The Economic Journal of Nepal,Vol.9,No.4,Issue 36,October-December 1986 ⓒ DOE-TU

North-South Trade and Economic Relations: New Directions or New Disasters?

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During much of the postwar period, trade, finance, and development were viewed by most as a plus-sum game. All parties benefited, ultimately, through growing world trade and increasing real economic activity. The global economy -- bound together by increasingly complicated linkages of trade, investment, technology, and debt -- offered enormous opportunities to both industrialized and less developed countries. Even during the 1970s, when some developing countries tried to politicize economic relationships with demands for commodity cartels and large scale transfers of wealth, all nations and most constituencies within those nations sought more, rather than less, involvement in the world economy.

This may be changing in the mid-1980s. In the industrialized countries, especially the United States, many traditional advocates of free trade and globalization have discovered the short run attractions of protectionism or the way station of "fair" trade. Commercial banks are heavily criticized or even penalized for past international lending and want to define the future in their domestic markets, to the extent possible. Opinion polls regularly record growing support for measures that restrict imports. In the developing world, there seems to be a growing predilection to politicize international financial relations and paradoxically, little support for a new multilateral trade round without which increased protectionism aimed at LDC exports seems inevitable. Countries that grew rapidly in the 1970s now see little or no prospect for growth or development and blame the international system as it now functions for their bleak outlook. Apparently, governments and their constituents increasingly suspect that participation in the global economy has become a negative-sum game.

This change, which is only beginning and admittedly runs counter to the internationalizing pressures that emanate from advancing technology, nevertheless threatens the whole inter-related structure of trade, finance, and development that was born at Bretton Woods. Yet it is easier to recognize the dangers that are conjured up by the spirit of Smoot-Hawley and the resulting implosion of world trade than to reinvigorate or redefine the institutions and functional relationships among counries that constitute the global system.

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For the developing countries, it would seem that the issues are clear. Trade -- dependent on increasing access to industrial country markets and technologies -- will play the decisive role in the ultimate solution of the debt problem and, even more fundamentally, the growth problem. Almost none of the developing countries have any realistic alternative: their markets are too small, technology is changing too rapidly, and the knowledge of the gap between the quality of life in the industrialized and developing worlds (the "Dynasty" factor) too widespread to support economic autarky and political isolation.

But all cannot be exporters; some must import. The question is whether, and under what conditions, the debtor countries will be allowed to increase further their exports to creditor countries. In addition, sooner or later the creditor countries must agree to reverse the flow of financial resources if growth is to be resumed: for several years the net flow has been from debtors to creditors, which cannot be sustained indefinitely either economically or politically. The creditor countries, led by the United States, must reexamine the relationships among trade, finance, and growth and devise a strategy that optimizes the needs of creditors and debtors, exporters and importers. But this would require a renewed recognition by the United States that improved conditions are in its own immediate interests. It also probably requires that international economic institutions and arrangements, which were largely constructed in the late 1940s, be updated to reflect present economic and political realities. To the extent that this process spreads the burden of economic adjustment widely, then it is likely to be more politically sustainable. To the extent, however, that particular countries or groups bear the burden of adjustment disproportionately -- or perceive themselves as doing so -- then the process will fail.

In short, the solution to the trade and debt problems that plague North-South economic relations today must be as politically sensitive as they are economically sensible. The problems will be addressed at a time when political momentum seems already to be moving away from orthodox solutions. If this momentum is unchecked or if a new orthodoxy cannot be defined that is rooted in a renewed commitment to a global trade and finance system -- perhaps even one whose basic building blocks are bilateral rather than multilateral -- then those who believe that economic internationalism has become a negative-sum game will be proven right. And, almost inevitably, all will suffer.

This chapter reviews the evolution of North-South economic relations in the 1970s, describes current conditions in the developing world, and summarizes U.S. commercial and financial links with developing countries. Throughout this discussion the emphasis is on the interrelationship of trade and financial issues. Finally, there is consideration of broad U.S. policy options and the need to define a strategy that is compatible with U.S. political and economic resources as well as U.S. willingness to absorb the costs of economic leadership. Only a mutually beneficial set of relationships will ultimately be sustainable. The United States should reexamine its commitments from this perspective. In this context, the trade and debt problems could become

opportunities to solidify long-term economic and political relationships between the United States and key developing countries.

The alternative, which unfortunately seems to be the course on which the United States is now headed, is certainly not in the U.S. national interest. But it will take careful rethinking to change direction.

THE 1970s AND THEIR CONSEQUENCE

Part of the reason for the failure of the North-South dialogue of a decade ago -- which many attempted to turn into a North-South confrontation -- was the great diversity of the developing countries. Differences of economic structure, resource endowment, political orientation, and stages of development made dialogue among the developing countries almost as difficult as between the industrailized and developing worlds. The resulting largely sterile, debate kept many bureaucrats and a few journalists busy, but did little of affect the evolving shape of North-South economic relations.

Indeed, by the early 1980s the reality of the interrelationships between North and South had advanced well beyond some of the more extreme demands of 10 or 12 years ago. Under the guise of debt, direct investment, and imports there was a massive transfer of financial resources from the industrial to the developing countries. At the same time, markets were opened and LDC exports rose dramatically. The twin stimuli of massive borrowing and rapid export growth fueled much stronger then expected economic growth despite the oil shocks of the 1970s and generally poor economic performance in the industrial countries.

