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ROUTING AND RECORD SHEET

SUBJECT: (Optional)
Letter to J. William Middendorf, II from the DCI

FROM:	EXTENSION	NO.
David B. Low NIO/Economics		NIC 03157-85
		DATE 19 June 1985

STAT

TO: (Officer designation, room number, and building)	DATE RECEIVED	DATE FORWARDED	OFFICER'S INITIALS	COMMENTS (Number each comment to show from whom to whom. Draw a line across column after each comment.)
1. Executive Registry	19 JUN 1985		[initials]	
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4. DCI	20 June	20 JUN 1985	[initials]	
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The Director of Central Intelligence

Washington, D.C. 20505

2 0 JUN 1985

The Honorable J. William Middendorf, II
U.S. Ambassador to the Organization of
American States
Room 6494, Department of State
Washington, D. C. 20520

Dear Bill,

Thank you for your letter of May 28, 1985 and the enclosed address entitled "Free Enterprise: Key to Latin American Economic Revival."

As you well know, I concur with your views about the need for positive steps to expand private sector development in Latin America. While the measures you have mentioned are steps in the right direction, I believe that more imaginative mechanisms of US support will be required before we can expect any significant change.

Sincerely,

/s/ Bill

William J. Casey

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SUBJECT: Letter to J. William Middendorf, II from the DCI

NIO/Econon/David Low:rr [redacted] 19 June 1985 NIC 03157-85 STAT

Distribution:

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EXECUTIVE SECRETARIAT

ROUTING SLIP

TO:

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3	EXDIR				
4	D/ICS				
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11	IG				
12	Compt				
13	D/OLL				
14	D/PAO				
15	VC/NIC	X			
16	LA/DO		X		
17	ALA/DI	✓	X		
18	NIO/Econ	✓	X		
19	NIO/LA		X		
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SUSPENSE 21 June 85
Date

Remarks

To 15: Pls have NIO/Econ prepare response for DCI signature.

STAT

Executive Secretary

17 June 85

Date

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United States Department of State

United States Permanent Mission to the Organization of American States

Washington, D. C. 20520

Executive Registry
85- 2420

May 28, 1985

Dear Bill:

In spite of news reports to the contrary, the economic picture in Latin America has not substantially improved, even though 58 percent of the entire $11.5 billion increase in exports that the Latins registered last year worldwide came to the U.S., and despite the fact that they had a $20.7 billion trade surplus with us last year. For the near and long term, everybody has good reason to be worried about the debt and security problems in our hemisphere, and I fear that these problems are not going to improve until a basic restructuring of their economies takes place, redirecting them towards free enterprise. In our country, we take free markets and the free enterprise system for granted. What is overlooked is that most of the largest debtor countries in our hemisphere have over 50 percent of their productive economic activity owned by the government, with all of its potential for inefficiency and bureaucratic interference, to say nothing of official corruption. Inflation rates are skyrocketing. No substantial debt principal payments are being made, and interest payments are being financed largely through new loans. If the U.S. business cycle turns down, all hell could break loose and we must be aware of it.

In 1981, Ronald Reagan began the deregulation of our economy and the creation of incentives for vigorous economic growth. Then Margaret Thatcher led the way in England with privatization, and now a number of Europeans are looking at these success stories as a model. Recently, several Latin countries have been revising their own views on the role governments should play in the market place. Working through the OAS, I have now visited every country in our hemisphere carrying President Reagan's free enterprise message.

In this regard, you might be interested in the enclosed study--Free Enterprise: The Key to Economic Revival in Latin America--outlining solutions for freeing up these economies.

The Honorable
William J. Casey,
Director of Central Intelligence Agency.

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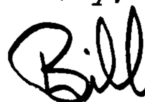
Unless real progress is made in this direction, I fear the security troubles that are now largely confined to Central America (see my paper, Nicaragua: The Stolen Revolution, which I sent you last week) will proliferate from the Straits of Magellan to the Rio Grande.

We need your help. With your own valuable contacts in the hemisphere, can you help us in this effort to spread the Reagan message?

Sincerely,



J. William Middendorf, II
Ambassador
Permanent Representative

Enclosure: as stated

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Current
Policy
No. 692

J. William Middendorf II

Free Enterprise: Key to Latin American Economic Revival

United States Department of State
Bureau of Public Affairs
Washington, D.C.

Following is an address by Ambassador J. William Middendorf II, U.S. Permanent Representative to the Organization of American States (OAS), before the International Conference on Latin America sponsored by the Center for International Relations, San Jose, Costa Rica, February 22, 1985.

It is a pleasure for me to join the illustrious group here in the discussion of the conference theme: "Basic Freedoms in Latin America: Their Past, Present and Future Prospects." The fact that this historic conference is treating both the political and economic aspects of Latin America's situation is indicative of what Secretary of State George P. Shultz stated in his testimony before the Senate Committee on Foreign Relations, entitled "The Future of America Foreign Policy: New Realities and New Ways of Thinking" [Current Policy No. 650], January 31, 1985:

> The United States seeks peace and security; we seek economic progress; we seek to promote freedom, democracy, and human rights. The conventional way of thinking is to treat these as discrete categories of activity. In fact, as we have seen, it is now more and more widely recognized that there is a truly profound connection among them. And this has important implications for the future.

