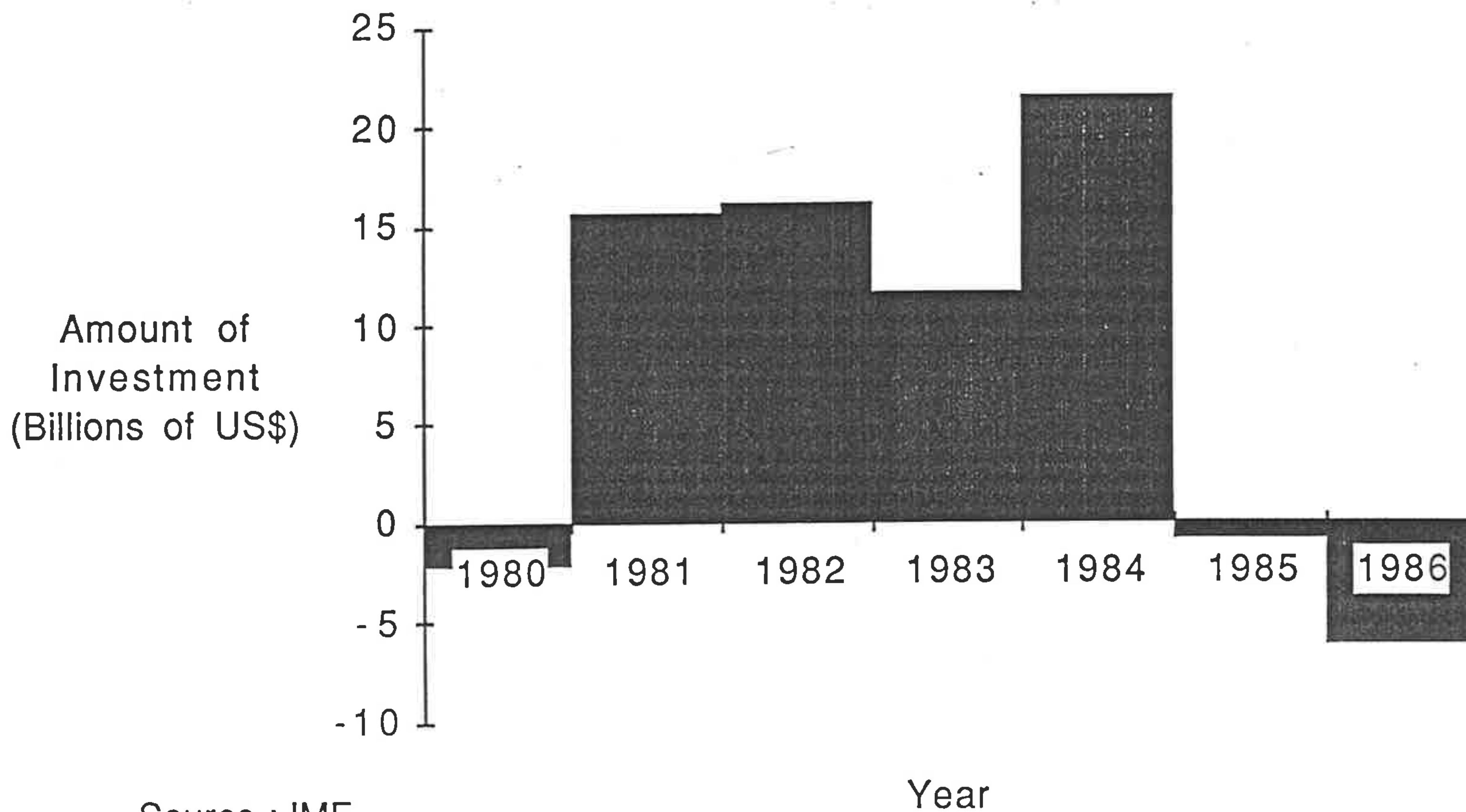


FIGURE 11

UNITED STATES - GOVERNMENT

FINANCE - (Deficit)

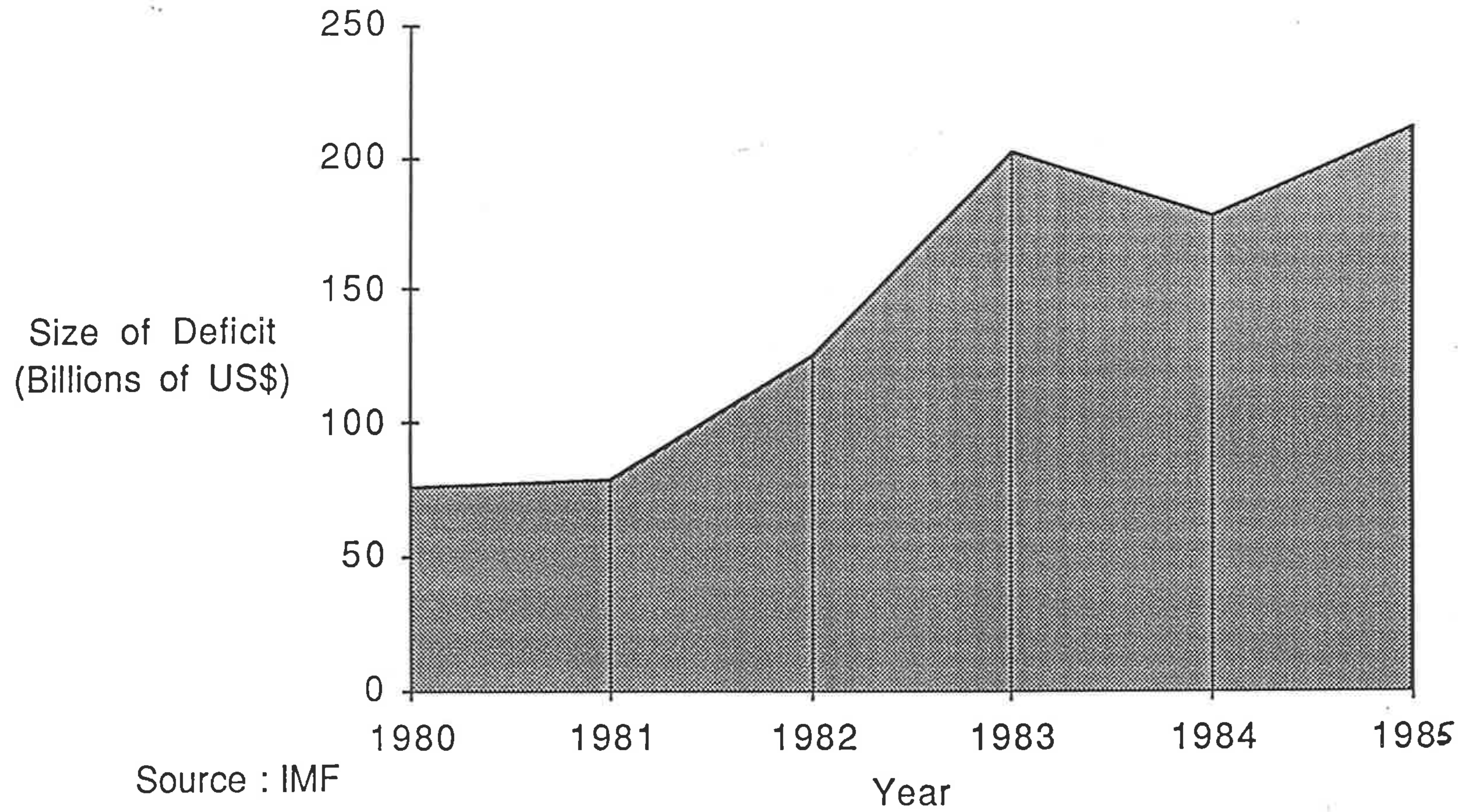
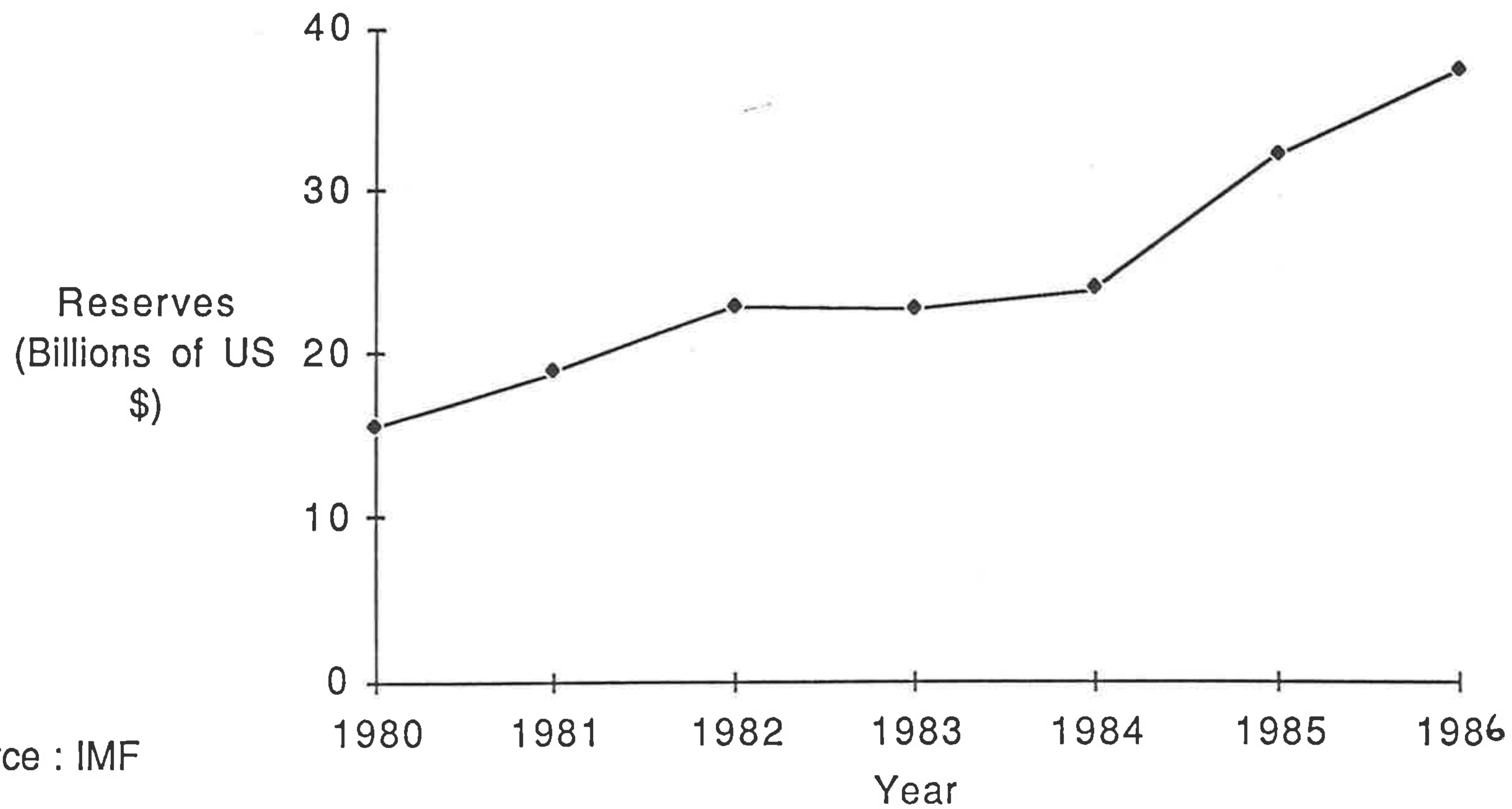


FIGURE 12

UNITED STATES - TOTAL RESERVES
(Minus Gold)

End Calendar Year



Source : IMF

FIGURE 13

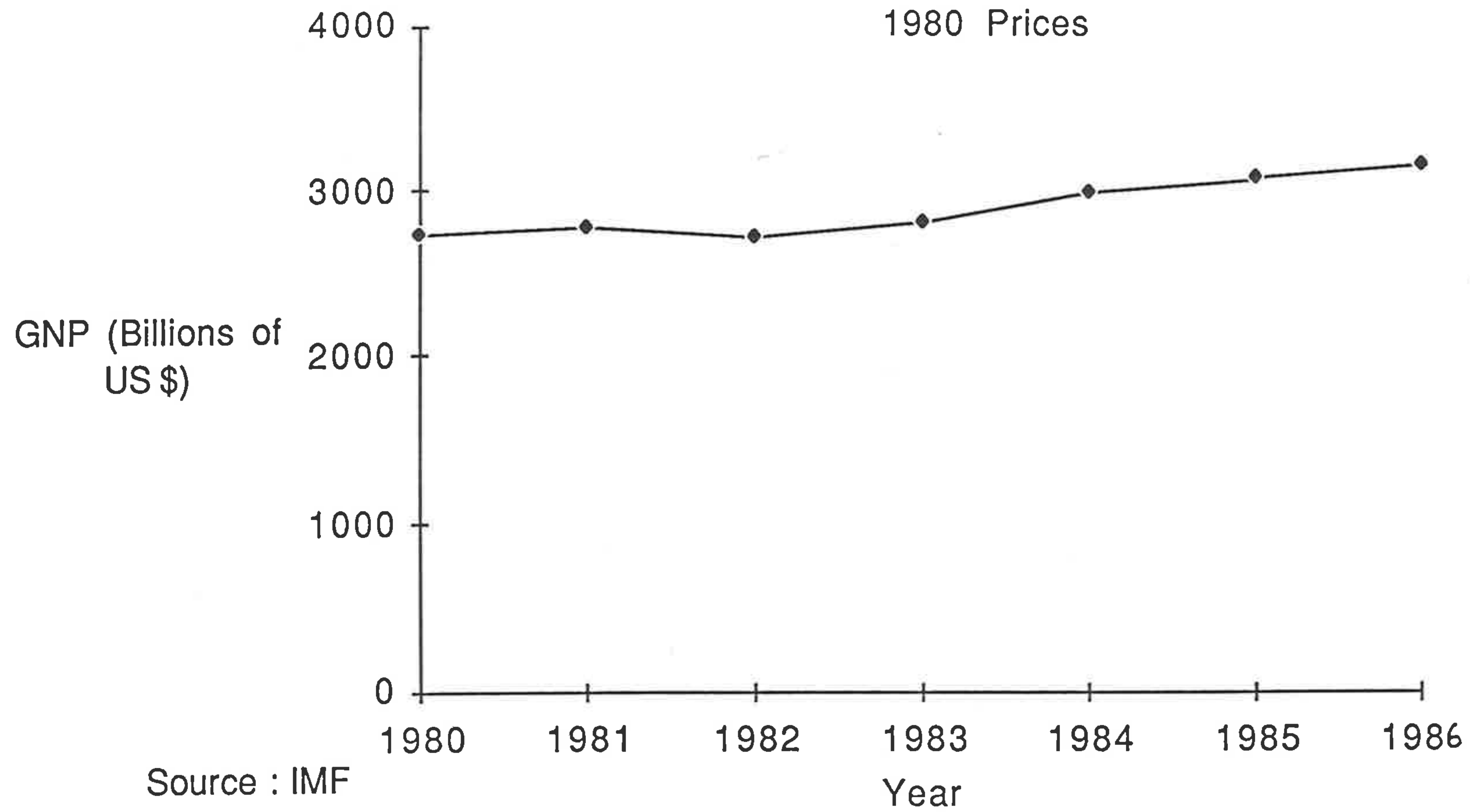


FIGURE 14

KOREA - BALANCE OF PAYMENTS -
(Current Account)