Ultimately, of course, sustained economic growth is the best measure of the success or failure of the whole matrix of economic policies, development strategies, and North-South interaction. And, during the 1970s, most developing countries grew rapidly, both in absolute and in per capita terms. According to World Bank data, developing country gross domestic product (GDP) increased 5.5 percent on average during 1973-1980, while per capita GNP grew 3.3 percent per year. (See Table 1). Economic growth was strongest among exporters of oil and manufacturers and stronger in East Asia than in Latin America.

Of course there were important differences among countries. Some, especially in East Asia, relied heavily on exports -- particularly of manufactured goods -- as the major engine of growth, pursued generally conservative monetary and fiscal policies, maintained competitive excahnge rates, and favoured foreign investment instead of debt. The large Latin American countries, in contrast, developed a kind of state socialism with public sector enterprises dominating key industries, remained more dependent on the export of primary goods, favoured import substitution over export promotion, pursued loose fiscal and monetary policies that laid the groundwork for progressively higher (and eventually hyper) inflation, allowed exchange rates to become overvalued, and borrowed heavily from the international banking system.

Table 1
Economic Growth Rates, 1973-1980 (Average Percentage change)

	GDP	GNP per capita
Developing countries	5.5	3.3
Low income	4.9	3.1
Middle income oil importers	5.6	3.1
East Asia	8.1	5.7
Latin America	5.4	2.9
Southern Europe	4.8	2.2
Middle income oil exporters	5.8	3.1
High income oil exporters	7.7	6.2

Source: International Bank for Reconstruction and Development.

The differences in performance in Asia and Latin America in the years before the debt crisis are also evident in the balance of payments. Over the past two decades the export performance of most of the largest Asian developing economies exceeded the growth of world trade. By contrast, Latin American exports tended to grow more slowly and less than the increase in world trade. In addition -- and part of the explanation for the better performance in Asia -- exports of manufactured goods have been more dynamic in Asia than in Latin America. (See Table 2). According to data compiled by Morgan Guaranty, the share of manufactured goods in total Latin American exports rose from 11 percent in 1970-1972 to 16 percent in 1980-1982; in Asia (excluding China) the share rose from 48 percent to 54 percent.

Table 2
Growth of Merchandise Trade (Average percent change in export volumes)

	1960-1970	1970-1982
Asia		
Hong Kong	12.7	9.4
Indonesia	3.5	4.4
Korea	34.7	20.2
Malaysia	6.1	3.8
Philippines	2.3	7.9
Singapore	4.2	12.0
Taiwan	18.4	17.9
Thailand	5.2	9.1
Latin American		
Argentina	3.8	8.3
Brazil	5.3	8.8
Chile	0.7	9.5
Colombia	2.6	2.2
Ecuador	2.8	- 1.3
Mexico	3.4	8.6
Peru	2.1	4.8
Venezuela	1.1	- 7.2
Industrialized countries	8.5	5.6

*Source: International Bank for Reconstruction and Development.

Trade in manufactures has grown more rapidly than in commodities in recent decades, and prices have been more stable. Thus, Latin America's failure to develop its potential to produce and export manufactured goods and its continued reliance on commodities (including processed commodities) have contributed to its slower and more variable export growth.

In addition, the Latin American countries ran larger current account deficits and depended more heavily on foreign borrowing to finance these deficits and to supplement domestic savings. The result was the accumulation of large foreign debts, in some cases in excess of a country's ability to repay or even to service. In 1980 the foreign debt of Asian economies was $228 billion, which grew to $360 billion in 1985. In Asia only the Philippines, which followed development strategies more similar to the countries of Latin American than of the Far East, has been caught up in the full intensity of the debt crisis of the last several years. Other countries, despite large debts, have been able to maintain their access to international financial markets through the implementation of prudent economic policies and the maintenance of strong export growth. In contrast, all of the Latin American countries to some degree have been affected by the debt crisis.

LDCs in Asia and Africa have also been affected, although the debt crisis is only one of the factors contributing to their economic decline. Declining terms of trade, economic mismanagement, failure to encourage development of agriculture, drought, political instability, and inadequate capital inflows have all contributed to economic stagnation or decline. (See Table 3). In sharp contrast, China and India in the last several

Table 3
Estimated Foreign Debt of Selected Debtors
(& billions)

	1980	1985
Brazil	63.5	104.5
Mexico	58.5	97.9
Argentina	27.2	50.8
South Korea	27.3	46.7
Indonesia	18.9	35.9
Egypt	19.8	28.1
Venezuela	31.1	32.6
Philippines	17.3	27.4
Chile	12.3	21.2
Malaysia	6.0	21.0

Source: Institute of International Finance; various national sources.

years have begun to reorient their economic policies, introducing market incentives and liberalizing government control of economic decision making. Although both countries are still in the early stages of reversing long entrenched, inward looking economic practices, both countries are already experiencing relatively strong growth, despite international conditions that other developing countries describe as a block to economic progress. (See, for example, the "Declaration of Montevideo," issued by the major Latin American debtors in December 1975). A key precondition for the kind of economic development and growth that now seems to be occurring in both has been structural improvements in the agricultural sectors; in both cases, dramatic increases in agricultural output have reduced economic cyclicality and encouraged (or allowed) the government to pursue and broaden economic reform programs.