Secretary Shultz expanded on these points by saying:

> . . . it is more and more understood that economic progress is related to a political environment of openness and freedom. It used to be thought in some quarters that socialism was the appropriate model for developing countries because central planning was better able to mobilize and allocate resources in conditions of scarcity. The historical experience of Western Europe and North America, which industrialized in an era of limited government, was not thought to be relevant. Yet the more recent experience of the Third World shows that a dominant government role in developing economies has done more to stifle the natural forces of production and productivity and to distort the efficient allocation of resources. The real engine of growth, in developing as well as industrialized countries, turns out to be the natural dynamism of societies that minimize central planning, open themselves to trade with the world, and give free rein to the talents and efforts and risk-taking and investment decisions of individuals.

Private and State Sector Approaches to Development

It is becoming more and more obvious throughout the hemisphere that without a dynamic free enterprise system, governments can neither stimulate nor sustain economic growth nor diversify their economies to foster economic development. Too often in the past, one heard the truism that first must come a proper infrastructure, but this has led to vastly overblown bureaucracies of government-owned means of production far beyond such basic infrastructure requirements as roads, utilities, and communications. Without an efficient and limited public sector at a manageable economic cost—and without an overall environment conducive to sound investment—privately owned enterprises are unlikely to make their full contribution to development and commerce.

Economic development can no longer be financed externally through massive amounts of foreign aid or foreign borrowing, which were hallmarks of the 1960s and 1970s. Now growth, if it is to come, must begin with each country's climate to attract and keep in country local savings and to attract foreign savings, i.e., having a set of motivations and attitudes that are concretely expressed in the absence of civil conflict, a system of generally accepted and enforceable property rights, and the ability of individuals to enjoy the fruits of their labor without confiscatory systems of taxation or arbitrary seizure of property. If government controls too much of the means of production, as is the case in many of the high-debtor countries in our hemisphere, or if it is inefficient and ineffective or all of the above, or if it pursues policies that significantly distort free-market decisionmaking, the overall prospects for economic development suffer, and international commerce with it. As Secretary Shultz noted in the testimony I cited earlier:

> . . . recent experience has fueled a broad and long-overdue skepticism about statist solutions, central planning, and government directions.
>
> This intellectual shift is partly the product of the extraordinary vigor of the American recovery. The United States has revised its tax system to provide real incentives to work, to save, to invest, to take risks, to be efficient. We have reduced government regulation, intervention, and control. We have opened opportunities for freer competition in transportation, finance, com-

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munication, manufacturing, and distribution. Last year's real growth in GNP [gross national product] was the sharpest increase since 1951; inflation was the lowest since 1967. The overall result was the creation of over 7 million new jobs in 2 years.

It is our sincere hope that the factors behind our present success in the United States will be emulated in Latin America because a return to sound economic policies in all of the hemisphere would be mutually beneficial and ultimately create a better standard of living for all. We are all one hemisphere, and what affects the Latin countries affects us all. Clearly, it is in my own country's trading interest, since we are running a $20 billion trade deficit with Latin America, largely as a result of its sharply curtailed imports from us. It is also in the interest of the world's financial institutions which have major loan exposures there. Finally, the ability of the hemisphere to withstand communist adventurism and narco-terrorism depends on sound economic policies for economic recovery.

As one who has worked with the Latins for 30 years, I don't think I can emphasize strongly enough my feeling that Latin America must work toward a better balance between government and free enterprise, which at present is so heavily skewed toward state ownership.

Unfortunately, we seem to be losing the semantic battle for the minds of Latin Americans when we extol the virtues of free enterprise. It is an unfortunate fact that Marxist teachers have infiltrated primary schools in many Latin American countries. From that key position, they take advantage of their young charges' formative years to make them feel that Marxism is the natural state of affairs of any society. Therefore, anyone who opposes it must be against humanity. Foreign private direct investment becomes "economic imperialism" in the Marxist-Leninist lexicon, and this economic imperialism opposes a "new international economic order" which calls for redistribution of the world's wealth. In the Marxist lexicon, we are in a zero-sum game where, if one group is to attain greater wealth (read "the exploiters"), another group must lose it. None of this helps to encourage the much-needed new capital to come in to create the jobs so desperately needed in countries with unemployment levels ranging up to 30% and 40%. In fact, one wonders if Marxists in countries with non-Marxist governments don't hope to keep unemployment levels high, in the hopes that the resulting unrest might help bring them to power.

The trend toward government ownership is clearly seen in Mexico, where, according to trend data, there were only 84 government enterprises in 1972. By 1982, there were 760. During the same period, total government spending as a percentage of gross national product increased from 23% to 46%. By 1982, following the bank nationalization, the great majority of Mexico's major industries were under government control, and the government's share of total capital formation had reached 45%. It is an interesting footnote that in the period 1957–72 (during most of which Dr. Ortiz Mena, now president of the Inter-American Development Bank, was finance minister), Mexico's compound annual rate of GDP [gross domestic product] growth was 6.6%, whereas during the period 1973–83, after the oil boom began, this GDP growth rate averaged 4.7%. Even in Brazil—where in 1979 President Figueiredo created a special ministry with the objectives of (1) selling government-owned enterprises to the private sector, where feasible; (2) restricting the indiscriminate growth of state-owned enterprises; and (3) strengthening the free enterprise system—little progress has been made and the spending of government and its companies approaches 50% of the gross domestic product.

A good sign for positive change is that some of the empirical research which has been conducted on the macroeconomic consequences of the statist "solutions" so long favored in most of Latin America is beginning to receive wider publicity and beginning to affect the thinking of high-level policymakers. Ke-Young Chu and Andrew Feltenstein, in their paper "Relative Price Distortions and Inflation: The Case of Argentina, 1963–76" (International Monetary Fund, *Staff Papers*, Volume 25, September 1978), for example, estimated that, in Argentina, government transfers to cover public enterprises' losses were proportionately 10 times as inflationary as the financing of private enterprises' losses through commercial bank borrowings, primarily because it is assumed that only in the former case are the losses translated into high-powered money through central bank financing of the government deficit. Because the state in Argentina owns the vast majority of its industrial production, and since most of these state-owned industries operate at enormous losses which only government printing presses can make up, the inflation rate there last year approached 700%.