Negative Values = Deficit

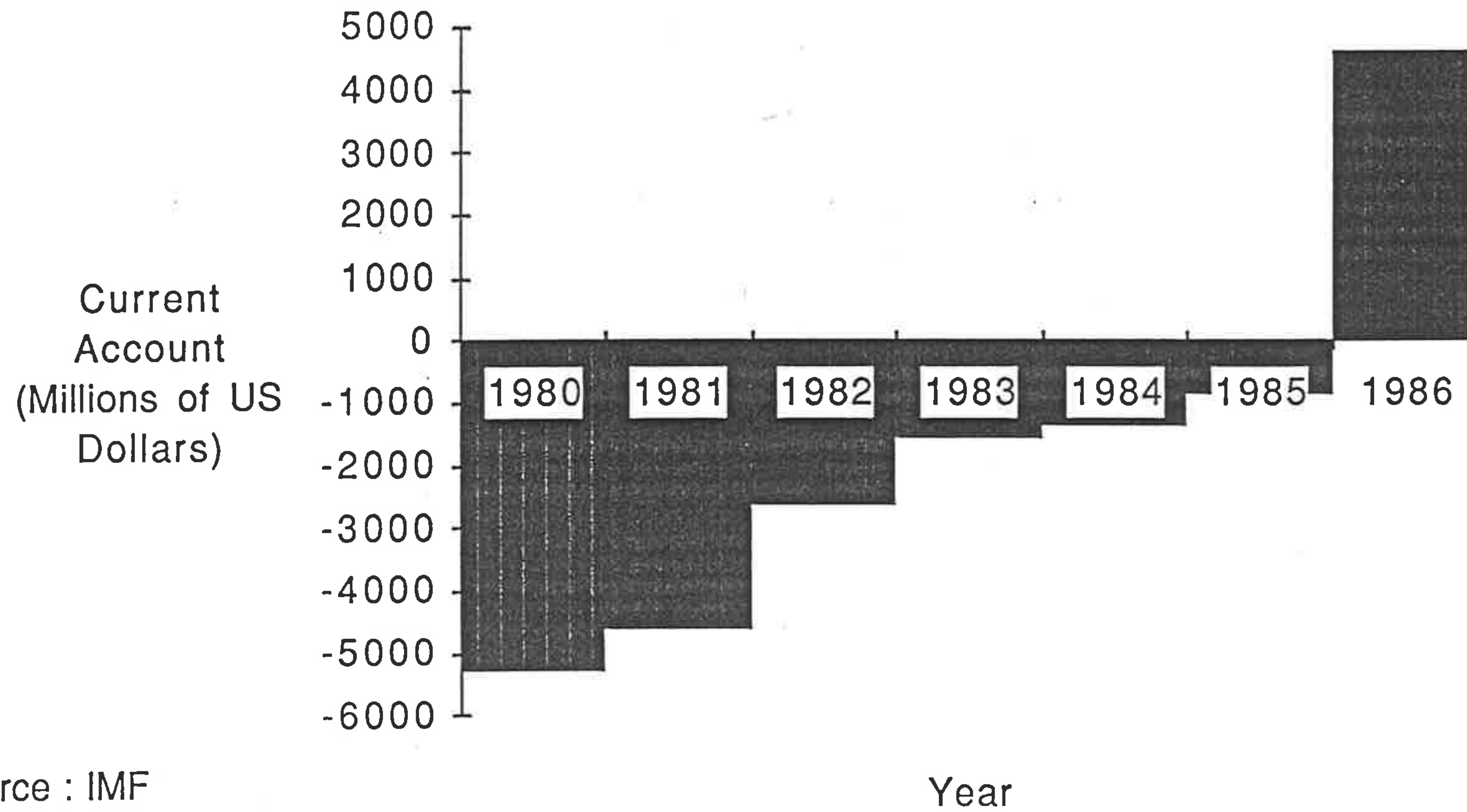


FIGURE 15

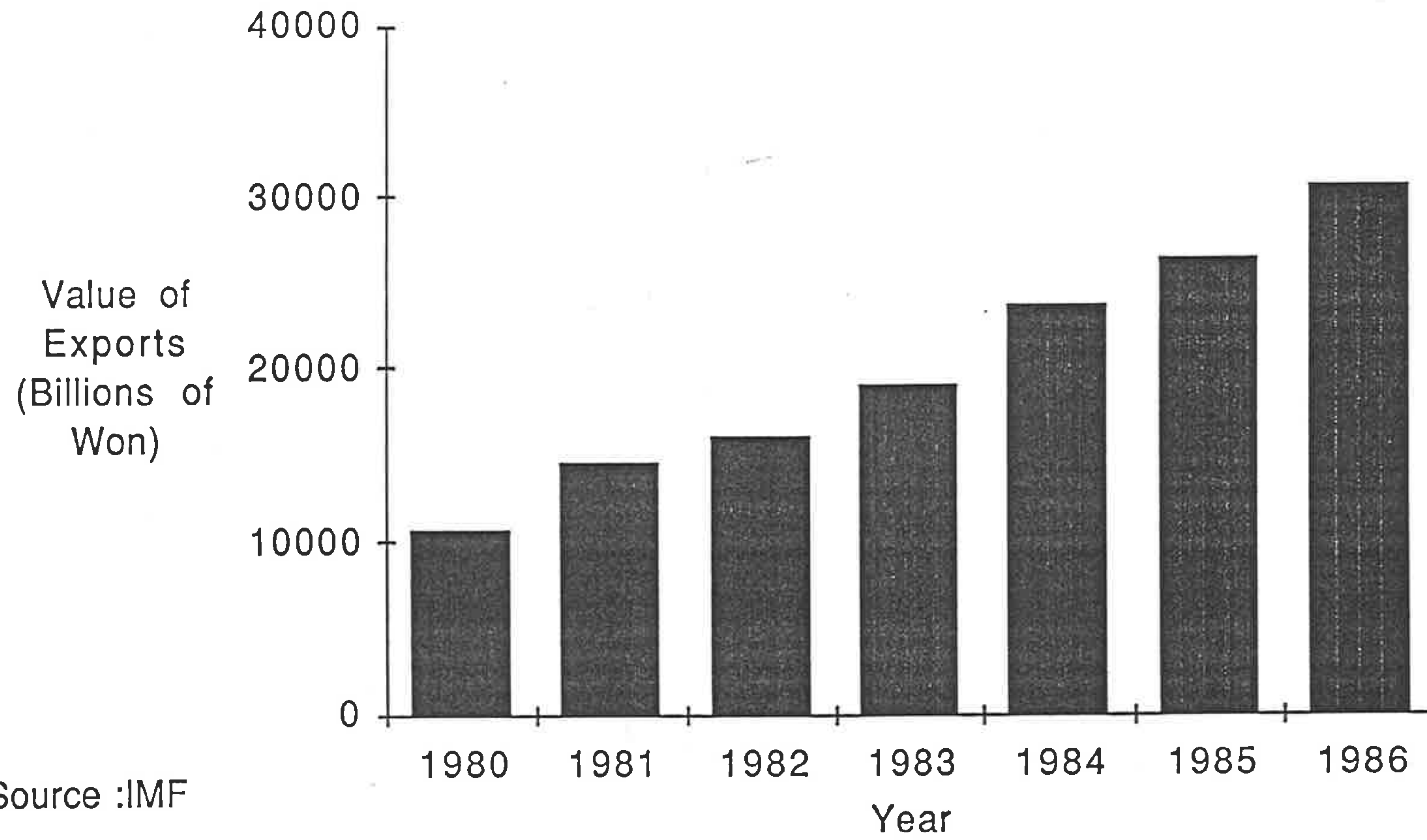


FIGURE 16

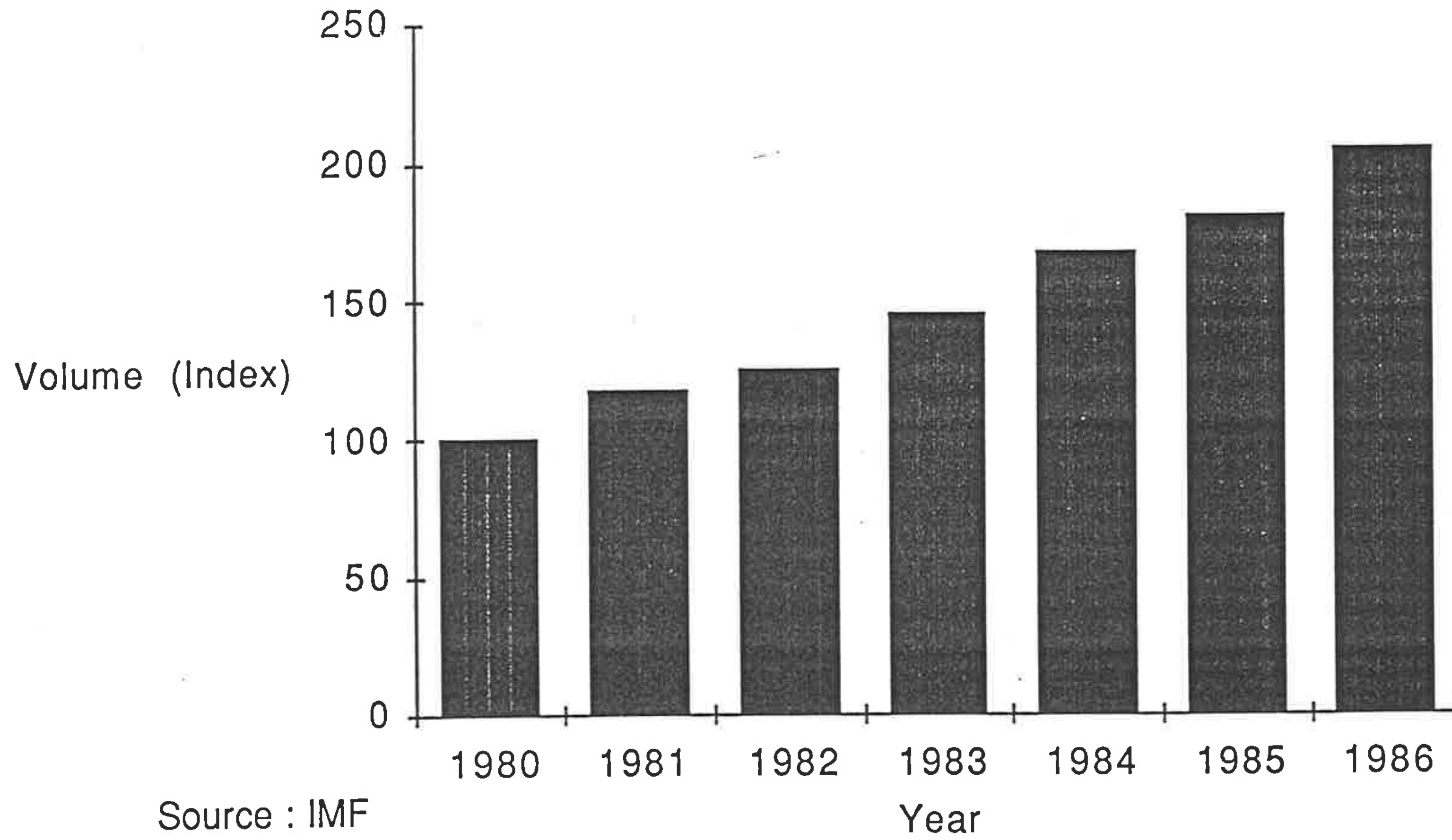


FIGURE 17

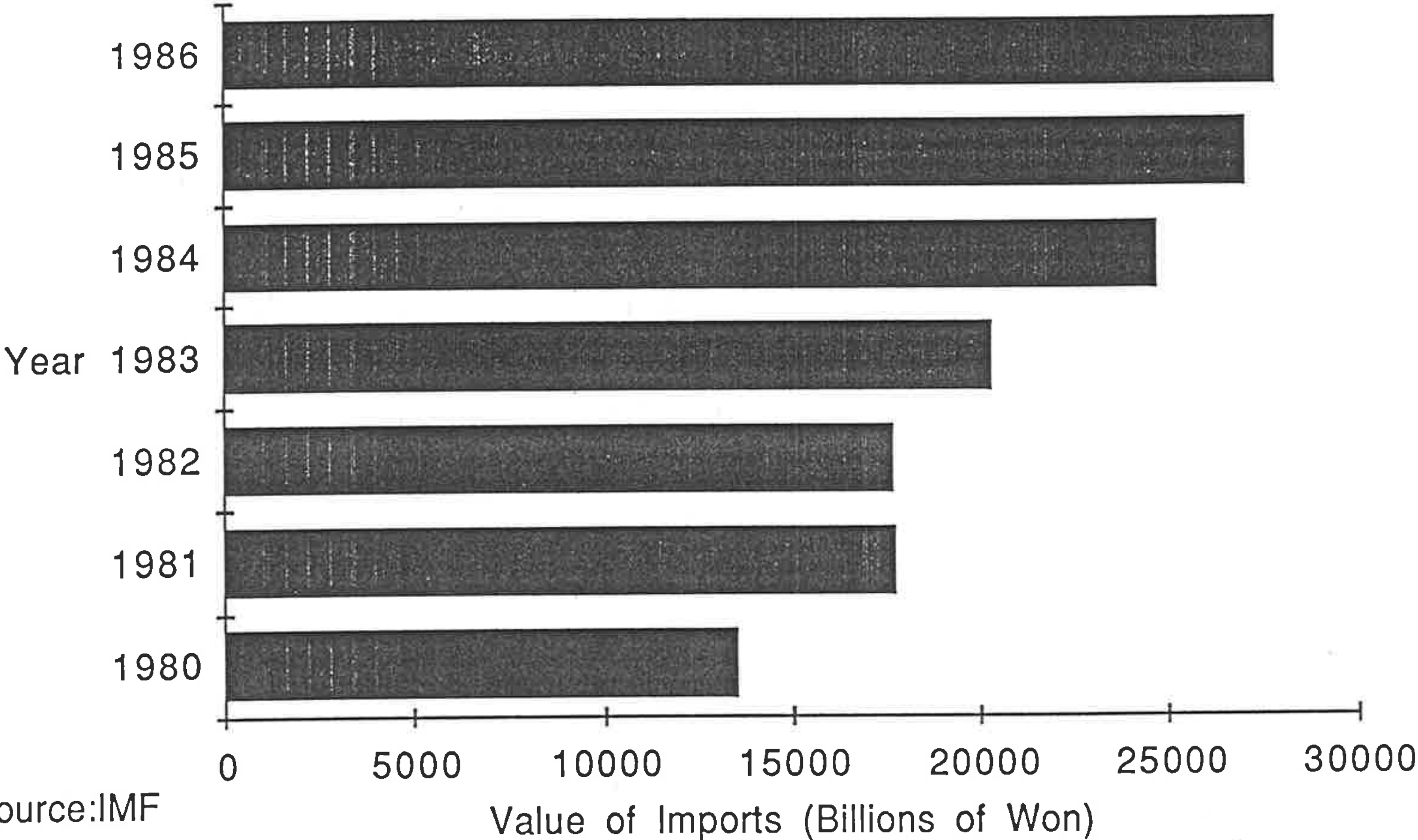


