The Heritage Lectures

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Free Market Prescriptions for Third World Growth
Three Lectures

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The Heritage Foundation

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FREE MARKET PRESCRIPTIONS FOR THIRD WORLD GROWTH

Three Lectures by

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HOW TO TURN THIRD WORLD WORKERS INTO CAPITALISTS

by Ambassador J. William Middendorf, II

I appreciate the opportunity to speak today. I do not think there is a greater issue in all of our lives than the very message that we are going to talk about today – private property, free enterprise, free market principles, and employee ownership – popular capitalism, spreading the means of production to as many as possible, and the benefits therefrom.

This all sounds routine to Americans. We take it for granted, we go on strike if we do not get these opportunities. It is all built into our Constitution and our way of thought. It is just like breathing air. But in my experience of 30 years or more of working with the Latins and other countries, the concept of private property ownership and free market principles has been under attack continuously for at least that long and a good deal longer. I plan to base my talk today on the Presidential Task Force report, which we just presented to the President.

It is a hard-hitting report, produced without tax dollars. Congress offered to help with it, but we said that, if we are going to establish the principle of private initiative/private enterprise, we will start by raising our own means of support, and we did from many, many people.

Broad Support. The recommendations, in turn, can be implemented without fiscal impact. Most of them change policies to get more bang from foreign aid bucks. We had broad Hill support. Liberals and conservatives working together – Chris Dodd, Mike Barnes, Phil Crane, Dick Lugar, Paul Laxalt, Russell Long* – were our sponsors of the legislation for the Presidential Task Force. And it brought together management, labor, Republicans, Democrats, people with private and with public sector experience, businessmen, scholars, theologians, and economists. We had testimony from Walter Biss of the Steel Workers' Union about West Virginia's 100 percent employee-owned Weirton Steel, where an employee ownership program was used to save 8,500 jobs. Weirton is now one of the most consistently profitable, integrated steel companies in the United States with fourteen consecutive quarters of profitability, and as you know, just a few short years ago it was facing Chapter 11. But when the employees decided to band together, buy the company, establish controls, and establish incentives for individual initiative, Weirton had a dramatic turnaround, probably the most dramatic in the history of the steel industry.

Having just returned from two years working with the Common Market helping to negotiate the Basic Steel Agreement in response to pressure from U.S. basic integrated

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steel companies to restrict the imports to a certain amount, it was obvious over and over again that we were not competitive at all with the steel industries in Korea, Japan, and the European Community, and that not all of it was because of their dumping and their subsidizing steel exports. Most of it is because they have gone through the awful expense of converting to basic oxygen and continuous casting. They had modernized on the capital side and established remarkable incentives on the labor side.

Labor Statesmanship. Bill Dougherty of AFL, which is the AFL/CIO unit for Latin America, agreed to support the lifting of the remaining Caribbean Basin Initiative (CBI) trade barriers for Employee Stock Ownership Plan (ESOP) companies in the region. I thought this was remarkable testimony to the statesmanship of the AFL/CIO in this area, as they were willing to sacrifice a bit in order to try to expand and see growth in Central America and Latin America and the Caribbean that must occur.

The major banks (the big creditor banks) testified in favor of including employee ownership in the debt equity swaps. We had support from the "*Solidarista* Associations in Central America. The American Enterprise Institute was represented on the Task Force. The Teamsters also were on the Task Force as well as privatization experts and several religious scholars, including Michael Novak.

All recommendations were unanimously approved by the Task Force. We had no minority reports. The Kissinger Commission, as I recall, was heated. They addressed the question of security on the political side, whereas we addressed primarily the economic side and the moral side of the malaise in Central America, and our report was unanimous.

Answer to Marx. President Reagan, in warmly endorsing our report, characterized employee ownership as the next logical step on the path that benefits a free people. The President's endorsement reflects more than a decade of support on his part for employee ownership. In 1975, he said, "Could there be a better answer to Karl Marx than millions of workers individually sharing in ownership of the means of production?"