Other equally devastating findings are discussed in *Public Enterprises in Mixed Economies*, by Robert H. Floyd, Clive S. Gray, and R.P. Short:

> For 25 developing countries for which data were available, Short estimates the average (weighted by GDP) overall public deficit, before reduction by government current transfers, at 5.5 percent of GDP during the mid-1970s. He further estimates that the overall deficit in developing countries increased by 2.5 percentage points of GDP between the late 1960s and mid-1970s.
>
> Defining the "budgetary burden" of public enterprises as the residual of government transfers and loans, less loan service payments by the enterprises, Short estimates this burden to average 3.3 percent of GDP for 34 developing countries, compared with a 4.4 percent estimate for the central government's overall budget deficit in these countries. In other words, public enterprises accounted for three-fourths of the central government deficit in the countries in question.

As I have witnessed during the last 30 years, the Latin American countries have suffered ever more stifling bureaucratization of their economies. Government intervention—often buttressed by nationalist and/or socialist ideologies—has resulted in substantial increases in:

- State ownership of economic activities in, for example, extractive industries, manufacturing, financing, and international trade and commerce, far beyond the traditional limits of infrastructure and often accomplished through expropriation without adequate compensation;
- Regulation of private economic activity via money, credit, and exchange controls, licensing systems, and price and wage controls;
- The state's consumption share of gross national product; and
- Government investment expenditure—typically more than half of national capital formation.

Informal Economy

In spite of these trends, which amount to a fight for survival on the part of free enterprise in many parts of Latin America, there are several countertrends. A good example of how the private sector can triumph in spite of governmental restrictions is revealed in the study by Peruvian businessman and economist Hernando de Soto. Because it takes a person 6 months to get government approval to set up a simple business in Peru, an informal economic system has grown to rival the more traditional business. According to de Soto, an informal economy developed

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and grew despite the tremendous handicap of being illegal.

De Soto's study estimates that the informal economy of Peru now accounts for 90% of Lima's garment industry, 25% of its furniture industry, 60% of housing construction, and even a good part of the automobile and truck industries. The informal Peruvian economy, says the study, has grown so fast that it now accounts for an estimated 60% of the total Peruvian economy, and almost none of this output is counted in the official $22 billion Peruvian gross domestic product. Perhaps most important is the free enterprise system's ability to create jobs: in Peru, an estimated two out of every three jobs are now in the informal sector.

Another factor Mr. de Soto's study points out is that South American economies often have two kinds of private sectors: one that is seriously burdened by excessive regulation and hampered by bureaucratic inefficiency but is officially sanctioned, and a second one which is far more in accord with free market principles but whose existence is barely acknowledged. This difference is made clear by an experiment documented by a study group from Mr. de Soto's Institute for Liberty and Democracy, in which it tried to set up a legal garment firm without easing the way with bribes. According to a *Wall Street Journal* article:

> It took a lawyer and three others 301 days of full-time work, dealing with 11 government agencies to complete the paperwork—which, when laid end-to-end, measured 102 feet. (One of the researchers then tried the same experiment in Tampa, Florida, and finished it in 3½ hours.)

Debt Crisis Management

As we all know, Mexico's extreme illiquidity in August of 1982 precipitated the "debt crisis." The response was a provision of immediate emergency assistance by the U.S. Government and other creditors which led to the development of a rescue package and an IMF [International Monetary Fund] stabilization program. By the spring of 1983, the U.S. Government had developed a strategy designed to deal with the liquidity problems, primarily of the major countries, and to encourage the adoption of needed stabilization measures. What has not been widely understood is that the strategy was not intended to be one of "solution" for the "debt crisis" but rather one of "management" of the crisis with the central purpose of preventing the liquidity problems from developing into a crisis of the entire international financing system.

I think it would be helpful to recall the elements of the U.S. Government strategy for management of the debt crisis as reaffirmed at the Williamsburg summit:

- Credible economic stabilization measures to be undertaken by the individual debtor countries;
- Sustainable economic growth in the OECD [Organization for Economic Cooperation and Development] countries, combined with the maintenance of open markets;
- Support from the IMF and other international financial institutions for economic adjustment; and
- The provision of bridge financing by creditor governments when needed.

I think we can all agree that, up to now, the strategy has succeeded in its central purpose of avoiding the development of a systemic crisis while, at the same time, supporting stabilization efforts in the debtor countries.

Not Yet Out of the Woods

I believe that, with what I have said up to this point, it should be clear that we are not out of the woods. In fact, I would agree with the testimony of Dr. Norman Bailey, former Assistant to the President for International Economic Affairs, before the Subcommittee on Western Hemisphere Affairs of the U.S. House of Representatives on January 29, 1985: ". . . Unfortunately, we have always been in the woods and the path out of them is obscure and easily lost." Agreement with this statement stems not from an attitude of pessimism but rather from an acute recognition that the real world is pregnant with danger—the economists' definition of the real world being "the nominal world minus inflation" notwithstanding.