FIGURE 18

1980 = 100

KOREA - VOLUME OF IMPORTS

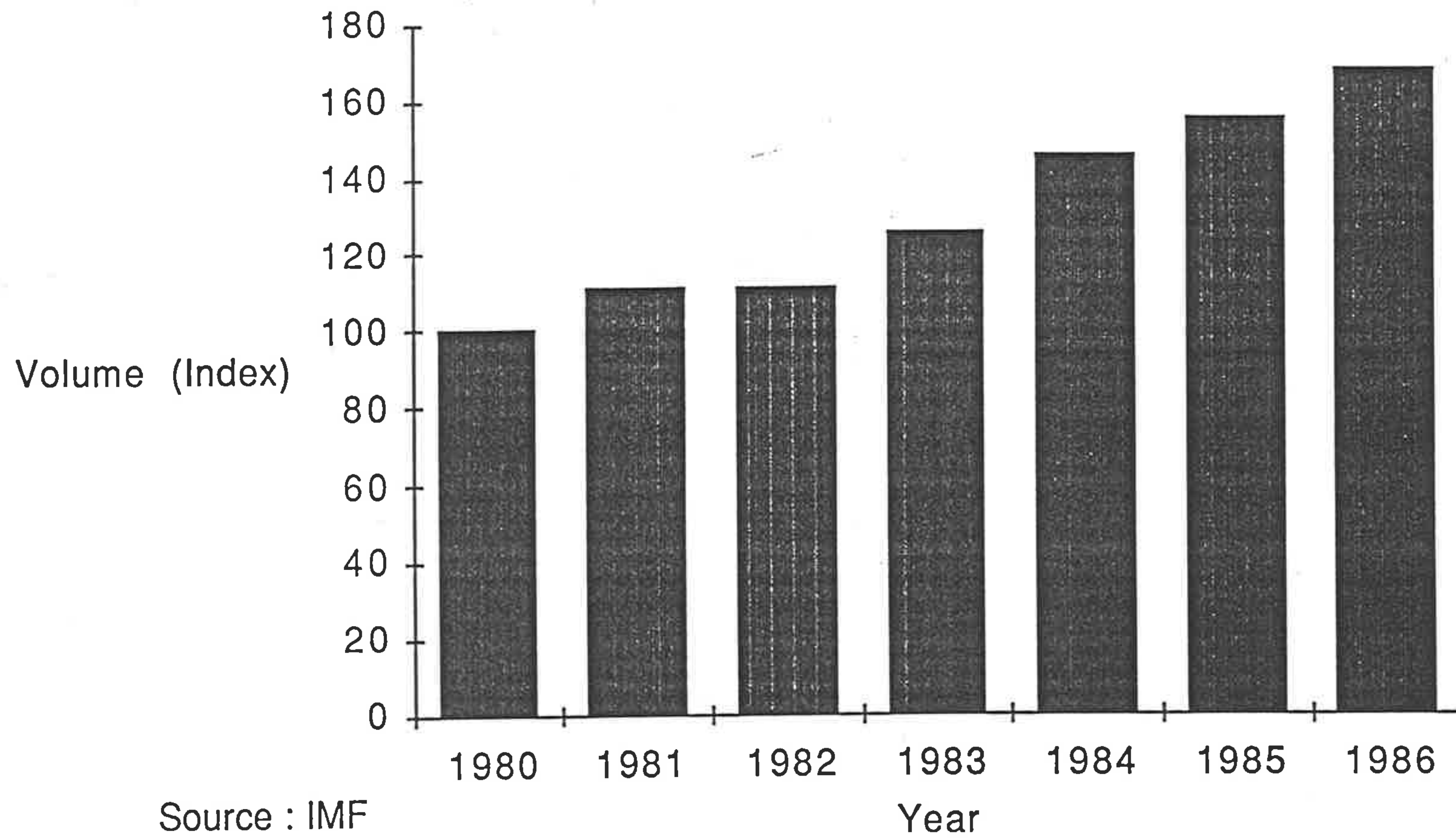


FIGURE 19

KOREA - EXCHANGE RATE (Average Market Rate)

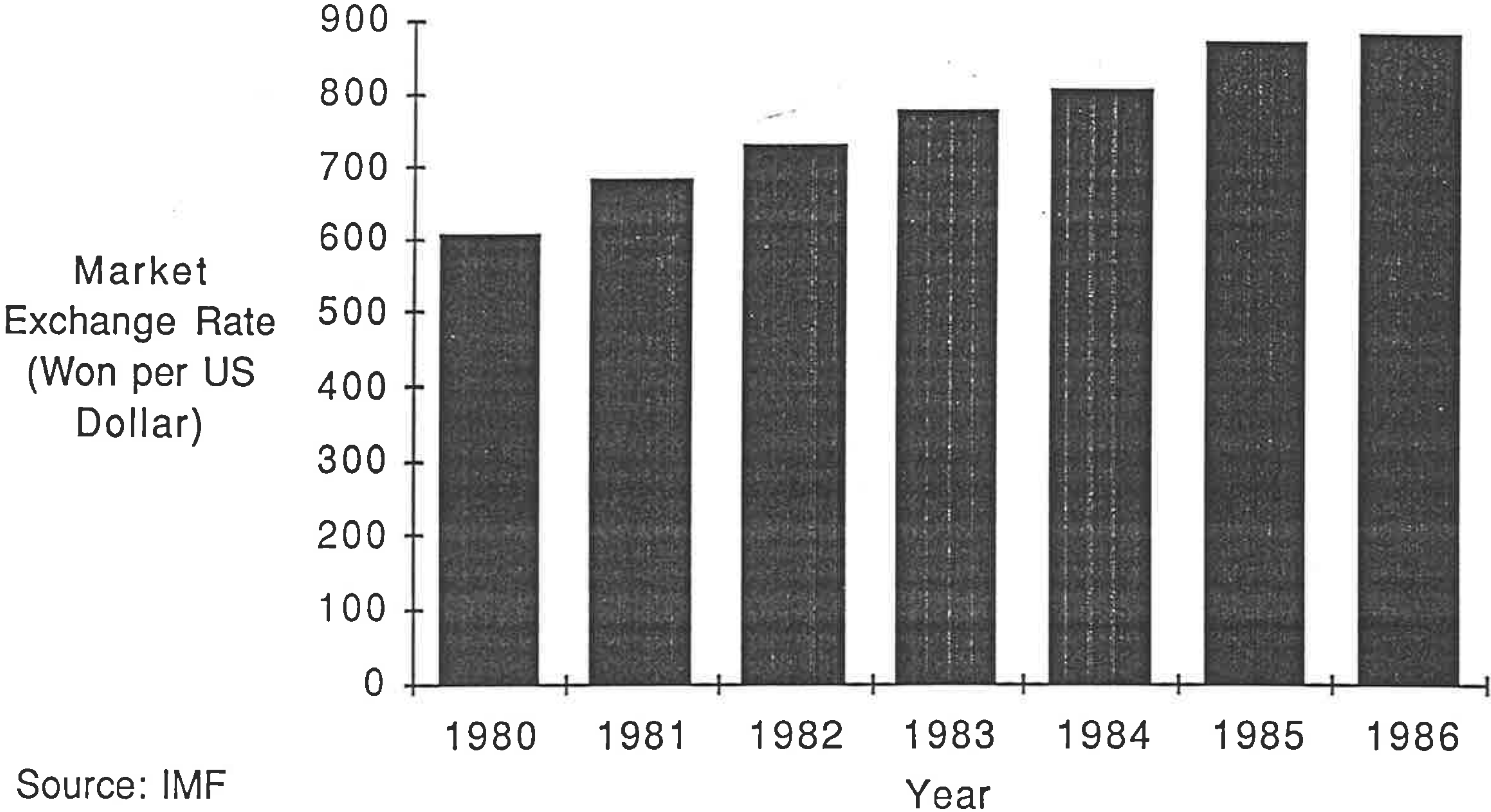
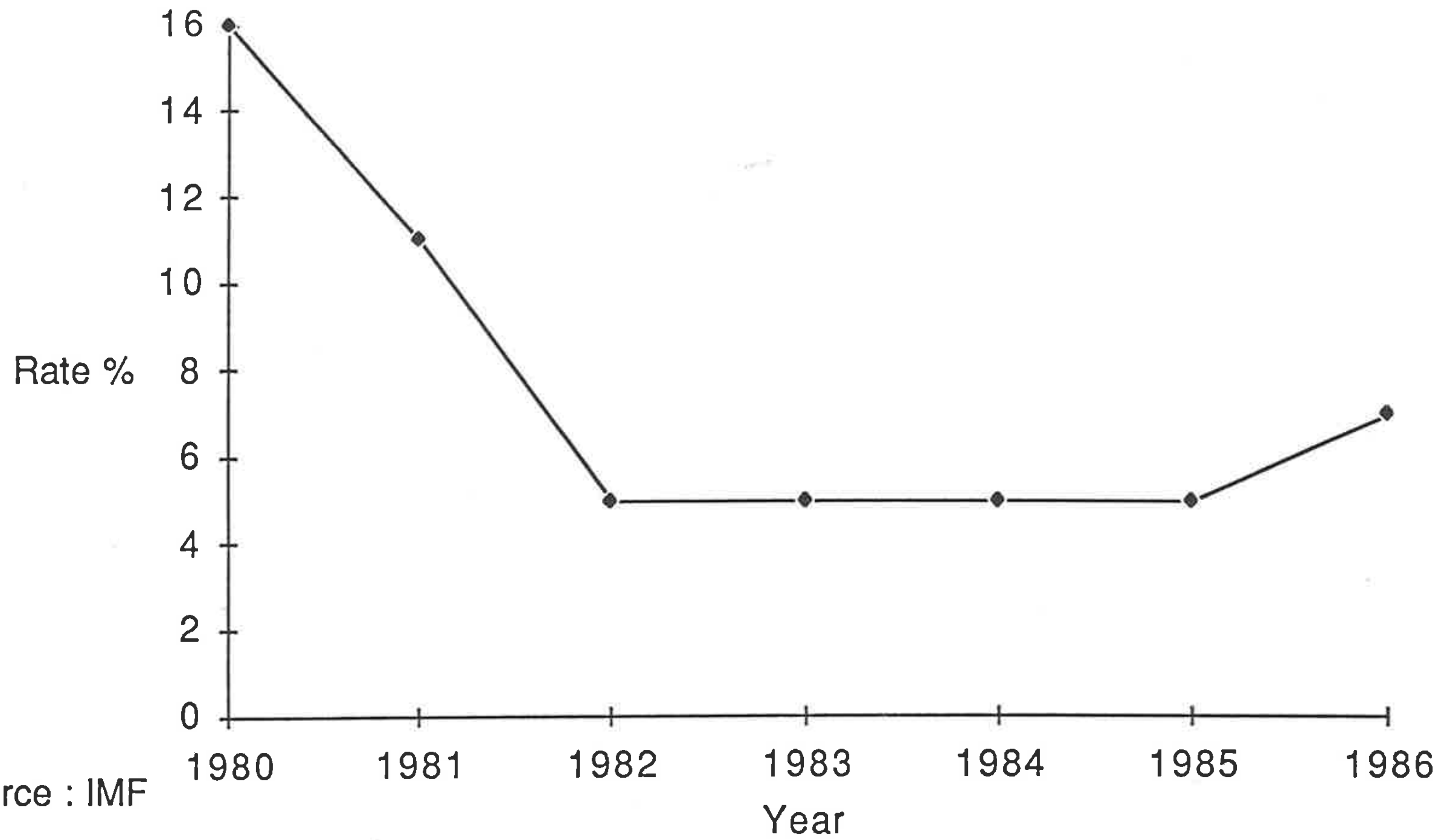