The most visible economic effects of the debt crisis have been dramatic improvements in countries' external payments positions and balance sheets and significant deterioration in their economic performance. The reduction in the current account deficit of all developing countries (from $99.6 billion in 1982 to $43.9 billion in 1984) and particularly of highly indebted ones (from $112.6 billion in 1981 to $37.9 billion in 1984) has been remarkable. This external adjustment initially reflected a sharp decline in imports. Exports grew strongly in 1984 but, with slower growth in industrialized countries, lower oil and non-oil commodity prices, and increased protectionism, stagnated in 1985.

The loss in economic activity and the acceleration in inflation have also been remarkable. Overall, real GDP in Latin America increased by only 2.3 percent between the end of 1980 and the end of 1985; excluding Brazil (which grew rapidly in 1985, at the cost of sharply rising inflation and, probably, of lower future economic growth), the rest of Latin America declined by 0.4 percent. During the same years real per capita GDP fell by a cumulative 9 percent (more than 11 percent excluding Brazil). The drop in economic activity has had profound social consequences, especially in countries that have highly skewed income distributions; as documented by the World Bank and the Inter-American Development Bank, most measures of living standards have dropped sharply since the crisis began.

Despite the balance of payments improvements and the consequent slowdown in the growth of debt accumulation, after several years of effort no country in Latin America claims that its economic strategy has really worked. This is as much the fault of poor execution -- economic adjustment programs have been implemented so inconsistently that inflation is generally higher and the outlook for growth generally lower than at the beginning of the debt crisis -- as it is of inadequate financial resources -- in 1985 commercial bank exposure to developing countries apparently fell. (See Table 4). The net flow of financial resources (defined as loans, investments, interest payments, and profit remittances) has been strongly from debtors to creditors: the Economic Commission for Latin America and the Caribbean has estimated that the transfer of financial resources from Latin American countries to their creditors totaled $106 billion during 1982-1985. Adding capital flight, which represents movement of Latin American capital to the United States and other safe,

Table 4
Latin America: Growth and Inflation

	Per Capita GDP from 1980-1981 peak to 1985 (% change)	Consumer Prices (% change, most recent 12 months)
Argentina	-17.1	826
Brazil	-5.6	220
Chile	-14.4	37
Mexico	-9.4	56
Peru	-13.7	192
Venezuela	-17.1	13

Source: Morgan Guaranty, "World Financial Markets," September-October 1985.

or at least profitable, havens, would dramatically increase the total outflow. Industrial country protectionist action aimed at LDC exports have contributed to the problem and, perhaps more important, to developing country resentment of creditors. In these circumstances democratically elected governments are increasingly hard pressed to maintain stabilization programs; the LMF, the banks, and "austerity" became convenient political targets. One consequence has been the beginning of a search for unorthodox economic strategies in several of the debtor countries (Argentina, Peru, and to a lesser extent, Brazil); another has been to raise concerns among creditor governments and banks that a new strategy is needed to cope with the debt problem.

In this environment U.S. Secretary of the Treasury James Baker unveiled his debt initiative in October 1985. The so-called Baker Plan recognized that continued debt service depends on renewed economic growth, and the plan met, at least partially, the debtor countries' demands for a political response from the United States to their situation. The substance of the Baker Plan, however, is modest, renewed adjustment efforts by the debtors and some new lending by commercial and development banks (much less than projected debt service payments by the countries). The debtor countries, as well as many nongovernment analysts, view the resources called for by the Baker Plan as inadequate to the problem of reinvigorating sustained growth. Mexico alone could absorb most of the new bank lending that the plan envisioned ($20 billion over three years) if oil prices continue to decline.

The result seems to be that debtors are becoming even more frustrated with the existing system and more likely to adopt confrontational strategies aimed at creating the conditions for renewed economic growth or at least in satisfying the short-term political demands of their citizens. These include rejection of the IMF as the arbiter of appropriate economic policies, unilateral deferment of "excess" interest charges (with "excess" defined as the difference between the nominal and the long-run real interest rate), or the imposition of a payments cap tied to a specified share

of export earnings. Any of these would have significant impact on the international financial system and, more particularly, on the creditor banks.

There is another specter on the horizon: that the debt crisis that has largely been a phenomenon of Latin America could spread to previously unaffected countries in Asia. (As noted earlier, the financial situation in Africa is widely recognized as part of a much broader economic and political crisis, which involves the basic survival of peoples if not countries.)

Several of the Asian debtors are highly dependent on continued strong export growth (especially Korea, Taiwan, and Singapore) and no more than minimal further declines in oil and non-oil commodity prices. If recession or protection reduces U.S. imports or if commodity prices fall -- a U.S. recession in 1986-1987 would almost certainly push the price of many commodities sharply lower, even if the dollar fell at the same time -- then the debt crisis could again spread as it did in 1983. Sharp declines in oil prices early in 1986 have raised new concerns about the ability of countries like Indonesia and Malaysia (as well as Egypt, Algeria, countries like Indonesia and Malaysia (as well as Egypt, Algeria, etc.) to sustain their scheduled debt service.

The debt crisis is obviously one legacy of the poor economic management of the 1970s. In a sense, the growing rhetoric and, increasingly, the reality of industrial country protectionism aimed at LDC-produced exports is another. GATT has estimated that 30 percent to 40 percent of total non-oil developing country exports are under restraints in industrial country markets; almost 40 percent of the exports of the five debtors consist of "sensitive" products, which are affected by some kind of restriction in creditor countries. The major trade restrictions faced by developing nations are nontariff barriers, especially as the Tokyo Round tariff cuts are implemented. World Bank data indicate that, in 83, 20 percent of the industrial country imports from the developing countries were subject to nontariff barriers, including 21.8 percent of LDC imports sold in the EC, 12.9 percent sold in the United States, and 10.5 percent in Japan. In 1985 many new protectionist measures were taken, although in light of the continuing very high import and import penetration levels, at least in the United States, it is safe to say that the actual level of protection is not as great as is the potential for future trade restriction measures.