One is led to this opinion by simple arithmetic. At the end of 1981, the Latin American countries owed approximately $297 billion. At the end of 1984, their external indebtedness amounted to about $371 billion. Despite the high visibility of U.S. banks in this situation, they, nevertheless, only hold one-fourth of this debt, the rest being held by foreign banks, multilateral lending institutions, and governments. After 3 years of crisis and austerity, Latin America, therefore, has increased its indebtedness by about $75 billion on which, by the way, interest is due. About $34 billion of the $75 billion was lent by commercial banks in countries reporting to the Bank for International Settlements, and of the $34 billion, $12.6 billion was lent by U.S. banks. During the period 1981–84, as a result of rescheduling agreements, the debt service ratio—i.e., interest and principle payments as a percentage of foreign exchange earnings (export earnings from goods and services)—of the debtor countries declined from 51.2% to 43.3% of merchandise exports. The ratio of net interest payments to merchandise exports declined somewhat to about 35% in 1984, demonstrating the sensitivity of these economies to both export growth and the changes in world interest rates.

From the point of view of the balance of payments, we have seen Latin America accumulate a $74 billion merchandise trade surplus in the period 1982–84 inclusive, but one which is apparently largely due to tremendous cuts in imports. The most recent estimates indicate that the value of Latin American exports in 1984 was still somewhat below 1981, although export volume showed an increase. During the same 3-year period, debt service payments amounted to $109 billion, and new money and the surplus on the trade balance amounted to about $148 billion, which I read to mean that approximately $39 billion was spent on services, fled the region, or was added to international reserves. Even under optimistic assumptions, the World Bank, the Inter-American Development Bank, and others have concluded that it will be the end of the decade before 1980 pre-recession per capita levels of gross domestic product will again be achieved.

Major Uncertainties

There remain a number of major uncertainties which render the global economic environment pregnant with danger. Highest on my list of uncertainties is the debt crisis, where we are by no means out of the woods, despite a recent spate of news articles to the contrary.

One fact which is often overlooked is that the country with the largest external debt in the world is not Brazil or Argentina, it is the United States of America. By the end of June last year, foreigners had lent our treasury $171 billion, which was 15.6% of the total. The foreign debt of the American private sector at the end of June 1984 was estimated to be another $299 billion. It has been estimated that, by the end of May this year, the United States will become a net international debtor for the first time since shortly before World War I. Perhaps, when we bemoan the international "debt crisis," we should remember the words of John Donne: "Ask not for whom the bell tolls, it tolls for thee." Nevertheless, the size and

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growth of our economy, coupled with positive encouragement of free enterprise by President Reagan's policies, give us grounds for more optimism than in those countries where the parastatal, government intervention model predominates.

With regard to international debt prospects, Assistant Secretary of State for Economic and Business Affairs Richard T. McCormack posed two questions in a speech delivered last November ("The Medium-Term Outlook for the World-Economy," November 22, 1984, Current Policy No. 664):

> **First**, is our [worldwide] present success in reducing these [balance-of-payments] deficits based on a draconian depression of activity . . . that is not sustainable either socially or politically?
>
> **Second**, is the present outlook viable only under the most favorable assumptions and vulnerable to new shocks, such as OECD recession or higher interest rates?

Solutions

I believe these questions remain valid, but for these questions to be given favorable answers in a historical sense, the "debt crisis" must be genuinely resolved. And for a genuinely favorable resolution, the solution must be sought in the reform of the domestic economies of the debtor countries of the hemisphere themselves.

The economic policies necessary to achieve such a reform are relatively easy to summarize. In terms of monetary policy, there must exist positive inflation-adjusted interest rates, realistic exchange rates, economically sound measures to control inflationary pressures, and measures to induce the return of flight capital. In terms of fiscal policy, the governments of our Latin American neighbors must rein in parastatal enterprises—which, for the most part, are deficit-ridden and a major source of inflation—reform their taxation and tax collection systems, and reduce subsidies. Simply put, they must put their own houses in order by creating clear and stable rules of the game for economic activity—clear rules which encourage productive activity by offering a secure climate for investment, both domestic and foreign.

What is needed was succinctly defined by Secretary of State George P. Shultz in his address of December 6, 1984, entitled: "Democracy and the Path to Economic Growth" [Current Policy No. 641].

> I am calling here for the reversal of state ownership and anti-import policies. These policies have placed stifling controls on private agriculture and industry. They have made them dependent on restricted markets. They have built costly protectionist barriers at national frontiers. And they have produced inefficient state enterprises that divert resources from more productive activities.
>
> I call, instead, for a development strategy that works through an open economy, one that rewards initiative, investment, and thrift.

Maintaining an Open Multilateral Trading System

The world economy continues to be involved in a process of adjustment. Simply put, this adjustment involves converging the levels of consumption and production. During the 1970s, many countries lived beyond their means, as reflected in their unsustainable balance-of-payment positions. This situation must now be corrected by either increasing the "means" or living more modestly or both. While this process is not cost free, it is inevitable and has as its ultimate goal the restoration of sustainable noninflationary global economic growth.

A key element in this adjustment process is the maintenance of an open multilateral trading system, which is essential to position the countries of the hemisphere for servicing their external debt and for enabling the export and import sectors of all our economies to make their contributions to domestic economic recovery and growth. I also want to make three further points.

First, protectionism poses a serious threat to the prospects for a medium-term recovery in the world economy. Virtually all economic projections are predicated on open trade. If the assumption about the maintenance of open trading policies is removed, the medium-term outlook for the world economy becomes bleak.

Second, protectionism poses a fundamental threat to the strategy that has fostered development since 1945. International trade is a powerful engine of growth. The experience of the 1960s and 1970s demonstrated that countries with "inward-looking" development strategies—characterized by liberal import regimes, adequate incentives for producers, and the maintenance of realistic exchange rates and prices as well as positive real interest rates—have performed better than countries with "outward-looking" development strategies. Protectionism would threaten the viability of the "outward-looking" strategies with far-reaching consequences for economic efficiency and world trade.