FIGURE 20

FIGURE 21

KOREA - INTEREST RATES

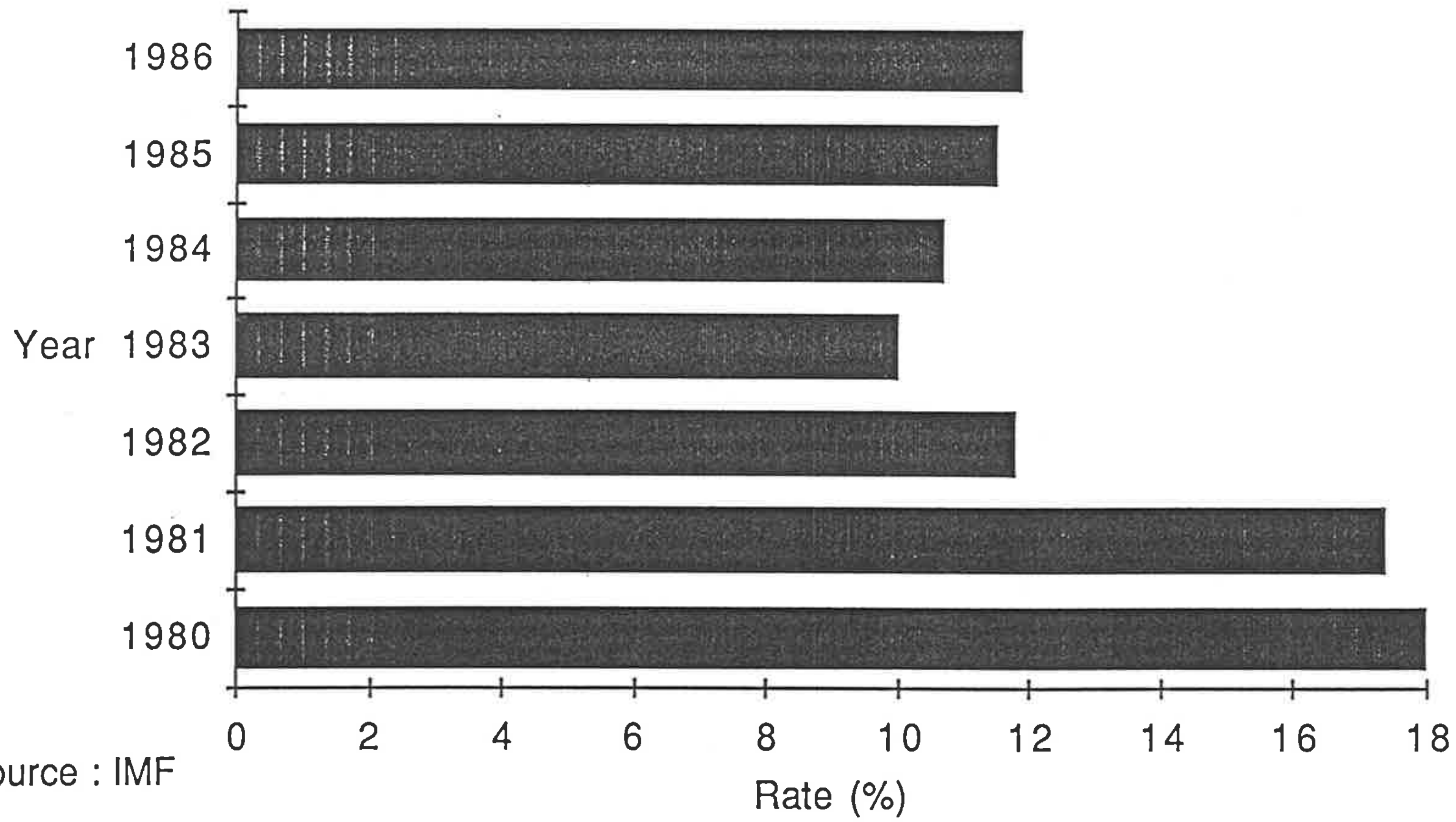
Discount Rate at End-Year



Source : IMF

FIGURE 22

KOREA - INTEREST RATES (Prime
Lending Rate)



1980 = 100 KOREA - WAGES INDEX (Monthly Earnings)