At the same time, it is important to recognize that developing country trade policies, perhaps with more justification than in industrial countries, have tended to be highly protectionist. Following the onset of the debt crisis in 1982, many debt-impacted countries adopted policies to reduce their imports -- including licenses, outright prohibitions, prior approval schemes, and restrictions on the availability of import finance. Along with the sharp decline in economic activity and in exchange rate levels, the result was a dramatic drop in imports: for Latin America as a whole, imports fell $42 billion between 1981 and 1983. Although there was some recovery in 1984-1985 (reflecting limited

economic recovery and slower exchange rate depreciation or even appreciation in real terms), imports declined again in 1985 (both the value and volume of Latin American imports in 1985 stood at only 64 percent of 1980 levels); import levels in Latin America and all over debt-impacted countries remain well below peak levels. Because overall GDP has increased marginally over the same period, there clearly has been some import substitution, and, because economic activity in most debtor countries remains depressed, it is not yet apparent whether the changes in import intensity are structured or cyclical.

The debt crisis provided a degree of macroeconomic justification for LDC protectionism: the need to reduce payments deficits dramatically and quickly encouraged the use of both market and administrative mechanism. In addition, many developing countries, even the rapidly industrializing ones that are already competitive exporters across a range of increasingly sophisticated products, insist on protecting domestic industries to encourage their development or to protect entrenched business and political interests. Brazil, for example, has legislated a highly protectionist informatics law, which, although it could isolate the country from new technological developments in the telecommunications field, benefits certain local producers and reinforces strongly held nationalistic political preferences.

Regardless of its justification, LDC protectionism, combined with aggressive export promotion, forms a kind of modern day mercantilism: this increases protectionist inclinations in the United States especially at a time when U.S. exports and export jobs are under enormous pressure.

Countries must export to avoid financial problems, however, generating enough revenue to maintain both debt service and bankers' goodwill--or at least to cope with them. Indeed, a caricature of the economic model that helped Asia largely to avoid the debt crisis forms the basis of the orthodoxprescription for financial and economic stabilization in Latin America. The Latin debtors are being advised to reorient economic policy to encourage exports, to dismantle inefficient public sector enterprises, to increase savings and to channel local savings more effectively into productive investment, to discipline fiscal and monetary policies, to relax price and wage restraints, and, in general, to rely on free market mechanisms to allocate resources. In practice this often translates into export promotion or even subsidization as well as import substitution because of the lack of available foreign exchange, because of the short-run political imperative to protect indigenous jobs and business interests, and because of the effects of rapid exchange rate devaluations on import costs. Nevertheless, the intent and--in recent years, the effect--has been to increase LDC exports and export market shares.

The theory that Latin America's (or, more generally, the developing world's) future effectively lies in imitation of what might be called the Korean miracle is not unchallenged. Some development economists have begun to point out that the relationship between export growth

and overall economic growth may not always be as strong as in the leading Asian economies: "...the true impact of more rapid export growth ... is typically between 0.1 and 0.2 percentage points of aggregate growth for each percentage point of export growth, with a smaller elasticity as other causal variables are added."[1] And there are--or should be--serious questions about the political and social consequences of switching to Korean style economics in countries with very different resources, histories, institutions, and structures. For example, shifting to a more export-intensive strategy is likely to reinforce the already skewed distribution of income in a country like Mexico. Nevertheless, the conventional wisdom, strongly supported by the World Bank, the IMF, and almost all creditor and debtor governments, is that the developing world must increasingly become more export oriented.

Of course there are important differences in the ways in which debtors have been treated. From the beginning of the crisis it has been clear that the financial and economic health of large debtors like Argentina, Brazil, and Mexico are far more important to the maintenance of stable international financial conditions than the condition of small debtors. As a result, the former have attracted the bulk of the attention of creditor country policymakers and, far more important, the largest share of what new financial flows have been available. The consequence for the small debtors has been even less credit and poorer recovery prospects. In some cases, partly because of their own extreme mismanagement but also because of adverse economic conditions, countries that previously had some access to the international capital markets such as Sudan, Bolivia, and maybe Jamaica seem permanently cut off. These countries appear to be caught in a vicious cycle of bad management, weak export demand or low export prices, high interest rates, payments arrears, inability to borrow from private or public sources, lack of essential imports, and political instability. The result is economic decline.

Although this has important consequences for the countries as well as their creditors and trading partners, however, it does not seem to have much impact on the overall financial system. For the system as a whole--and, perhaps more important, for the policymakers of the major creditor institutions--it seems to be only the condition of the largest debtors that matters.

From the onset of the debt crisis in 1982, the strategy promoted by creditors and more or less accepted by debtors has been flawed by an apparent contradiction: unless world trade growth could be sustained at a very high level (implying historically high rates of industrial country growth), the more successfully the system coped with the debt crisis, the more intense would become protectionist pressures in the industrial countries. In this sense, the "cost" of managing the debt crisis was being shifted from creditor to debtor to industrial country manufacturers and producers who become the objects of LDC mercantilism.