The postwar strategy in many Latin countries of industrializing through import substitution, with its high tariff barriers, has been disappointing. It has fostered dual economies, crippled development in the agricultural sector, resulted in frequent balance-of-payments crises, and contributed to rapid urban growth and political instability. Studies by the OECD and the World Bank both recognize that a substantial relaxation of import restrictions coupled with moves toward appropriate exchange rates are necessary to expand exports and overcome the shortage of foreign exchange that most developing countries (except for some of the oil exporters) seem to face.

It should not come as a surprise that the development strategies based on import substitution have produced such poor results. Import substitution carried to excess is a little like a soccer team that plays only itself. Competition hones the skills and tactics of a soccer team, and, by definition, Brazil could never have won the world soccer championship if it had not been willing to play against foreign teams. Moreover, import substitution policies often also violate the law of comparative advantage since they amount to a *dirigiste* attempt to outguess the marketplace.

For these reasons, developing countries are urged to use great caution in applying import-substitution measures, and such countries are encouraged to focus more actively on the possibilities which exports offer their economies, while striving to keep our markets open to those exports. Since the 1970s, many of the more successful developing countries have been pursuing precisely such a strategy. The economic success stories, such as Taiwan, South Korea, and Singapore, have all adopted policies which emphasize exports as a means of promoting rapid industrialization.

In recent years, these and other countries have shifted toward more liberal trade and payment regimens. Often, these moves have not been as rapid nor as encompassing as we might want. But overall, particularly in East and Southeast Asia, there has been a clear tendency of the more economically progressive and successful countries to move in the direction of liberalizing trade barriers and adopting policies aimed at stimulating exports. The U.S. Mission to the OAS has recently chaired meetings of the ambassadors of the ASEAN [Association of South East Asian Nations] countries with the Andean OAS ambassadors, with the thought that fellow "developing countries" along the Pacific rim might com-

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pare notes so that the most successful features of each economic system might be examined.

Third, protectionism is, by definition, "anti-adjustment." It is an administrative way of delaying adjustment to changes in competitive positions stemming from changes in technology and productivity. We must jointly and severally rise to the challenge of structural adjustment rather than run away from it. Renewed growth and the reinvigoration of all our economies demand it.

I would like to note here that the U.S. commitment to an open multilateral trading system remains firm, as was demonstrated yet again in President Reagan's call for a new round of trade negotiations under the GATT [General Agreement on Tariffs and Trade] in his State of the Union Address. It has been contended that no country has an entirely open system. In this imperfect world, however, the United States is still the most open market among the major trading nations, as witnessed by our recent horrendous trade deficits. What is needed in the new trade round is a rededication to work toward perfecting the multilateral trading systems so that opportunities for fair trade can be increased for all participants. By fair, we mean that the goal posts should be the same width for each side. If ours is 20 feet wide and our trading partner wants his to be only 2 feet, we're going to lose a lot of games, and nobody believes that's fair.

Vast Capital Needs

Latin America still needs vast amounts of capital for progress or, indeed, to maintain present living standards. According to an Inter-American Development Bank study, between now and the year 2000, Latin America and the Caribbean will have to create 100 million new jobs, since half of the population is under 20, and birth rates are running at 3% (with Mexico's at 5.8%). The average cost for creating one new job in the region is estimated at $12,500, leading to an approximation that $1.25 trillion in capital will have to be generated in the next 15 years—a figure perhaps twice the amount of all transfers of funds to the hemisphere in the past 15 years, which includes the huge borrowing splurge of the 1970s.

For Latin America, if the decade of the 1960s can be considered as the decade of official aid from the developed countries (including the Alliance for Progress) and the decade of the 1970s as the decade of commercial bank lending (nearly $300 billion), then the decade of the 1980s must be the decade of foreign direct investment. Why? Because, regarding future prospects for official aid, it would be prudent not to expect that support via the International Monetary Fund, the World Bank, and other multilateral lending institutions will be a replacement for private sector lending—and I stress the word replacement—for a number of reasons.

First, the sums needed are simply too large.

Second, virtually all industrialized country governments, including that of the United States, are grappling with the issue of controlling their own government deficits.

Third, it is unlikely that industrialized country central banks will be as accommodating toward these deficits as they were in the 1970s.

Further, it is now widely recognized that Latin America will not receive even remotely the same high level of borrowed capital from the banking systems to which it became accustomed during the 1970s, particularly in light of debt servicing problems on existing loans.

Of course, borrowing is only one of the three types of international monetary transfers—the other two being direct aid, either government-to-government or multilateral, and foreign direct investment. It is obvious to all that foreign direct investment, if it can be gotten, has the advantage over the other two of providing management knowhow, technical skills, and technology transfers resulting in a high degree of export potential and, therefore, of being a source for valuable foreign exchange.

In order to attract this scarce and needed capital—in competition with other countries also aggressively seeking it, such as members of the OECD and the Pacific Basin countries—the climate for investment must be much more conducive in Latin America. The best test of this is found where local investors themselves find it attractive to reinvest their own funds and where there is no capital flight.

Capital Flight

Just at the time when Latin America needs so much more new capital, there has been the reverse trend of hemorrhaging capital outflows through flight capital.