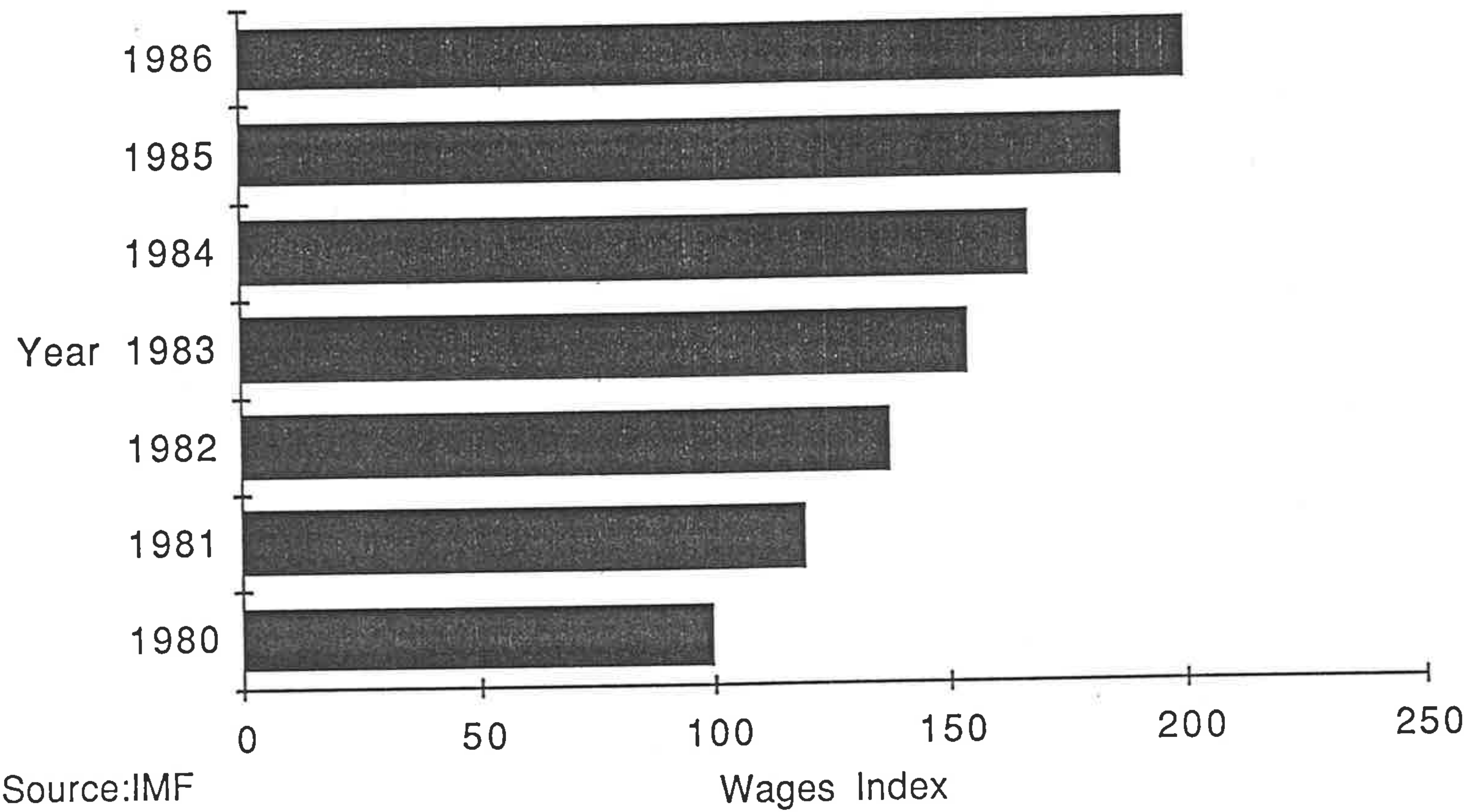


FIGURE 23

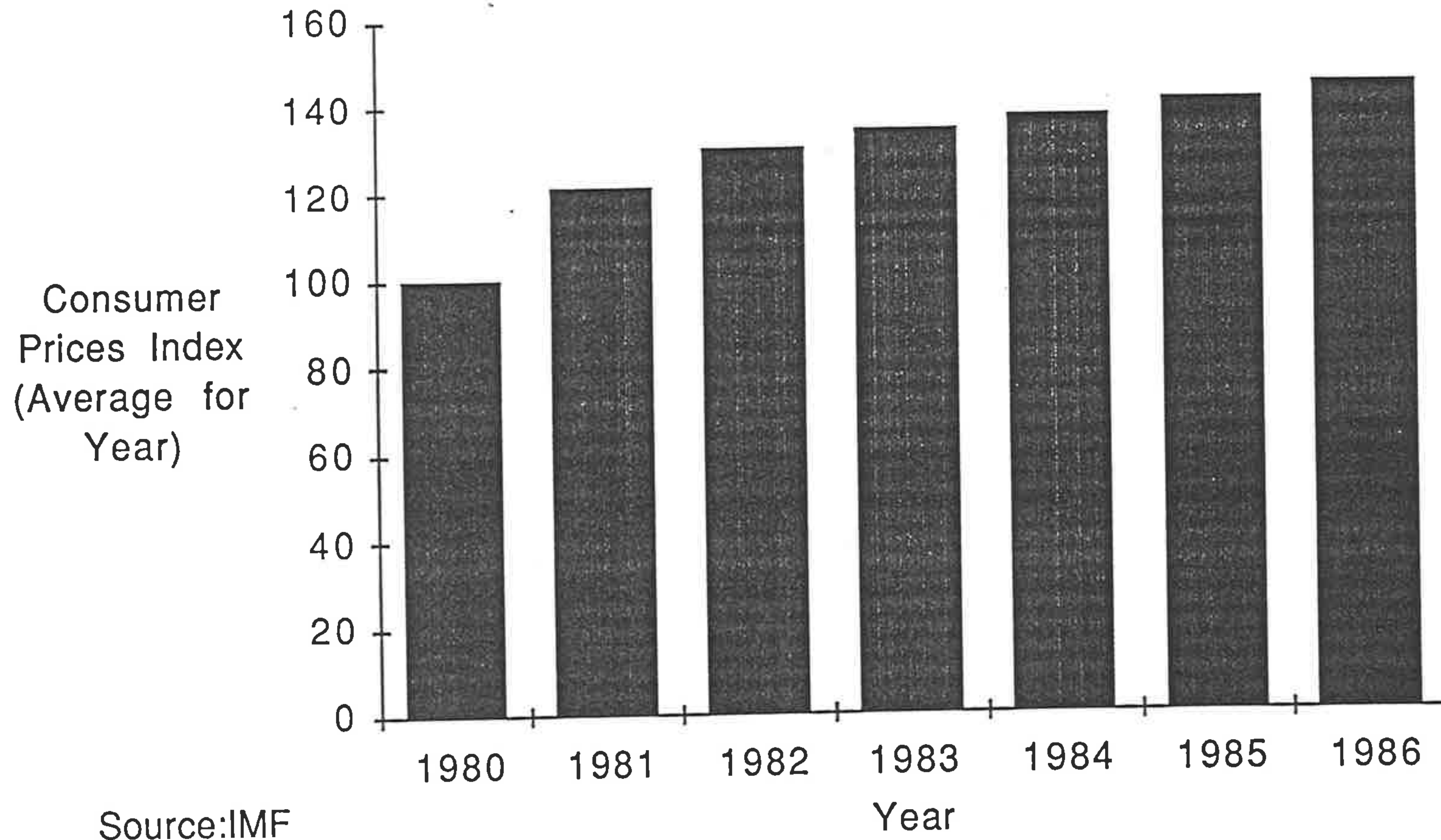


FIGURE 24

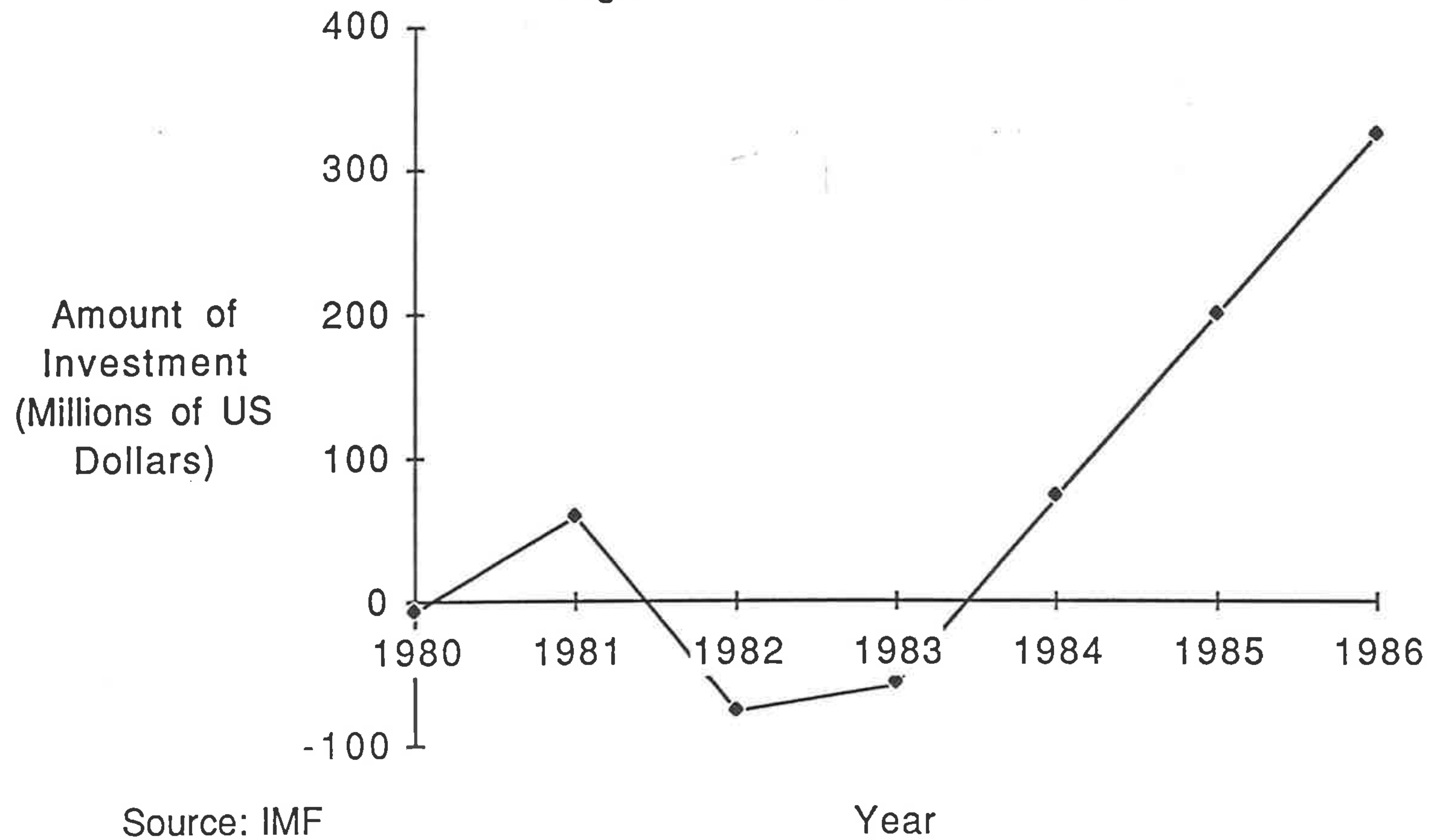


FIGURE 25

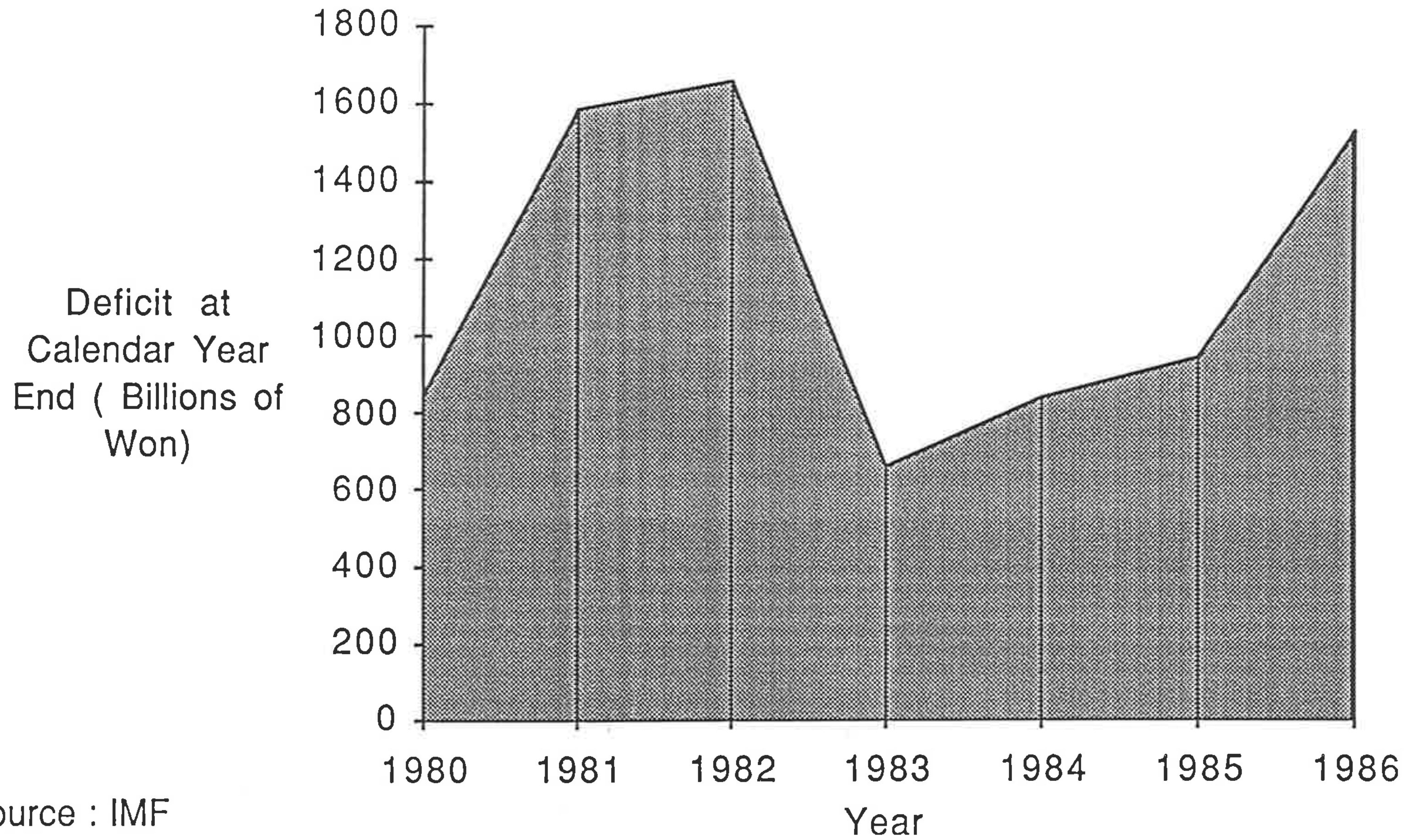


FIGURE 26

KOREA - TOTAL RESERVES (Minus Gold)

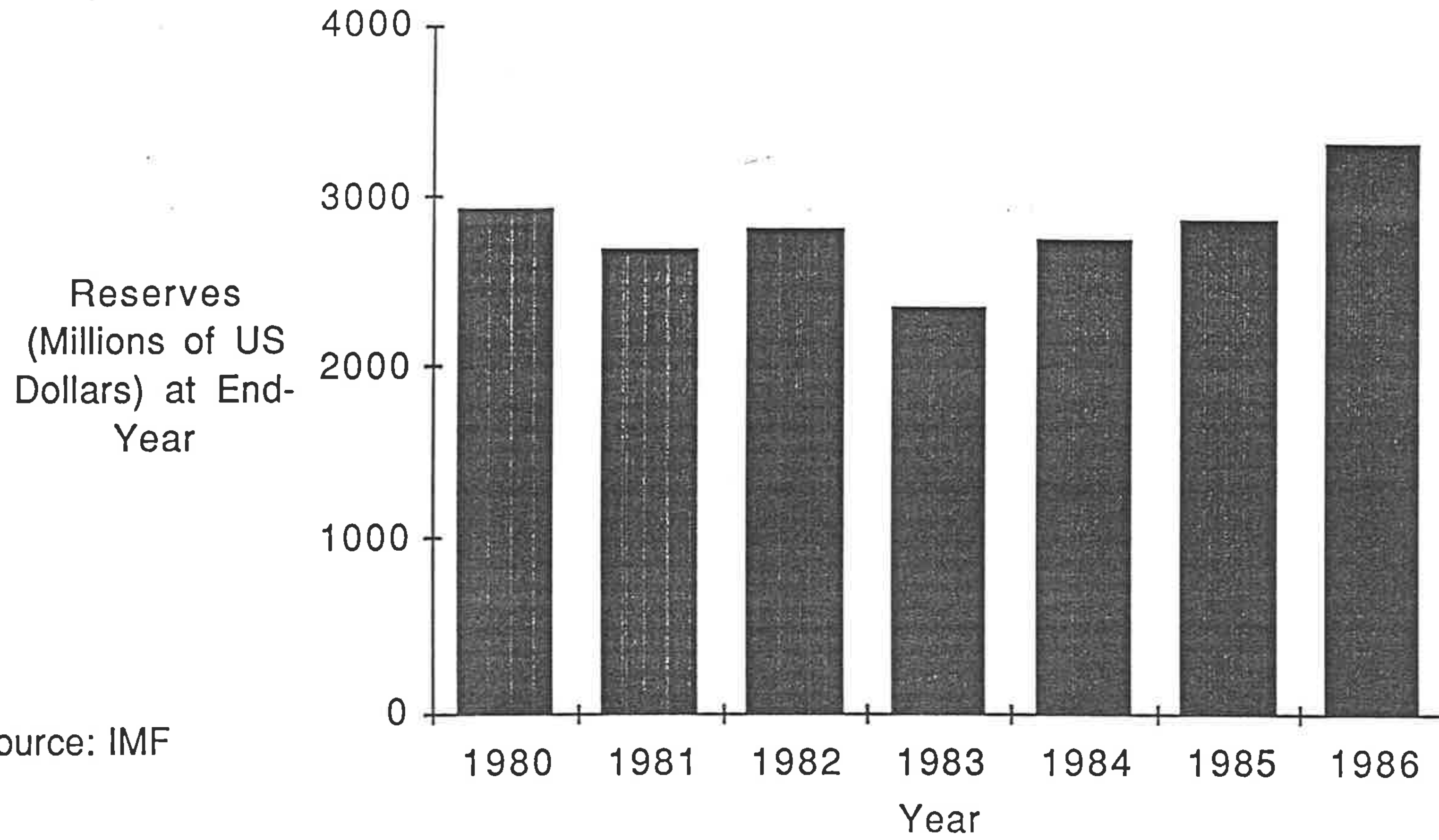
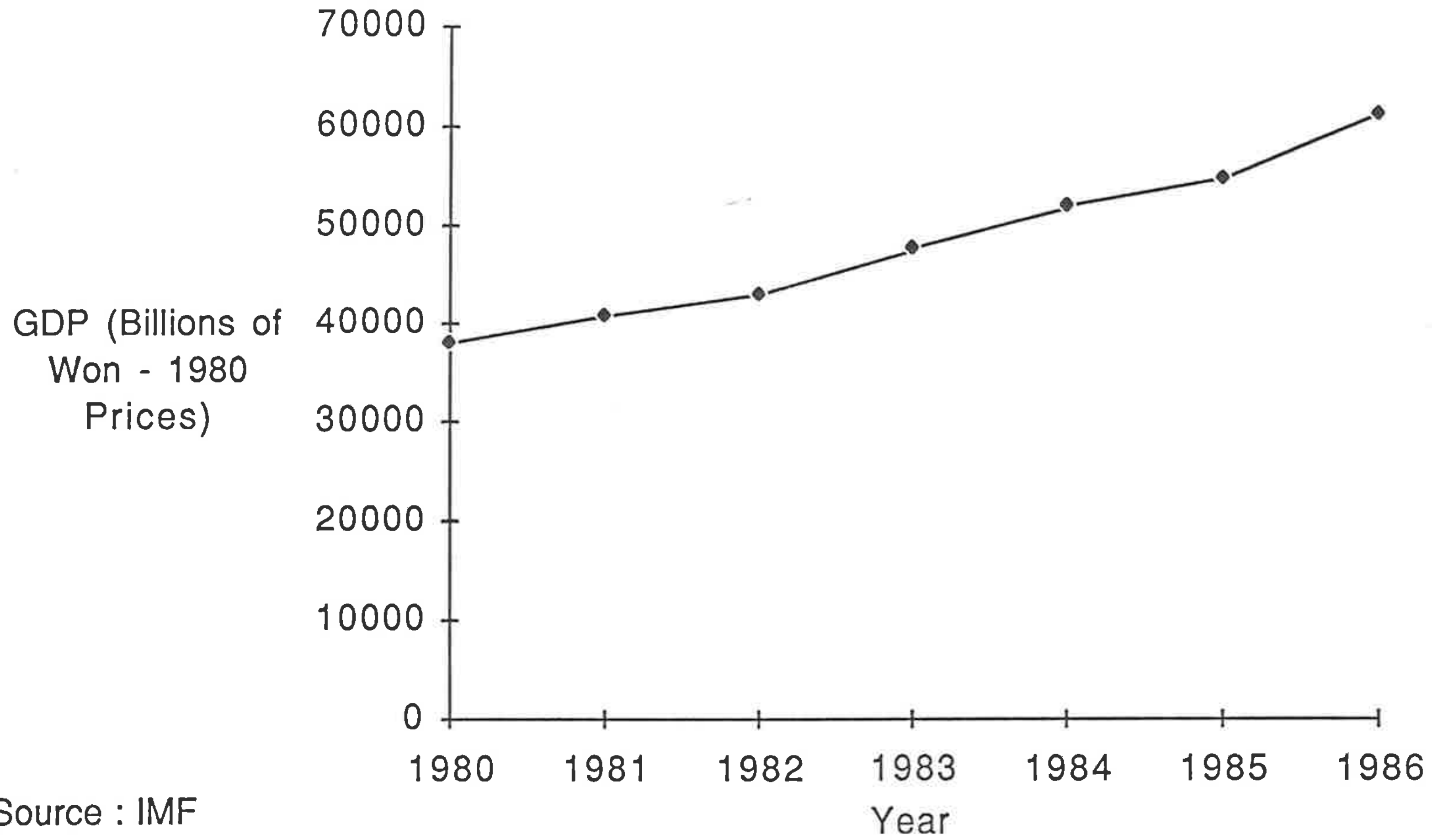


FIGURE 27



Source : IMF

FIGURE 28

ARGENTINA - BALANCE OF PAYMENTS
(Current Account Deficit)