We were blessed to have the support of President Oscar Arias of Costa Rica, who is famous for his peace plan for Central America. But in the economic area, he said, "We want to attain a modern economy with more private ownership. We cannot accept the false premise of economic efficiency or justice. Instead, we intend to pursue both goals simultaneously." And there are examples of Arias's action-oriented commitment both to privatization and to employee ownership. Recently he oversaw the transfer to employees of the largest agroindustrial company in Central America employing about 200,000, and he promises to reach the full potential of private initiative. He quotes de Tocqueville's *Democracy in America*, "The more widely personal property is distributed and increased and the greater the number of those enjoying it, the less a nation is inclined to revolution." I think that is significant for a country that has a very high debt per capita, and has followed some of our leadership, as in the Gunnar Myrdal formulas and others back in the 1950s and 1960s, and accordingly set up a number of parastatals.

That captures the essence of the Task Force recommendations and the reason it is called The Presidential Task Force on Project Economic Justice. It is not a thick report, but an

enormous amount of testimony went into it, and I think you will find it interesting, because it parallels the thinking of most of you here.

Between Extremes. The basic premise is that the development requires stability, and stability requires justice. When the countries in the Latin American region swing between the extremes of concentrated private ownership and government ownership, with no consideration of a middle road, no middle class can develop in many of the countries.

Thirty-two years ago, in a great lack of wisdom, I participated on Wall Street in starting the first mutual fund to invest in Latin America. I had a dream that all we had to do was invest down there and transfer a lot of the technology and business practices that were so successful in the United States. With U.S. investments and technical support, Latin America would transform itself and march rapidly toward a total free market/free enterprise economy. But Latin America has always gone through these remarkable cycles, in which the countries dabble with democracy, and after making a fiasco of that, turn around and take the military junta back in. The military junta are the biggest spenders the world has ever known. They set up parastatals all over the place, and crony capitalism sometimes, and many times they bring in their buddies — ex-generals — to run these companies. Nobody is watching the pocketbook, the parastatals become bloated, deficits become greater and greater, they take priority through the control of foreign exchange, and central banks are nationalized in order to bloat these parastatals further. The debts get bigger. The banks are willing accomplices — banks up here lend money to those down there — and pretty soon it ends up as it is today, 375 or more billions of dollars of uncollectible debts.

Tragedy for Mexico. We think this cycle has to be broken up. And in the meantime, during the period of expropriation and nationalization, there is a direct attack on private property. Since 1960, there have been 300 major expropriations in Latin America, most of them of companies that were the means of production, certainly the mining interests, and not always with any thought to adequate compensation at all. Expropriation of the banks to get control of the money is usually a marvelous tool for concentrating power. I remember being in Mexico City the night in 1982 that President Jose Lopez Portillo nationalized the banks — a horrible moment, in my opinion, and a great tragedy for Mexico. But there were riots in the streets and cheering that night. They thought Lopez Portillo was the greatest single hero, probably since the 1911 Great Revolution. They were going to put up a huge statue to him. All the newspaper headlines proclaimed it a marvelous development. I just felt sorry for Mexico. It was not long after that that Lopez Portillo left town with only a buck or two.

We feel that, in employee ownership programs, the approach is appealing. A broad political spectrum of multinational organizations and international financial institutions are behind it. The Agency for International Development (AID) favors ESOPs as a privatization financing technique. The Kissinger Commission noted the need for expanding capital ownership. Privatization is a key component for these reforms, and as President Reagan said, "To be an effective force for peace, the United States has a responsibility to work for constructive change and not simply to preserve the status quo." And to achieve that goal, he suggested that future economic assistance — through AID and other programs — must be carefully targeted and make maximum use of the energy and efforts of the

private sector. Also employee ownership creates an incentive to privatize bloated parastatals, and employee ownership can create a political constituency for further privatization. As Franklin's *Operational Feasibility of Privatization* says, if the sale is structured to tempt the motivation and dedication and initiative and enthusiasm of the employee owners of privatized companies, it gets away from crony capitalism where a country says, "Sure, we'll privatize," perhaps under pressure from the IMF/World Bank, the U.S. AID or others, and then turns the companies over to their inside buddies. That is not constructive, and it is just carrying on the vicious circle.