Henry C. Wallich, member of the Board of Governors of the U.S. Federal Reserve System, in a recent incisive paper entitled, "Why is Net International Investment So Small?," made the following comments:

> There seems little doubt that substantial capital exports have taken place from the countries that were borrowing. Unfortunately, one must assume that in large part this represents capital flight. The assets, thus acquired, probably do not produce income and taxes from the capital-exporting country, and probably are not available to strengthen its foreign exchange position and its economy generally. In other words, given economic and political conditions of the capital-exporting countries, these foreign assets are not likely to play the same constructive role for the home countries that capital exports from developed countries have ordinarily played. To be sure, changes in the politics and economic policies of the respective countries, giving adequate protection to the owners of capital and a positive real return on domestic assets, may change that situation. They may convert what today is flight capital into an important resource for the country.

The irony of this situation is that, in fact, Latin Americans own plenty of capital. It is just not located inside Latin America—the amounts in Swiss and Miami banks and in San Diego condominiums probably far exceed the liquid funds in the home countries. Indeed, generations of Latins claim they have been brought up to get their money out into "safer" havens as soon as they make it. This trend has to be reversed if Latin America is to grow at all.

Henry Wallich further states:

> For the [world's] eight largest [non-U.S.] borrowers over the years 1974–1982, . . . calculation[s] show an increase in debt (equity and direct investment included) of $317 billion, while the current account deficit adjusted for changes in official reserves, amounts to only $207 billion. Thus, there seems to have been a capital outflow of $110 billion. The degree to which borrowing financed this capital outflow differs among countries. For Brazil, only 12 percent of the inflow was compensated by outflows; for Mexico, 45 percent; for Venezuela, almost the entire inflow was absorbed into outflows.

Nearly 100% capital flight? Clearly, with a change in domestic policies away from the parastatal-import substitution approach to economic development, there is reason to believe that this money could be attracted back to Latin America, which would, of course, be a major contribution to a lasting solution of the debt crisis and job creation.

In his February 8, 1985, address, "The International Debt Situation in an American View: Borrowing Countries and Lending Banks," Henry C. Wallich states further:

> Unfortunately, one must assume that a large part of the borrowed money went for consumption, in the form of excessive im-

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ports of high-priced oil and various consumer goods. Frequently this spending was financed through government budget deficits, caused by subsidies and other unproductive expenditures, including purchase of weapons. A worldwide shift from negative real interest rates to significantly positive real rates, and the consequent rise in debt service, also used up some of the funds borrowed.

In adding up incremental investment, capital flight, and increased outlays (in nominal terms) for consumption, there is a danger of over-explaining the absorption of borrowed funds. The best judgment seems to be that the borrowing countries experienced a substantial increase in their income and debt-carrying capacity and that these benefits of added investment could be enhanced in future, if measures are taken to induce flight capital to return.

It may be that this audience will find itself closer to the Henry Wallich school of thought on flight capital than the point of view expressed to me recently by a prominent Argentine economist that, at least in the Argentine case, the term "flight capital" was misleading and that more accurate terminology would be "portfolio diversification."

Other Solutions

While it is relatively easy to diagnose the ills resulting from excessive governmental involvement in our economies, it is far more difficult to find constructive solutions. In many of the countries of our hemisphere, the state-owned sector is so large, relative to the domestically owned pool of private capital, that a simple sale of those state enterprises that are running the largest deficits would be difficult (who would want to buy them?), and attracting foreign capital for this purpose also would be difficult, for well-known political reasons. Indeed, there are still many in Latin America who would view selling off parastatals to "transnationals" in the same way as they view foreign direct investment—selling off their "national patrimony." There have been ideas floated that some debt could be exchanged for equity in the parastatals. Brazil considered this for a time, but may have given up on the idea, at least for the present.

However, I believe that there are other potential and feasible solutions over the long term, for, as President Reagan has said, "Developing countries need to be encouraged to experiment with the growing variety of arrangements for profit-sharing and expanded capital ownership that can bring economic betterment to their people." One such method of expanded capital ownership is advocated by Dr. Louis O. Kelso and Patricia Hetter in their book, *La Economia de los Dos Factores: Un Tercer Camino.* The plan involves employee stock ownership plans, which are nothing less than having the employees of the corporation also become the stockholders, i.e., owners. There are now approximately 8,000 corporations in the United States using these plans, and the experience with them has been quite good—productivity goes up, worker income is linked to profitability, etc. While they are only one form of expanded capital ownership, the point I am trying to make is that there are alternatives to state ownership, and they should be explored and adapted to the conditions existing in each of the countries of our hemisphere. Indeed, Costa Rica and Guatemala have rapidly increasing employee stock ownership plans.

But the benefits of expanded capital ownership go far beyond the economic, as has recently been demonstrated in the La Perla project in Guatemala. La Perla is a 9,000-acre coffee and cardamom plantation in northern Guatemala. It has 500 full-time employees, about 1,500 family members, and approximately 4,000 other people dependent on the economy of the estate. In September 1984, the farm's owners set up a trust in which they allocated 40% of the stock. The stock will be paid for out of the future profits of the farm, but upon the signing, full voting rights were passed through to an employee association.

Early this year, 120 insurgents attacked the estate and actually took control of the center. The insurgents, however, were then attacked and driven off the farm by 200 armed workers, and a number of workers and insurgents were killed. In the week following the attack, the estate's 300 unarmed worker-owners petitioned the owners for additional rifles to defend against future insurgent attacks and volunteered to help pay for them through a payroll deduction plan. As Joseph Recinos (a representative of the Solidarity Union of Guatemala, a movement aimed at expanded capital ownership as a means of economic and social reform), has stated:

> We can more clearly see what the true message of ownership and of vested interest in the free enterprise system means in viewing the La Perla model. There is no greater significance to the concept of defending the free enterprise system than a worker laying down his life to defend the company in which he is co-owner.
>
> If we want to prevent further Nicaraguas or El Salvadors, the American Government must address the problem of economic and social justice in Central America. Promoting broad capital ownership as an alternative to Marxist philosophy in Latin America, if they are actively pushed now as foreign policy objectives, can go a long way in giving people a vested interest in protecting the free-enterprise system.