This problem has been compounded by the macroeconomic realities of the last several years. Strong growth and the appreciating dollar --fueled by an unconventional mix of loose fiscal and tight monetary

policies--produced a nearly insatiable demand for imports in the United States. U.S. imports rose from $250 billion in 1980 to some $340 billion in 1985. More significant, imports have accounted for a progressively larger share of the U.S. market: the import share of domestic goods purchases was 7 percent in 1970, 11 percent in 1980 and more than 14 percent in 1984; import penetration in manufactures rose from 8 percent in 1970 to little less than 19 percent in 1984. Particularly over the last five years a major part of this increase was due to manufactured imports from developing countries: almost half of the increase in import penetration since 1980 has been due to growing purchases from the developing world. Although rising import penetration characterizes most mature industrial economies --Japan is a notable exception in which import penetration in manufacturers has remained stable well under 10 percent for the past 10 years--the rate of increase in the United States has been unusually rapid.

U.S. COMMERCIAL AND FINANCIAL RELATIONSHIPS

In this context, the U.S. trade and current account deficits were the necessary counterparts to the debt management strategy, allowing the debtor countries to expand export sales rapidly in a single market. According to UN data, U.S. imports from Latin America increased from $38.4 billion in 1980 to $49.2 billion in 1984; at the same time U.S. exports fell from $38.4 billion to $29.5 billion. U.S. imports from East Asia rose from $22.4 billion to $35.8 billion; exports increased only from $15.8 billion to $18.3 billion. Together those trade movements accounted for a $30.6 billion shift in the U.S. trade deficit. (See Table 5).

Table 5
Industrial Country Import Patterns* ($ billion)

	1980	1982	1984
Total imports from Latin America and East Asia	134.7	130.7	142.5
United States	60.8	62.6	85.0
Other Industrial Countries	73.9	68.1	57.5
Manufactured Imports	45.7	48.0	63.8
United States	23.0	27.5	45.1
Other Industrial Countries	22.7	20.5	18.7
Imports from Latin America	69.8	69.0	71.8
United States	38.4	39.1	49.2
Other Industrial Countries	31.4	29.9	22.6
Imports from East Asia	64.9	61.7	70.7
United States	22.4	23.5	35.8
Other Industrial Countries	42.5	38.2	34.9

Sources: U.S. Department of Commerce; UN Trade Data System.

*Latin America includes Mexico, South America, the Caribbean; East Asia includes the Association of Southeast Asian Nations (ASEAN), South Korea, Hong Kong, manufactures includes SITC codes 5 through 9.

Overall, U.S. imports from Latin America and East Asia increased almost $25 billion between 1980 and 1984; almost three-quarters of this was accounted for by manufacturers as commodity prices--and expenditures on commodities--fell. (These countries supplied roughly one-fifth of U.S. manufactures imports in 1984). At the same time that U.S. markets were absorbing these dramatic increases in imports, however, LDC exports to other industrial countries were actually falling. Total exports from Latin America and East Asia into industrialized countries other than the United States declined by some $16 billion, including a $4 billion drop in manufactures; the decline was split roughly evenly between Asia and Latin America. In 1984 more than 80 percent of U.S. imports from East Asia consisted of manufactures; only 35 percent of imports from Latin America were manufactures.

This shift in trading patterns reflected the relative dynamism of the U.S. economy, more effective European and Japanese protectionism, the improving quality and low cost of LDC manufactured products, and, of course, aggressive developing country export efforts, which in some cases included policies that are counter to GATT rules. (Because so many developing countries with important U.S. trading relationships effectively peg their currencies to the dollar, the general dollar strength of the past several years has probably had limited impact on LDC developed country trading patterns). One result has been to make some developing countries more sensitive to shifts in U.S. economic conditions. As an example, approximately 35 percent of Korea's exports come to the United States--and exports account for half of Korea's GNP.

Another result, of course, has been for developing countries to capture important segments of the U.S. market. According to U.S. Commerce Department data, in 1983 the major East Asian economies supplied 60 percent of U.S. clothing imports, 27 percent of its electrical machinery, 12 percent of its nonelectrical machinery, and 53 percent of its footwear. The list of individual products in which imports from East Asia have been concentrated include electronic components, televisions, tape recorders, toys, calculators, and computers. Latin American exports of manufactures are more diffuse: the largest concentration in 1983 was in footwear, accounting for 20 percent of U.S. imports. Although 1985 data by country and commodity are not readily available, these shares have almost certainly all increased.

Of course, the economic relationship between North and South and, more particularly, between the United States and the developing world, consists of more than just trade flows. Service transactions, public and private transfers, bank loans, and direct investment are among the principal links that can offset or reinforce the effects of trade imbalances. Because service industries such as banking, insurance, information services, telecommunications, and the law tend to be more sophisticated and more technologically advanced in the industrial countries, efforts to export services to the developing world have intensified in recent years. Because of the political sensitivity of some of these industries, the desire to develop indigenous industries, and the drive to protect existing, often inefficient, but usually highly

profitable producers (especially in banking), many developing countries have been reluctant to open their markets to foreign competition.

Part of the difficulty in responding to LDC service protectionism has been the diffuse nature of service industries and, consequently, of the restrictions that are imposed. These can range from outright prohibitions--many countries do not allow foreign banks to establish branch offices--to heavy licensing or disclosure requirements that make business impractical.

Nevertheless, U.S. service earnings from the developing world are increasingly important in the balance of payments. In 1984, such inflows totaled $62 billion; the net flow was $7.4 billion. The largest part of the inflow consisted of interest payments.