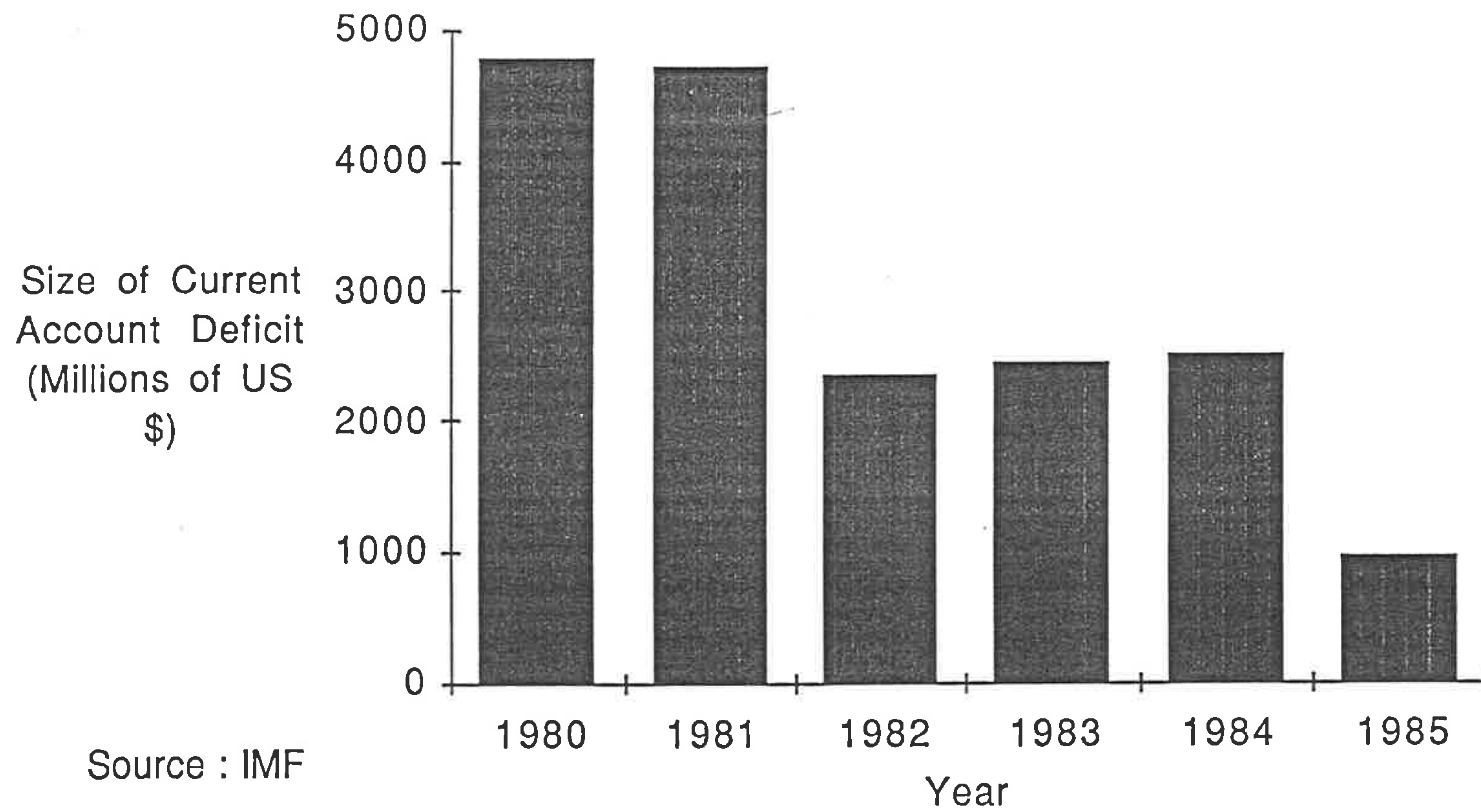


FIGURE 29

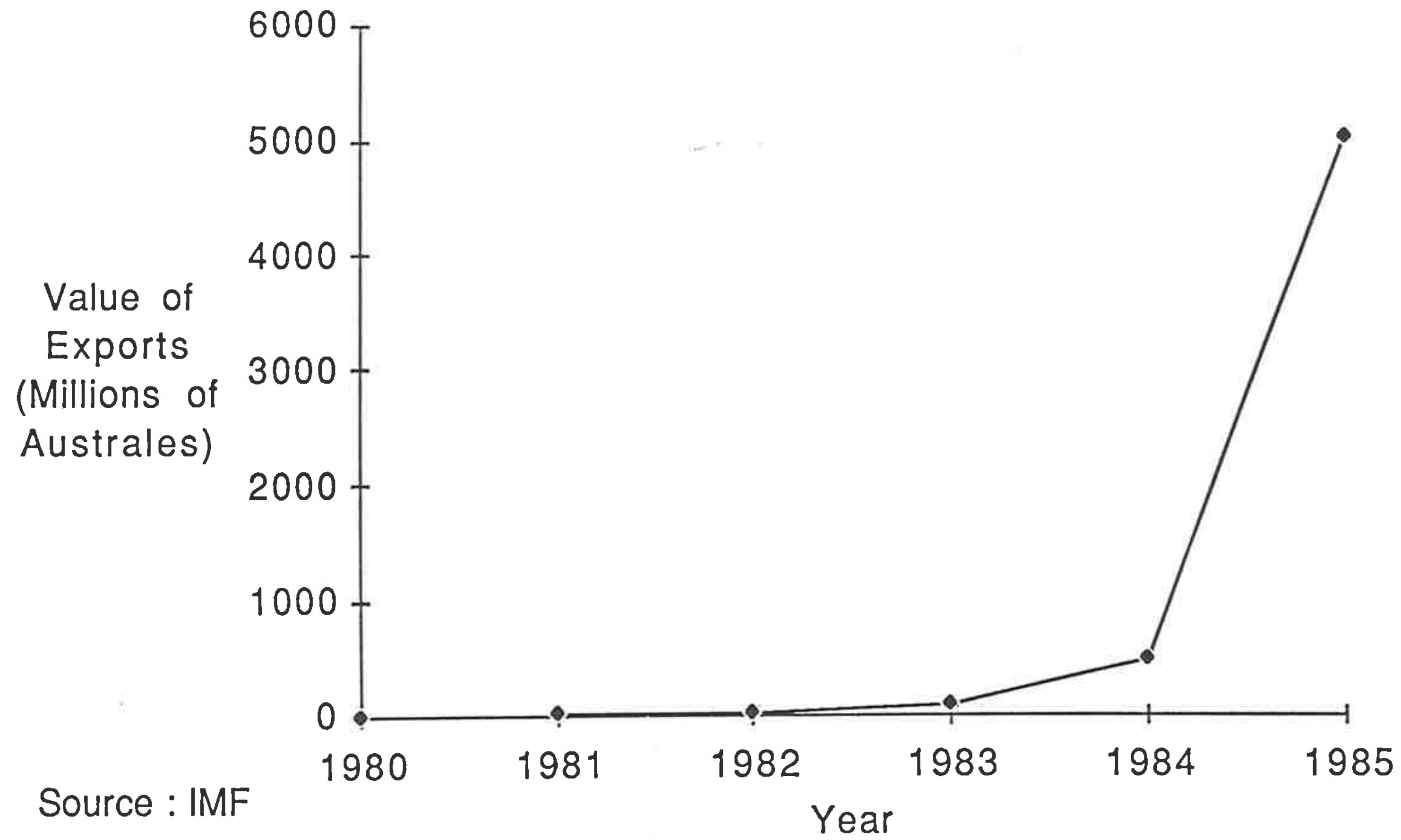
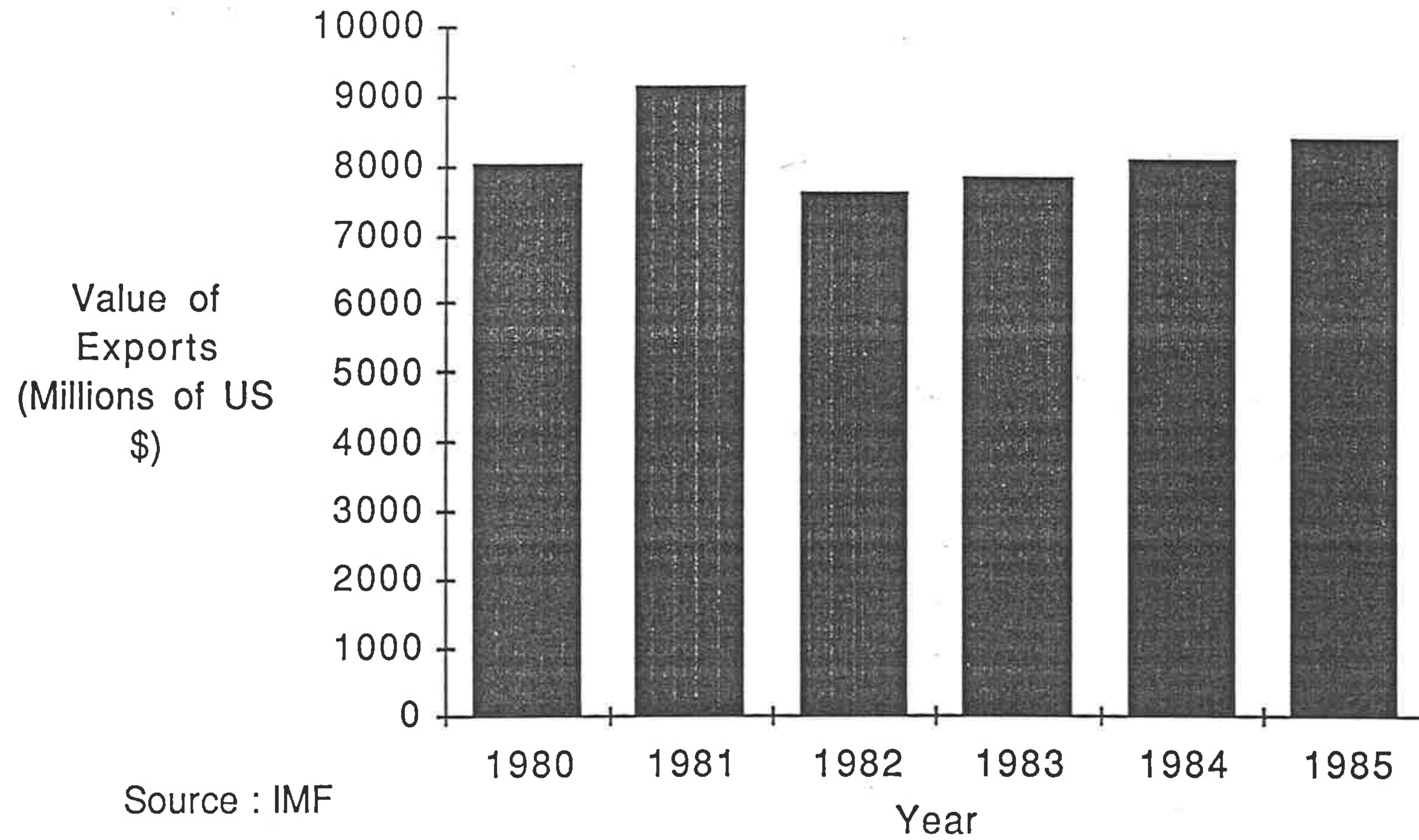


FIGURE 30

FIGURE 31

ARGENTINA - MERCHANDISE EXPORTS



ARGENTINA - IMPORTS cif

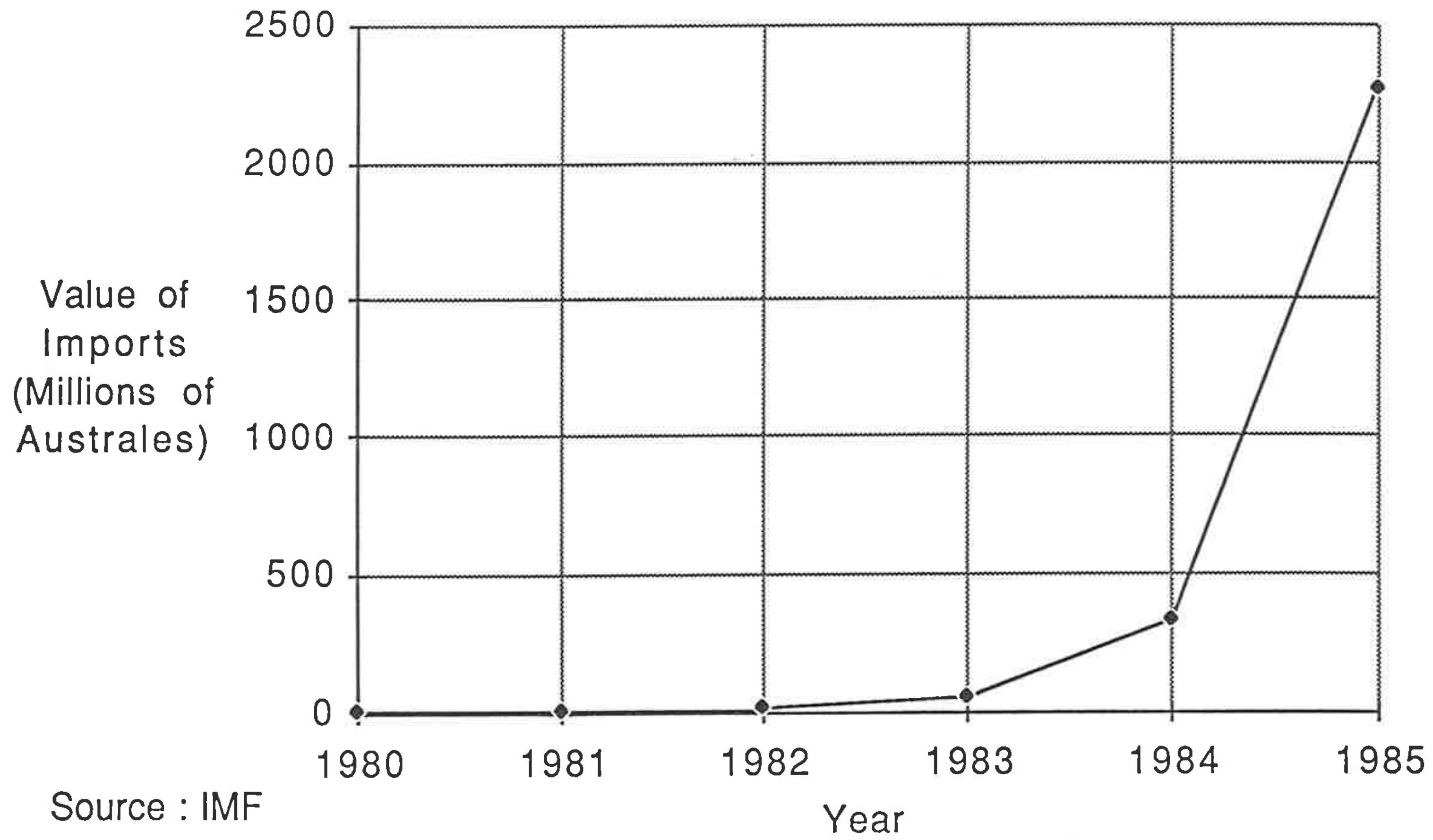


FIGURE 32

ARGENTINA - EXCHANGE RATE (Principal Official Rate)