Norman Kurland, one of the founders of the Center for Economic and Social Justice (a group whose goal is the promotion of employee stock ownership plans) stated in a *Washington Times* interview last September:

> To win over Marxism-Leninism you have to go beyond the military. Of course, you have to be militarily strong. On the other hand, there is an ideological battle. Marx and Engels stated that you could sum up the entire philosophy of communism in a single sentence: Abolish private property.
>
> The entire case of Marxism-Leninism disappears if we prove to the world that private property is essential for providing economic and social justice, and for providing human dignity to people in the Third World.
>
> Marx was wrong. However, we cannot simply attack him on the basis of the problems he was focusing on but rather on the basis of the means that he would use. The solution is not to make enemies of the owners but to make owners out of the nonowners.

Foreign Direct Investment

Over the past 4 years, it has been made clear to me, in visits to every country in the hemisphere, that private foreign direct investment can play the key role in future trade and commerce. Indeed, it is the catalyst for economic development and international economic integration through the world trading system, as well as being perhaps the only remaining source of capital, technology, and management know-how on a scale needed for economic survival.

It seems intuitively obvious that the high-debtor countries of our hemisphere must take strong steps to court foreign direct investment as the most attractive alternative to new bank financing. Foreign direct investment has the advantage of not requiring fixed interest payments. Earnings are repatriated only if the investment is profitable. Local enterprises are able to sell to multinational companies and often gain access to new markets and distribution channels, both nationally and internationally. Finally, and most importantly, foreign direct investment creates real jobs as opposed to state-funded make-work jobs.

Unfortunately, the trend has been in the other direction. In 1950, U.S. direct investment in Latin America accounted for nearly 50% of the total U.S. investment overseas. By 1970, this figure had dropped 17% in Latin America and was 3% in Asia and the Pacific. At the end of 1982, the stock of U.S. direct invest-

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ment was down 15% in Latin America and had doubled to 6% in Asia and the Pacific. In a time when total flows of U.S. foreign investment were declining, flows to the Far East rose sharply.

I am encouraged by the increasing recognition of the importance of internal factors for the revitalization of Latin American economies now being expressed by prominent Latin Americans. Brazilian Senator and former Planning and Finance Minister Roberto Campos stated the issues succinctly in his speech, "The New Demonology": "The United States has become the magnet for European and Japanese investors precisely because they have two things we lack—a strong currency and stable rules of the game."

The prominent Argentine economist, Marcos Victorica, has also addressed these issues. Mr. Victorica estimates that Argentine capital abroad amounts to about $27 billion and that much of this capital left the country during the early 1980s, despite the fact that real interest rates in Argentina amounted to about 20%—double U.S. real interest rates—and he has ascribed these developments to a lack of confidence. Regarding policies affecting foreign direct investment, Mr. Victorica has noted one of the key difficulties (such as exchange controls): "No one will come in [to invest] where a way out is forbidden."

Argentine Presidential Secretary General German Lopez recently spotlighted this problem in comments reported on the Buenos Aires government radio network, when he stated that, "President Alfonsin is determined to modernize the country and that, to this end, there is no alternative but to resort to foreign capital so that the investments that will contribute to Argentine development are made." The only way to make up for the time lost, Lopez states, is to urgently attract investments, adding that:

> I want to say that the past 10 years have been very dramatic for Argentina and that I consider that in reviewing, in weighing our responsibilities, we are sometimes unfair. We have made mistake after mistake for virtually 50 years. We have practiced a sort of political cannibalism destroying each other. [Therefore] President Alfonsin is firmly determined to modernize Argentina in order to put it at the level of efficiency asked by public opinion.

Recently, the newly elected President of Uruguay, Julio Maria Sanguinetti, said that "those of us who historically defended a greater role for the State now have to say that we must reestablish equilibrium and that as a result our direction will be to reduce to the maximum extent expenditures of the State, and to encourage as much as we can private production."

I am pleased to see that some leaders of Andean Pact countries are taking a new look at their investment policies. During his recent visit to the United States, President Belisario Betancur of Colombia addressed a number of our business leaders on April 2. He said:

> The Latin American experience of the past 10 years shows that self-sustained development is not stable if it is mainly dependent on a growing foreign debt. The development effort should be based on domestic savings and productive investment, supplemented by foreign loans. . . . From these considerations you may well understand why I said that . . . it was better to have more partners and fewer creditors.
>
> We have made a proposal to the member countries of the Cartagena agreement to modify Decision 24 providing more flexible terms in keeping with foreign investment needs. The idea is to allow new investment in certain areas to be 100% foreign when the recipient country decides that its development needs so warrant.

It is now generally recognized by potential investors that one of the difficult impediments to foreign investment in Latin America has been the Calvo Doctrine. Many countries in the hemisphere incorporate the doctrine and other restrictions in their constitutions, in other laws, or in multilateral agreements, such as the Andean Pact decision 24. With regard to decision 24, I am pleased to note that there is increasing recognition on the part of member governments of the pact that more flexibility is required by member governments on foreign investment policies. This was one of the principal causes for Chile's withdrawal from the pact in 1976. Moreover, under the dynamic leadership of Craig Nalen, the Overseas Private Investment Corporation (OPIC) recently signed agreements with Colombia and Ecuador. These agreements were the result of countless hours of patient and persistent negotiation between Lorin S. Weisenfeld, Assistant General Counsel of OPIC, and various officials of Colombia and Ecuador, and it is to be hoped that other Andean Pact countries will follow.