The United States has been a major provider of finance to the developing world, especially over the past decade. U.S. direct foreign investment in developing countries was $54 billion in 1984. More than half of that total was concentrated in Latin America, especially in Brazil (9.6 billion) and Mexico ($5.4 billion). Direct foreign investment in East and Southeast Asia totaled about $16 billion, including $3.8 billion in Hong Kong and $2.2 billion in Singapore. According to U.S. Commerce Department data, 34 percent of U.S. investment in the developing world in 1984 was in the petroleum sector and 37 percent in manufacturing, with the largest concentration in chemicals. (See Table 6).

Table 6

U.S. Direct Foreign Investment, 1984 ($ billions)

	Total	Manufacturing	Petroleum	Trade
Developed countries	174.1	72.9	40.6	24.1
Developing countries	53.9	20.1	18.4	6.5
Latin America	28.1	15.7	5.9	4.0
Africa	6.2	0.5	4.5	-
Middle East	3.4	0.3	1.2	0.5
Asia	16.2	3.7	6.8	2.0
International	5.4	-	4.3	-

Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, August 1985.

Unfortunately, U.S. foreign investment positions are dwarfed by the foreign exposure positions of U.S. commercial banks. (See Table 7). Too many countries have relied excessively on debt rather than equity to finance their growth and development. In many cases countries apparently relied on large scale borrowing because it was easier to arrange, did not challenge entrenched local business interests, and could be used by national authorities with great flexibility to cover budget and payments deficits. As a result, however, countries accumulated debt burdens considerably in excess of their capacity to service them, on terms that were

Table 7

U.S. Bank Exposure to Major Debtors* ($ billions)

Mexico	25.4	Chile	6.3
Brazil	24.7	Philippines	5.2
South Korea	10.6	Hong Kong	3.4
Argentina	8.5	Indonesia	2.9
Venezuela	10.3	Taiwan	3.0

Source: Federal Financial Institutions Examination Council.

*As of June 1985. Adjusted for guarantees.

(and are) entirely unrealistic, and without enhancing their foreign exchange earnings capacity. Some countries in effect used their foreign borrowing to finance overvalued exchange rates, unsustainable rates of consumption growth, massive capital flight (particularly in Argentina, Mexico, and Venezuela), and highly inefficient government industries.

At the end of the first quarter of 1985, U.S. bank exposure to the developing world totaled $135.3 billion. Although the largest part of this is concentrated in Latin America ($83.7), there has also been significant lending in Asia ($36.8 billion). The largest borrowers from U.S. banks are Mexico ($25.4 billion), Brazil ($24.7 billion), and South Korea ($10.6 billion).

DIRECT INVESTMENT

Many countries, especially some of those in East and Southeast Asia, have encouraged foreign investment inflows to greater or lesser extent. Relative political stability, consistent economic policies, well motivated and cheap labour forces, limited demands for technology transfer, tax benefits, access to foreign exchange, liberal--or at least open--profit repatriation systems, patent and trademark protection, access to domestic credit and capital markets, the possibility of maintaining effective parent control regardless of joint venture requirements, and legal recourse can all contribute to increased foreign investment inflows. Many countries have deliberately discouraged or prohibited foreign investment, however, such as Korea, or maintained policies that prevent foreign investment from growing too rapidly, such as the insistence on majority domestic ownership, and the imposition of unreasonably high domestic value-added requirements.

Restrictions that affect foreign investment flows--a kind of capital account protectionism--fall only indirectly under the auspices of the multilateral institutions. The IMF, charged with maintaining a free payments system, criticizes restrictions but does not tend to focus more on promoting trade liberalization than on encouraging lowering of investment barriers. Recently the U.S. government has begun criticizing such policies as part of it strategy to resolve the debt crisis, but without much success.

During the last several years there has been an important innovation in the strategies of some multinationals, which may affect investment flows as well as trading patterns. Companies have begun to enter into coproduction projects, often in partnerships with local investors, to supply components from several countries for assembly in another, and have begun to market worldwide. Generally, some part of this process occurs in the United States, but the imported component's lower cost and the global marketing strategy opens new export markets for the U.S. companies. The automobile companies, with their "world car" concepts, have been among the leaders in implementing such strategies. This approach allows companies to take advantage of various national comparative advantages in producing a single product and to reduce import resistance by sourcing at least part of the product locally.

If this approach to the international market becomes more widespread or if U.S. producers come to rely on foreign components or foreign production for major parts of their product lines (for example, sourcing certain lower price models in low wage countries), it will eventually impose a constraint on U.S. trade policy and the trade policies of other nations. Import surcharges, quotas, and other restrictions will increasingly affect not only foreign companies but domestic companies as well. Put another way, some U.S. multinationals, in light of the realities of the high costs of producing in the United States, are responding by globalizing--which presumes the maintenance of an open trading system. Whether this is a miscalculation or whether this shift can contribute to keeping the system open will only gradually be known.

Regardless of the form or motivation, foreign direct investment could play an important role in financing future growth in the developing world, although such flows are unlikely to cover a very significant part of any country's external deficit or internal investment needs. Nevertheless, foreign investment will increase only in an environment of prudent and consistent economic policy that--if adequately financed --is the precondition to solving the debt crisis ultimately.