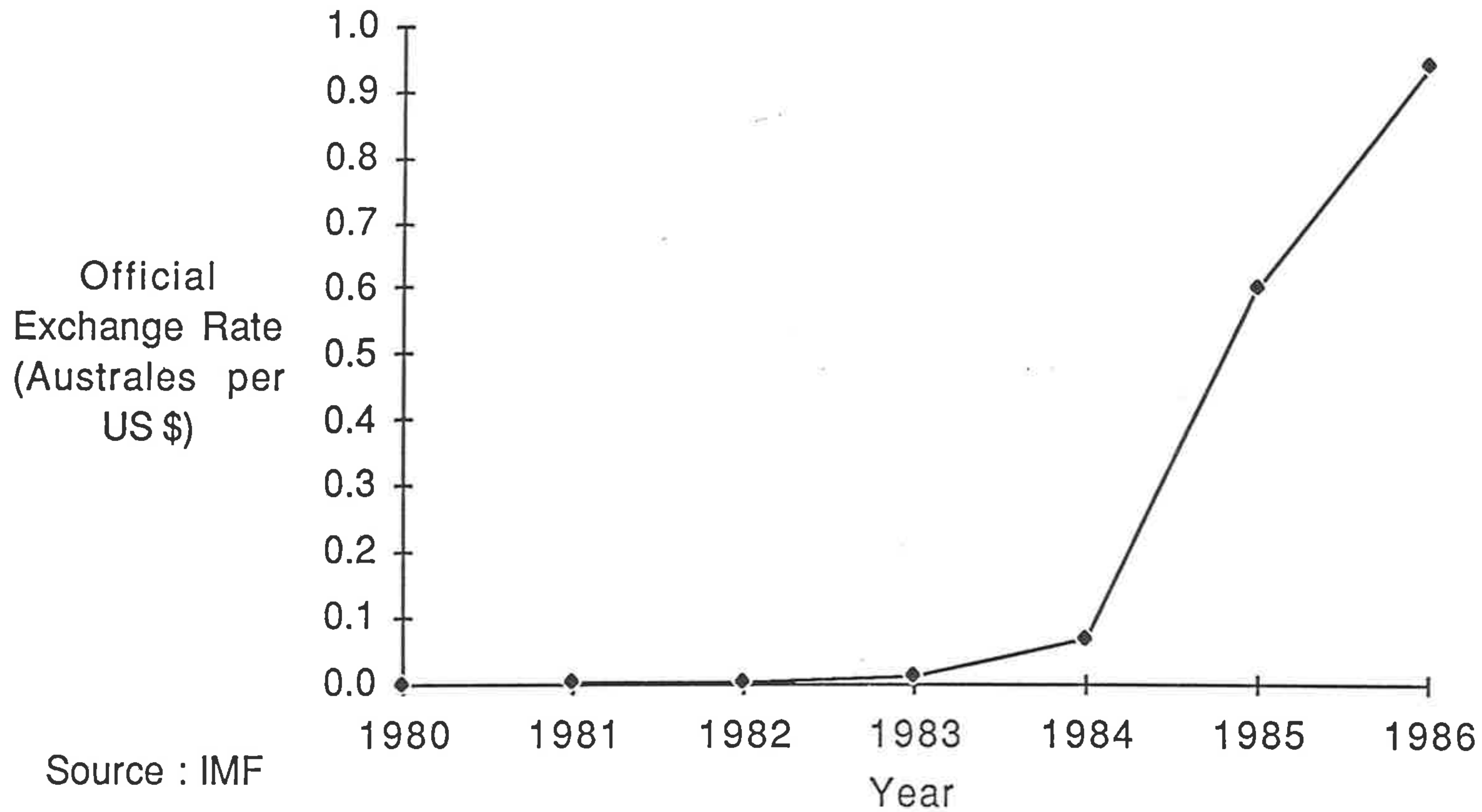
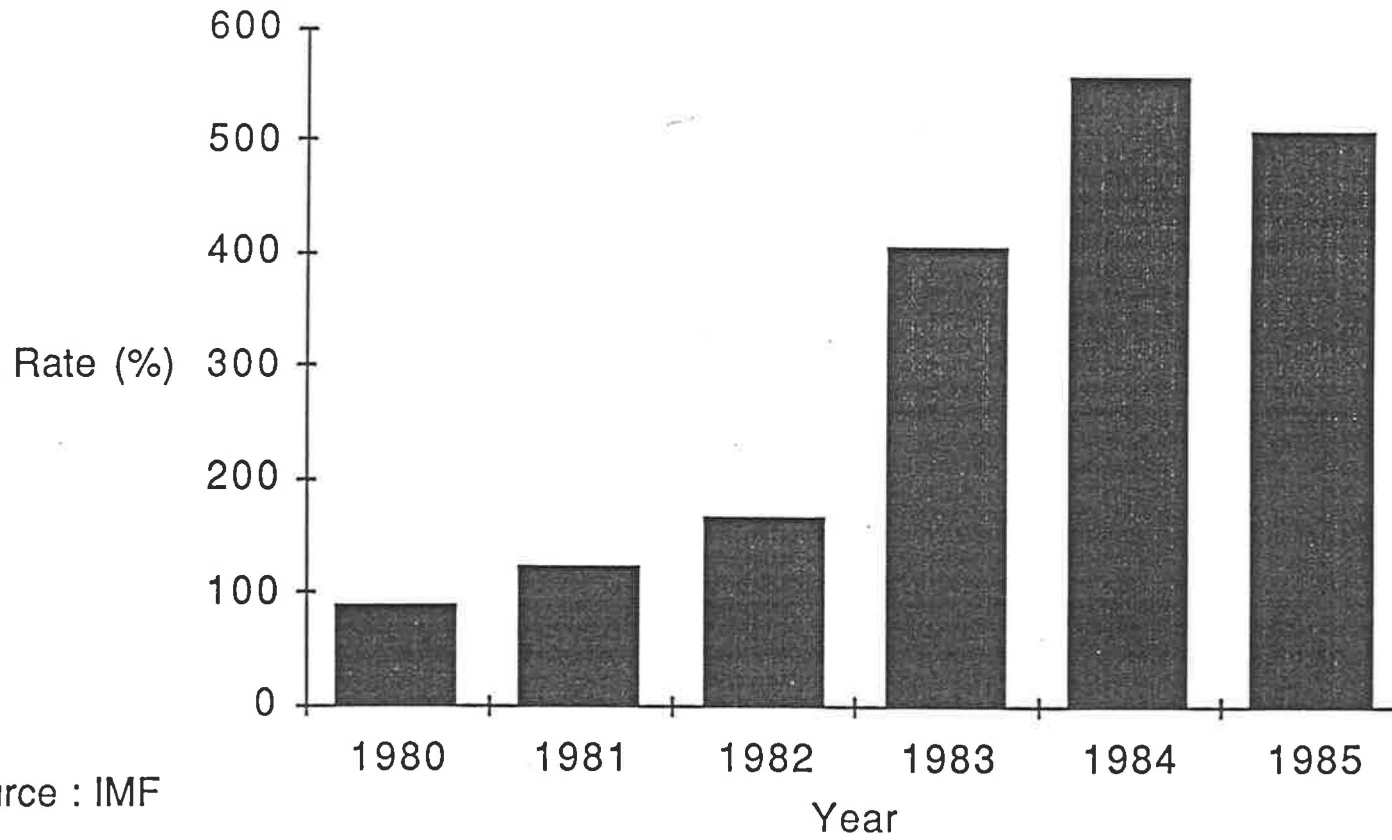


FIGURE 33

ARGENTINA - INTEREST RATES (Deposit Rate)