Hubert Humphrey once said, "The only thing wrong with private property is that so few people own any of it." And Daniel Webster said, "Power naturally and inevitably follows property."

Respect for Property, Responsibility. In the opinion of the Task Force, the best route to economic justice lies through widespread ownership of property, including productive capital. And the only way to improve the investment climate in Latin America, which is dreadful right now, is to strengthen respect for private property and individual responsibility. When a deal, a contract, is made, it is supposed to be lived up to. It will not be expropriated, nationalized. It will not be chased out of town through exchange controls, through interference, overregulation. So many U.S. companies have fled Latin America over the years. You cannot do business down there, and it is a tragedy when these countries so desperately need the foreign direct investment that brings with it management skills, and technology, and the capital that, in turn, creates export markets for those countries back up in the investing country. We support the idea here in the United States. Think for a moment what would have happened if the U.S. had not had the British and the German investments back in the 1880s and 1890s to help build our railroads, or today, those of the Japanese and others. Think of the inflation that we have had, the problems, the crises we have here in the United States today. How much more do the underdeveloped countries need it? They not only must attract new investment, but, and much more significant, they have to stop the outward flow of capital.

The Morgan Guaranty Trust estimates that over the last several years, $200 billion has fled from the LDCs. One of my Peruvian friends told me while he was at the OAS that, when he emerged from the womb, his mother said, "Son, there are two things I want you to remember the rest of your life. One, be a good Catholic. And number two, get your cash out of the country as fast as possible."

This cycle has just got to break. That is what the Presidential Task Force addressed. We think that nothing is preordained — that the money has to get out and that everybody has to be broke. Across the border in Mexico, the per capita income drops to one-tenth of what it is in Texas. Now, is it preordained that those folks should be poor, that the Latins do not have brilliant poets, musicians, artists, scientists, businessmen? Of course they do. They have all those things. Some of the best farms in the world are those of Bolivian *campesinos*, who cultivate their crop on a three and a half hectare plot on one of those marbled hills and produce a crop to feed their families. I think they have to be an example of some of the greatest farmers in the world. And when you consider that price and wage controls drive many of them to the cities in most of these countries, it is, of course, a miracle that there are

any farmers left among those Latin countries, since such government interference is the main social ill down there.

Worker/Owners Defending Themselves. There are many wonderful examples of employee ownership. We mentioned in the report La Perla Project in Guatemala (the President had talked about it). Forty percent of this coffee plantation, which is owned by the government and formerly was owned by a group in Guatemala City, was turned over to the employees. Unlike the other coffee plantations, it was not overrun by the guerrillas and decimated. The insurgents showed up. There were a number of guerrilla attacks, many deaths, but the workers said, "We own this and we are going to hang in here." They did, and they fought them back. La Perla is the only coffee plantation in that area that still survives, and it is thriving. All the employees contribute payroll deductions to buy rifles to further protect themselves and their families. And now, many of the insurgents are coming across to seek to join the enterprise. And so it has been a success, which deserves support.

Right now, it is very expensive for them because it is 30 miles through jungle to the nearest town. They have to helicopter a lot of their goods and provisions in there, and they need a road and bulldozers to help with that. My wife and I have donated a large bulldozer to help clear the roads, and they are working on the road to develop it so they can have more access to the markets.

It is a program that we should get behind, because these concepts are consistent with Catholic social teaching dating back to 1891, which is the only feasible way to create a broad property-owning, free enterprise system that we know of. Everybody agrees widespread capital ownership is a worthwhile goal, but there is a catch-22 – how to broaden wealth without redistributing wealth? How do you make investors of those without funds to invest (a typical case for most workers)? Obviously, under these circumstances, widespread capital ownership can only be accomplished on a financed basis, borrowed money to acquire capital on terms whereby the loan is repaid from the earnings on the capital acquired.