While the United States rejects the Calvo Doctrine on the theory that the investor's government has an independent interest in fair treatment for its nationals, the Calvo Doctrine has unquestionably had a negative impact on the ability of foreign governments to provide diplomatic protection in the event of a miscarriage of justice. This doctrine had its origin in the early part of this century as a reaction to perceived abuses of protection by the United States and European powers on behalf of their investors and traders in the last century.

In countries that subscribe to the Calvo Doctrine, the foreign investor is considered to have agreed that all disputes—including those relating to expropriation—will be definitively resolved through local legal processes, and to have renounced any right to invoke the diplomatic protection of his home government in the event those processes give rise to a miscarriage of justice following expropriation. In the 1960s and 1970s, there were over 300 major expropriations in the hemisphere (excluding the $1.85 billion in thousands of unsettled expropriation claims of former U.S. investors in Cuba) where compensation was not arrived at through international arbitration and was often grossly inadequate or delayed in many cases. Corporate boardrooms around the world have long corporate memories, and as Cicero said to Atticus, "It is the right given to any man to err, but to no one, unless he is a fool, to persist in."

Another negative consequence of this policy is that potential U.S. investors are constrained from obtaining OPIC insurance coverage because of requirements limiting possible litigation to local courts, and of a prohibition of direct subrogation.

The United States has long favored an open international investment system. A major U.S. goal in the 1980s is to reverse the trend toward government-induced distortions in the investment process through international understandings and voluntary guidelines leading to a more open investment climate in which investment flows are able to respond to market forces.

Recent Positive Steps

As part of continuing efforts in this area, the U.S. delegation to the 14th annual General Assembly of the OAS introduced a resolution entitled "Promoting Ecomonic Justice Through Strengthening Private Direct and Indirect Investment in Latin America and the Caribbean." The operative part of the resolution reads as follows:

> To instruct the General Secretariat to conduct a study of requirements necessary for the creation of economic and regulatory environments conducive to attracting and fostering direct and indirect investment in the countries of Latin America and the Caribbean. This study should identify the various private and official, multilateral and national agencies involved in the promotion of investment while also considering and evaluating

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the growing variety of arrangements for profit-sharing and expanded capital ownership now available for the promotion of economic justice with a view to identifying operational mechanisms and sources of funding for cooperative efforts with said agencies that may be implemented in the framework of the OAS.

While the resolution did not come to a formal vote, the U.S. delegation was able to secure agreement, as noted in the rapporteur's report, that these topics would be taken up by the Permanent Executive Committee of the Inter-American Economic and Social Committee of the OAS in 1985. I view this agreement as a major achievement and a major step forward for Latin America, not because U.S., Japanese, or other OECD investors have any shortage of opportunities to invest at home or abroad, but because of the potential benefits to our own hemisphere that foreign direct investment brings in terms of improving standards of living.

The Reagan Administration is actively pursuing two programs in Central and South America which aim to improve the investment climate: the Caribbean Basin Initiative (CBI) and bilateral investment treaties. The CBI, by granting various products access to the U.S. market, provides important incentives for the private sector. Bilateral investment treaties offer important protection for investments. The intent of both programs is to stimulate additional foreign investment.

As you know, the key elements of the bilateral investment treaties are:

- New and existing investment to be granted national treatment or most-favored-nation treatment, whichever is more favorable, but both sides are allowed to list exceptions to national treatment in specified sectors of economic activity;
- Conditions for expropriation which accord with international law principles, including payment of prompt, adequate, and effective compensation;
- Unrestricted transfer of capital, returns, compensation, and other payments into and out of the host country; and
- Dispute settlement procedures involving third-party arbitration both for disputes between the host country and a national or company of the other country and disputes arising between the governments.

While these treaties are generally reciprocal in their provisions, the major inducement for the developing country is the assurances such a treaty offers a foreign investor.

As a result of the leadership of Bill Brock of USTR [U.S. Trade Representative], several countries have negotiated such agreements with us. In this hemisphere, we signed treaties with Panama in 1982 and with Haiti in December 1983. We are also very close to agreement with Costa Rica, and we have had negotiations with Honduras and El Salvador.

While the treaties mentioned above are laudable achievements for the parties concerned, in all candor, much remains to be done for our hemisphere to realize its full economic potential.

Conclusion

I titled my remarks today, "Free Enterprise: Key to Latin American Economic Revival." I would like to end on a positive note. Simon Bolivar said 150 years ago that Bolivia was a beggar sitting on a throne of gold. In an expanded sense, this is still true for resource-rich but extremely poor Bolivia and for several other countries in Latin America. The hemisphere is so rich in natural resources and populated by men and women of such talent and good will that there is no reason that our hemisphere cannot have a bright economic future. All that is needed is for the economic and political leadership of Latin America to reembrace the wisdom of their own founding fathers, Simon Bolivar and San Martin. These men of vision, along with our own Founding Fathers, were swept up with the liberalizing writings of Locke, Rousseau, Hume, and Adam Smith, which called for a separation of political and economic power and emphasized the sanctity of private property. Similar wisdom can be found in the words of Muhammad Ibn Khaldoun, the 14th century Arab jurist, historian, and statesman: "When incentive to acquire and obtain property is gone, people no longer make efforts to acquire any. This leads to destruction and ruin of civilization." ■

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