Source : IMF

FIGURE 34

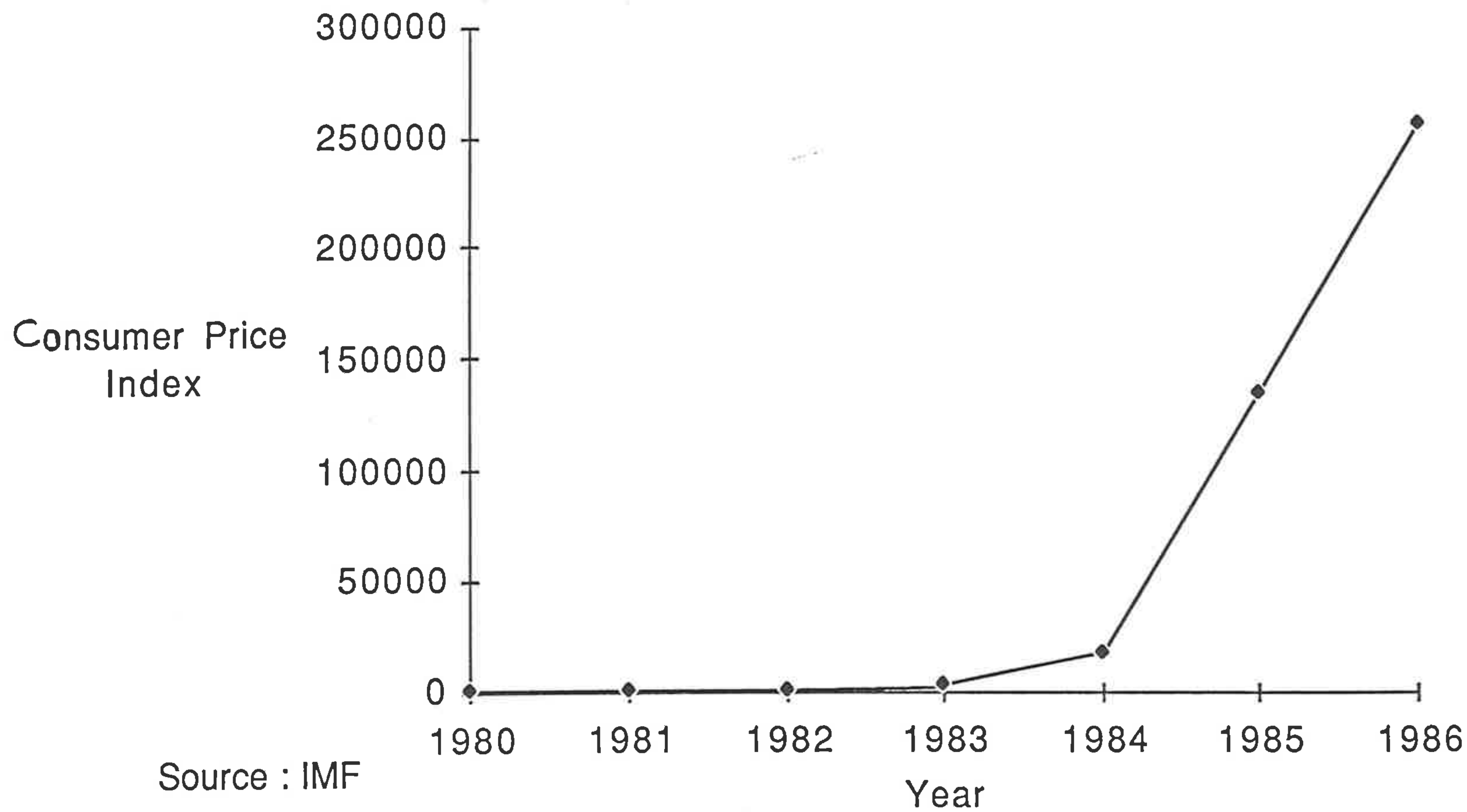


FIGURE 35

ARGENTINA - DIRECT INVESTMENT

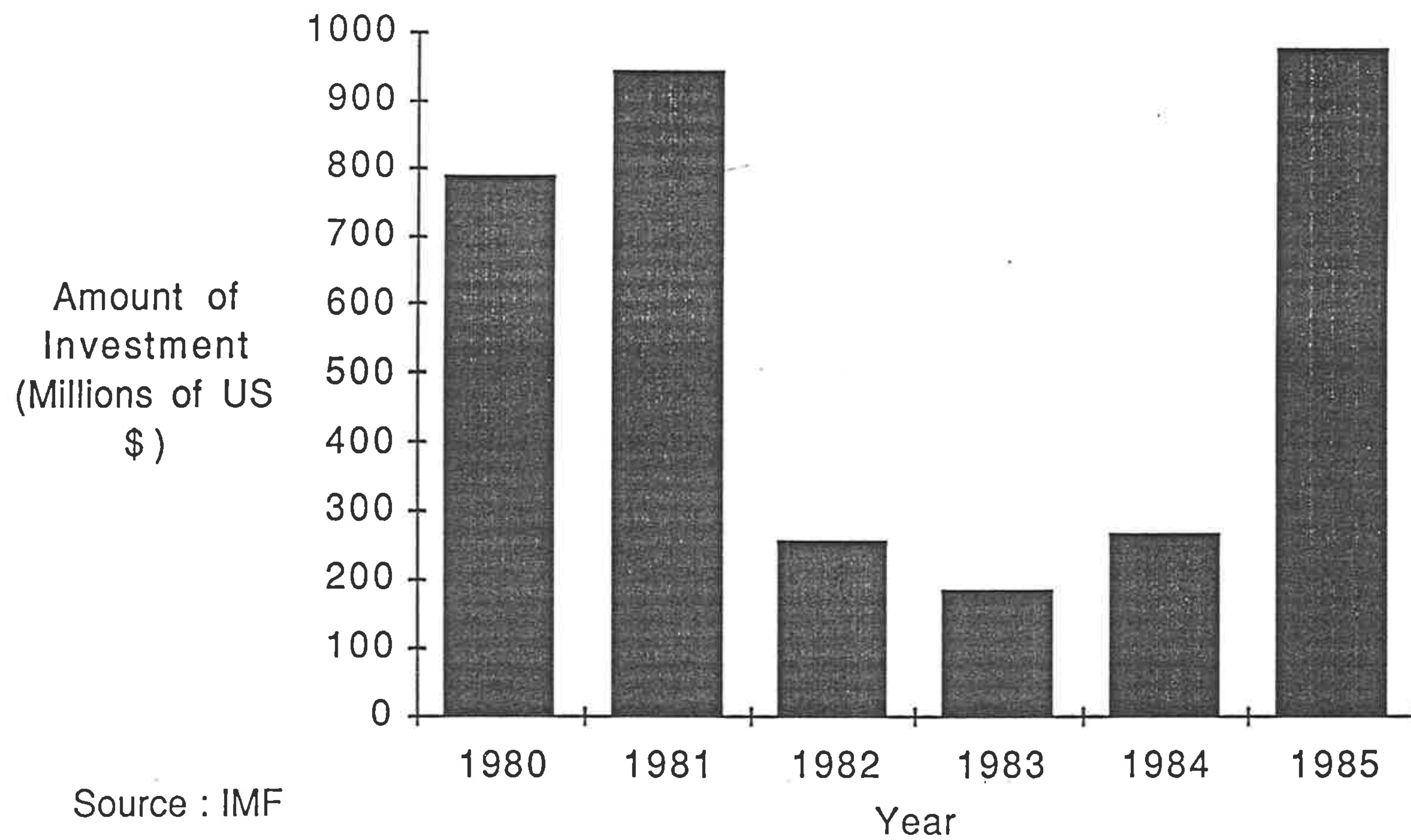
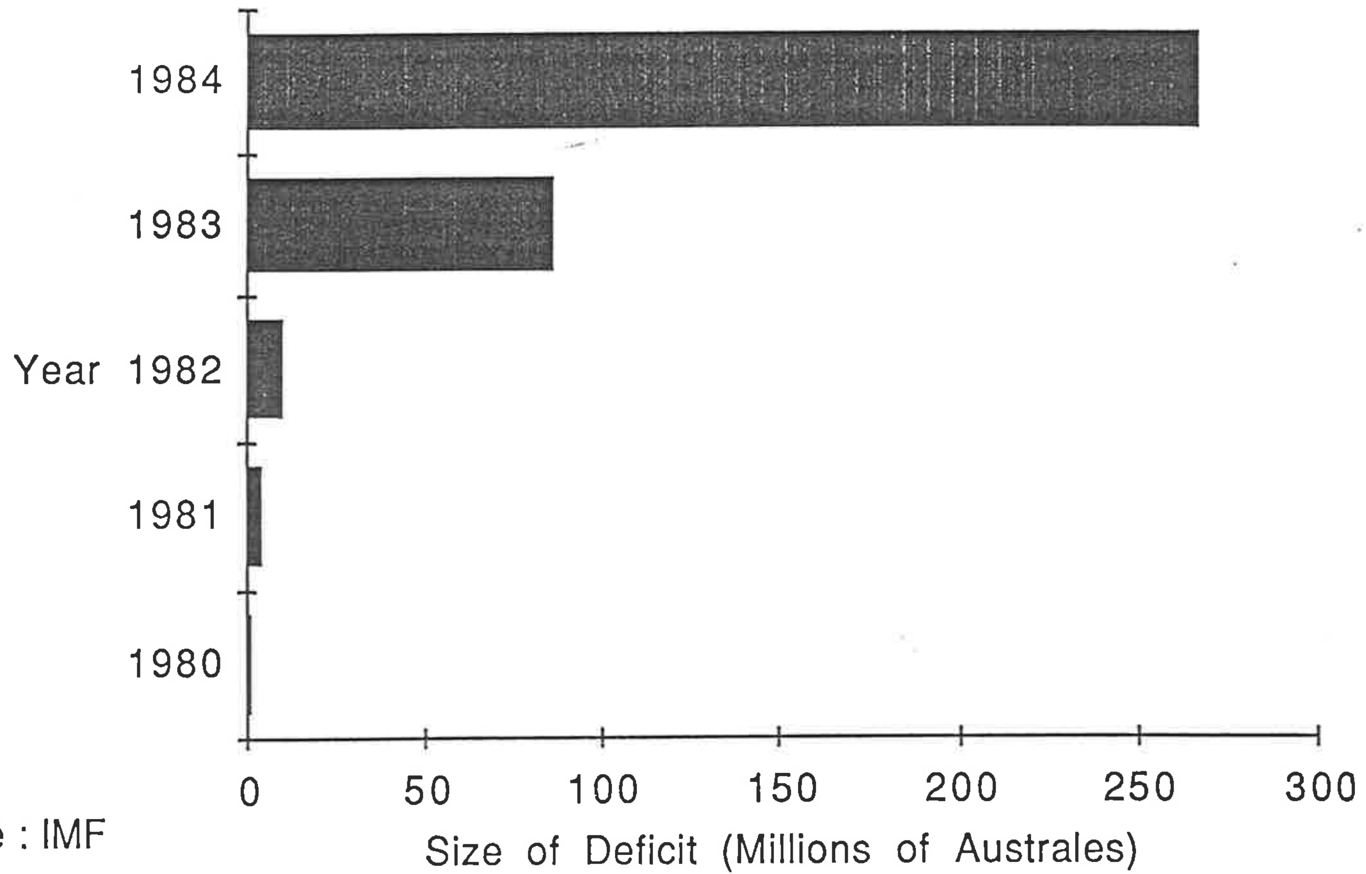


FIGURE 36

ARGENTINA - GOVERNMENT FINANCE
(Deficit)

(End Year - Dec. 31)



Source : IMF

FIGURE 37

ARGENTINA - TOTAL RESERVES (Minus Gold) End Year

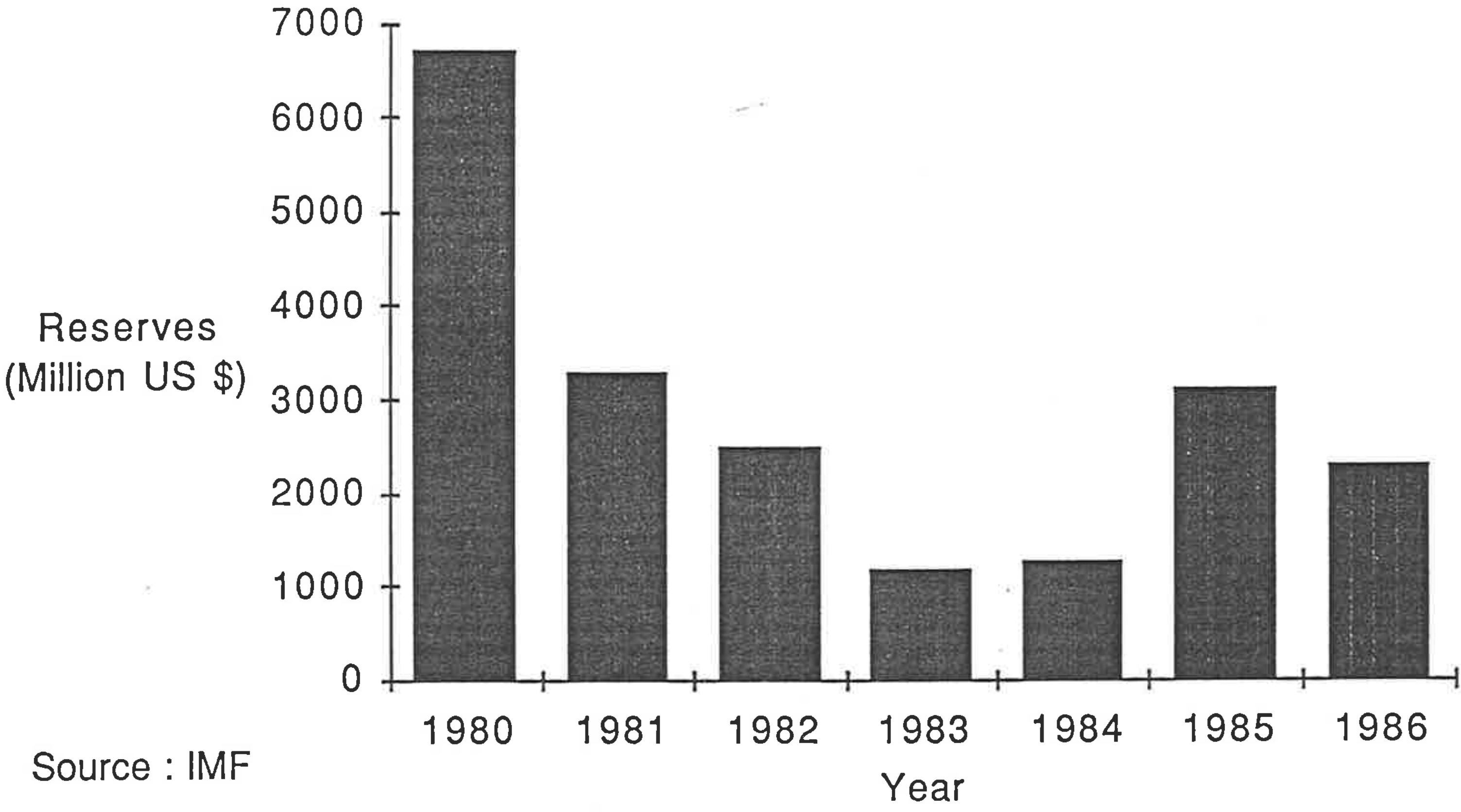


FIGURE 38

ARGENTINA - GROSS DOMESTIC PRODUCT
(1980 Prices)

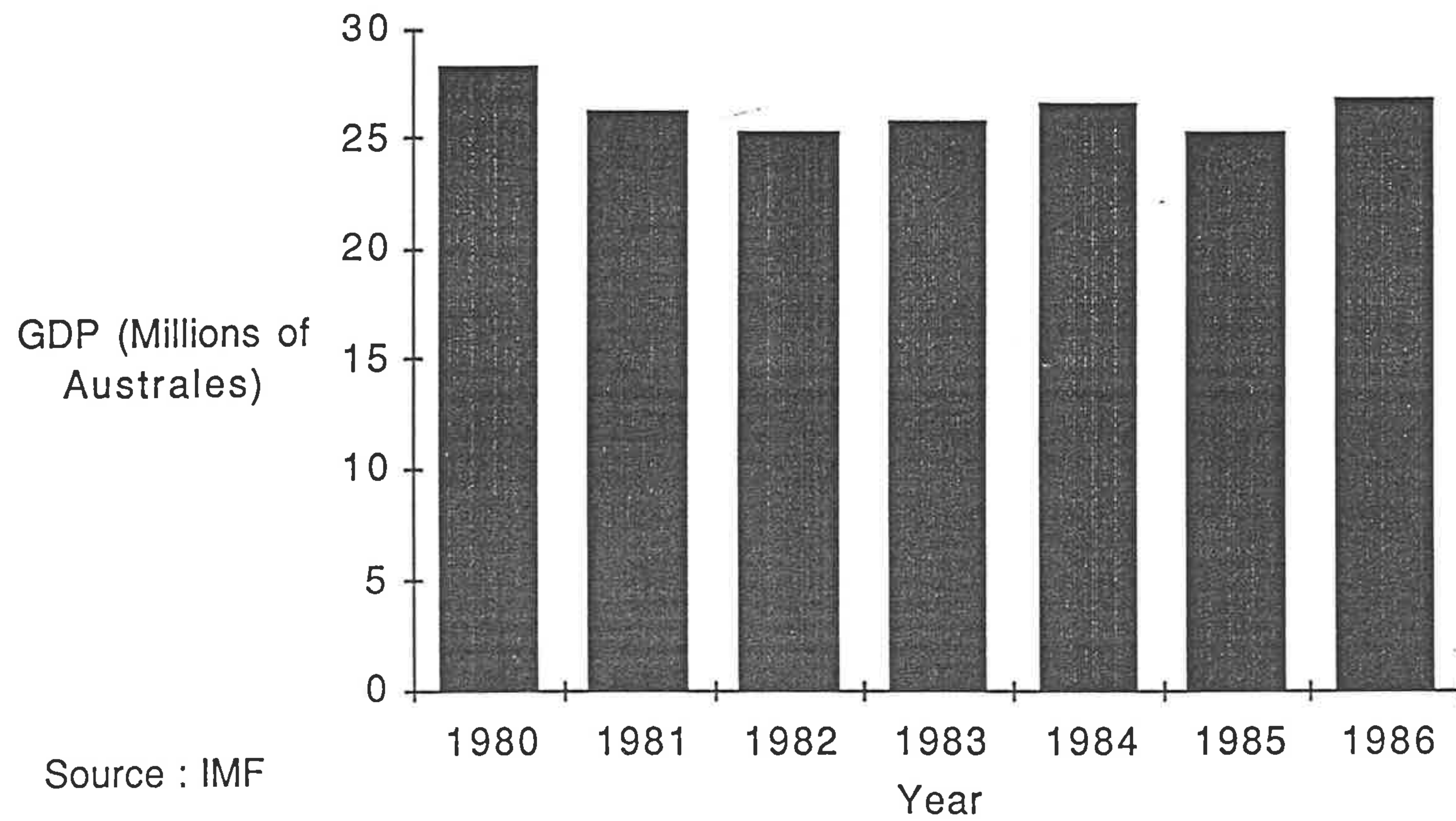


FIGURE 39

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