U.S. POLICY OPTIONS

The extensive financial and economic interrelationships between the United States and the developing world create a need to develop mutually beneficial ways to manage,--or preferably resolve--the problems of inadequate growth in the LDCs, self-reinforcing (and self-defeating) protectionism, and financial instability. The prevailing view in U.S. policy circles seems to reflect a clear preference to reinforce the multilateral system created at Bretton Woods, relying on the IMF, IBRD, and GATT as the basic vehicles for promoting financial discipline, economic development, and open markets. This, of course, is consistent with the dominant economic philosophy of the last-40 years that was predicted on an assumption of globally open markets for goods and capital, with the United States as the system's ultimate guarantor (as well as its greatest beneficiary) because of the dominance of the U.S. economy. Moreover, this approach in theory should spread the costs of supporting the system as the relative size of the U.S. economy declines

and should avoid the intense political negotiations that would necessarily accompany a shift toward a more bilateral system.

Yet many developing countries seem to prefer more of a bilateral approach to addressing these issues. They are increasingly skeptical of the IMF, find the IBRD to be overly bureaucratic and slow moving, and view the GATT and, more generally, the international trading system as a vehicle that favours established, that is industrial country, producers. Their preference apparently is for intensification of bilateral economic, financial, and commercial relations, particularly with United States, through which the United States could recognize the value of the particular country's supposed "special" relationship. Some of this sentiment was visible in the eagerness with which many countries responded to the possibility that trading relationships similar to the new U.S.-Israel free trade arrangement, negotiated in 1985, might be available to others.

Of course, more such special relationships exist in theory and in diplomats' conversations than could ever realistically exist in practice. And this preference for bilateralism may reflect an effort to avoid or minimize politically difficult economic adjustments, which are essential to being competitive in an open system, or a view that the economic system, as it is now being managed, is increasingly prone to instability.

But it may also reflect the unwillingness of more advanced developing countries in East Asia and Latin America to be differentiated from those that are less developed unless benefits are somehow guaranteed. They are unwilling to play more of a role in helping to define and manage the system--to be "graduated"--because such roles are usually defined only in negative terms. Graduation from access to concessional World Bank lending or from the benefits of special trade preferences are costs without corresponding benefits such as a greater role in shaping international trading rules. Inevitably, such one-sided transactions are resisted by developing countries.

It is no longer clear that the United States is able to sustain the kind of policy commitments implicit in managing a multilateral trade and payments system. In the past this has meant, in practice, being the financier and importer of last resort of the world economy. U.S. loans and investments financed new plant, equipment, and infrastructure, and U.S. imports encouraged the growth of foreign industries. But the United States has become--and looks to remain--a large net user of the savings of the rest of the world. Moreover, as import penetration of the U.S. economy has increased, at an unprecedented pace and to unforseen levels, the United States is increasingly attracted to protectionist solutions.

The United States must decide what it wants from the developing countries and how much it is prepared to pay, This means balancing the sometimes conflicting economic interests of U.S. consumers (who want low cost, high quality products), workers (who do not want to lose jobs to low wage foreign workers), banks (who want debt service, asset preservation, and profits), and corporations and farmers (who want sales, at home and abroad, and profits) with broad national political interests

(which include the advancement of relations with the developing world and the evolution of stable, pro U.S. democracies throughout the world) and economic interests (an expanding world economy). It is no longer clear that these diverse objectives can be realized through efforts to maintain a Bretton Woods type of an open trade and payments system, which assumes that the United States absorbs a more than proportionate share of the costs of running the system, if the result is the kind of imperfect arrangements that exist today.

In part this is because the U.S. commitment to an open multilateral trade and payments system is under attack from a variety of domestic constituencies, many of which were traditional supporters of the Bretton Woods system. Because this attack comes at a time when the developing world is subject to growing economic and political pressures, which only seem resolvable by more, rather than less, economic interaction with the developed world in general and the United States in particular, and because that interaction is unlikely to benefit both parties (developed and developing) equally, the political pressures running against renewed commitment to an effective multilateral system seem likely to grow. This renewed commitment would require the United States and other industrial countries to absorb yet a new round of the costs of system maintenance with largely indirect benefits or, even worse in a domestic political sense, benefits that are measured mostly by the avoidance of costs, such as unsustainable commercial bank losses.

Not only are current systemic arrangements unsatisfactory to important constituencies in the United States, but they are increasingly resented by many of the developing countries, who perceive themselves denied even the prospect of renewed growth and development. This situation will inevitably determine the character of U.S. political relationships with the developing world for years to come.

What are the alternatives? A return to a more open trading system, with enlarged and strengthened international institutions, and a renewed U.S. commitment--shared by Japan, Germany, and the other major industrial countries--to bear the costs of system management is one. Unfortunately, however desirable this might be, it seems unlikely to happen.

An alternative would be to deemphasize our multilateral commitments in favour of intensified bilateral relationships with select countries. Although economists will argue this is a second best solution, it may be more appropriate to our current economic and political resources and capabilities.

In practical terms this approach would entail defining economic and political selection criteria that emphasize the maximization of mutual advantages, then negotiating a series of bilateral arrangements covering trade, finance investment, aid, and other economic relationships. This would not necessarily result in greater government intervention--preferences already exist for many countries for many issues--but would focus these preferences on fewer countries in return for measurable benefits.

For example, the United States and Mexico have overriding political and economic interests in common: massive U.S. investment and loans to Mexico, sizable two-way trade flows, legal and illegal migration, the conflict in Central America, and the reality of a 1,500-mile border. In many ways no other bilateral relationship is more important to the long-term security of either country. Yet, in general, the United States continues to deal with Mexico on most economic issues in a multilateral context--through the IMF, the IBRD, and, at least prospectively, the GATT. This necessarily dilutes the U.S. ability to recognize the paramount importance of the relationship.

Admittedly, some Mexicans may prefer to deal with the United States through multilateral structures in an effort to make the relative bargaining positions less unequal. And managing the kind of intense bilateral relationships that this discussion anticipates would require considerable political sophistication from all participants. But in a world of finite resources, it might allow a better matching of resources to problems and more direct realization of the benefits of international commerce for U.S. companies and citizens.

The benefits of pursuing more intense bilateral relationships--of creating zones of mutual advantage--would have to be weighed against their costs. Two kinds of costs stand out. First, the selection of certain countries for preferential treatment (in return for preferential treatment) implies ignoring or deemphasizing others. Second, if the United States were to move away from a multilateral framework with regard to the developing world (with its explicit assumption of equal treatment), inevitably other industrial countries would do so as well. Of course, to some extent countries like Japan (in East and Southeast Asia) and France (in Africa) have long emphasize certain bilateral relationships. But for the United States to do so to any significant degree would seriously undermine existing multilateral arrangements and point toward a new international economic order.

It would probably be wrong to propose bilateralism or multilateralism as discrete alternatives; rather it is a question of emphasis. For the United States, the balance between the two presents strategic as well as tactical choices. For example, to what extent should the United States pursue its own Third World commercial agenda in the upcoming coun-try-by-country renegotiation of access to the Generalized System of Preferences (GSP), which should be completed this year, or a more general agenda of LDC policy changes (for example, with regard to intellectual property protection or more open investment flows) through the new multilateral trade round ? In terms of maximum effectiveness, the two are probably less compatible than they might initially appear.

The debt issue offers the greatest opportunity to develop the bilateral approach. U.S. exports to Latin American debtors have fallen dramatically; developing country imports are pressuring U.S. producers; U.S. commercial bank loans have declined in value; and many U.S. private sector investments in debtor countries are under pressure. For their part, the growth and development prospects of most of the debtors are

poor, and their political tolerance of the existing system is rapidly eroding. Perhaps a series of bilateral arrrangements could be ngtotiated that would exchange highly concessional loan rescheduling terms for priviledged trade and investment access for U.S. companies. Because on the U.S. side at least most of the participants would be private sector institutions, the role of the government would be to negotiate the framework and to help distribute benefits and costs among participants. Although both tasks would be challenging, requiring a considerable change in conceptual approach, neither would seem to present insurmountable obstacles.

One objection to such an approach is that it could tend to make the United States a regional power, assuming a natural concentration of economic interests in Latin America. Of course this is not necessarily the case; a country like South Korea might be prepared to enter into a broad based economic and political relationship with the United States that would be more beneficial to the United States than one with, say, Peru or Chile.

This implies something about possible selection criteria. Ideally they would combine strategic, political, and economic variables, with heavy weight given to the last of these. These might include market size, extent of existing relationships, complementarity, potential for future cooperation, as well as the cost of not developing a special relationship (e.g., default).

THE NEXT STEPS

The underlying point is that the United States should reevaluate its economic interests in the developing world and carefully consider the most effective means of pursuing them. Unfortunately, the United States seems to have lost either habit, assuming that long standing structures are by definition best, with the result that other countries often benefit at U.S. expense or that new problems are inadequately addressed. At the same time--and for much the same reasons--the United States should undertake a review of the international financial institutions to determine if there are gaps, such as the lack of an advocate for liberalized international investment conditions, or redundancies, such as that between the World Bank and the IMF with respect to economic policy conditionality and related lending programs.

For the United States such a reevaluation would be undertaken against the background of extensive existing economic interrelationships with the developing world and in the hope of seeing them expand. But the new reality that needs to be recognized--as much by officials in Washington as by those in the developing countries--is that this will happen only if it is demonstrably in the U.S. near term commercial interest. For better or worse, U.S. willingness to sustain an open trade and payments system for often abstract or indirect benefits seems to be rapidly eroding.

The bilateral approach suggested above is one possible alternative; there may be others. These need to be contrasted not with the multilateral free trade and payments system crafted 40 years ago at Bretton

Woods (and supported by a U.S. economy that was much larger compared to the rest of the world, as well as much less integrated into the global economy), but with the present day reality. That is a far from perfect system that increasingly seems to fail to satisfy either developed or developing country requirements and to lack an important political condition--a clear popular acceptance by the United States of its assigned role as manager of the system--that is essential for the system to work.

Under these circumstances, alternatives that are second or third best in theoretical terms, but are achievable, become more attractive. It is in the U.S. national interest and, indeed, global interests that the United States carefully examine these alternatives and then actively pursue its conclusions.

To be ultimately successful, this process will have to integrate the range of trade, finance, and development issues that have been discussed in these pages. If nothing else, the debt crisis, with its impact on growth and world trade, should have reinforced the message that they are not separable, although it is still the bureaucratic habit in Washington and elsewhere to treat them independently.

Finally, for the United States the current situation offers enormous opportunities, commercially and politically. A forthcoming, even generous, approach to the problems of the developing world--rooted firmly in carefully defined self-interest--could solidify relationships that might last for years. The opposite is also true; failure to act now could adversely affect U.S. economic and political interests in the South for decades. The choice should be easy.

FOOTNOTE

1. Albert Fishlow, "The State of Latin American Economics," Economic and Social Progress in Latin America, (Washington, D.C.: Inter-American Development Bank, 1985).