No More "Ugly Americans." This concept is encouraged in the U.S. through the efforts of former Senator Russell Long, one of our Task Force members, and the tax incentives of Employee Stock Ownership Plan financing. It is a wonderful program. But in the case of Central and Latin America, we are working with the political systems to help structure their trust laws to create further incentives. It is not quite as structured as it should be. We want to avoid becoming "Ugly Americans" again. For example, using the debt equity swap, Banker's Trust became the owners of Chile's largest insurance company, and that is a blessing for Chile. But there are these normal cynics, critics, and communist groups who say again, "This is an American expropriation – a colonialism" – the typical jargon that is heard all over Latin America from those who do not wish us well. For this approach could restart the cycle, because concentrated foreign ownership is seen as unjust and therefore could lead to expropriation again. Then the parastatals would begin borrowing for inefficient operations, again seeking foreign exchange, and so on.

George Shultz said recently, "America needs to get ahead of history." And the overall objective of foreign aid – U.S. foreign aid – is to create those conditions in the world

under which free societies can survive and prosper, thereby bringing up the whole potential of private enterprise, as President Arias said.

Pope Paul VI phrased it very well, "If you want peace, work for justice." But that justice can be obtained only through breaking up the restricted ownership patterns that have created rich elites and disaffected masses, doing so by strengthening the respect for private property, for contract rights – the sanctity of contract – and for the rule of law. Only in this way can we refute the Marxist claim, made not without some justification and reason, that private enterprise benefits only the rich. My recommendations include debt equity swaps along with employee enterprise. Expanded capital ownership should be a prime goal of U.S. development assistance. It is time for us to ask, "Whose economic development?" Channeling U.S. assistance into employee-owned enterprises, by such means as earmarking a portion of the Inter-American Investment Corporation funds for investment in employee-owned companies; promoting land reform efforts that retain the economic scale of large estates while making employees part owners or owners. That was one of the tragedies of the Prostemon Plan for El Salvador, which expropriated all the land, but then failed to turn it over to the employees or to the workers. It was just another way of extending government control. Opening U.S. markets to the products of employee-owned enterprises in the region without regard to U.S. quota restrictions may help, but it is a debatable point. Rebating tariffs collected on employee-owned enterprises; enterprise exports with the funds used to offset export duties; support for structural changes to assist in growth of employee ownership; and P.L. 480 – Food for Peace – local currency funds to underwrite employee owned investment insurance corporations for participating countries.

Even Soviets Agree. In that I have mentioned privatization and the spread of free enterprise, I would like to read a quote and ask you to tell me its source, because I think it is significant. "Over the centuries, humankind has found no more effective measure of work than profit. Only profit can measure the quality and quantity of economic activity and permit us to relate production costs to results effectively and unambiguously. The basic vice of our current economic system is the total irresponsibility of the upper levels of the pyramid, the absence of any feedback from below. Who will break our managers, especially the high level ones, of their futile ideology, castle-like haughtiness, confidence in their own invulnerability, and the God-given right to command? Why should they think they are above the law and immune to all criticism? What we need here is democracy in free enterprise." Now, who made that quote? Jack Kemp? Ed Meese? There are not too many answers, so I will tell you it is from the June issue of *Novy Mir*, the Soviet Union's leading political and literary journal. Its author was Nikolai Schmeliok in Moscow. If the Bolsheviks think this is an idea whose time has come, why cannot the liberal economists in the U.S.? If it is good enough for the communists, then now is the time for them to get behind it. And let me read you what some of those liberal intellects (not necessarily the communists) have said over the years. In 1956, Gunnar Myrdal (not one of my favorite economists) said, "All special advisors to the underdeveloped countries who have taken the time and the trouble to acquaint themselves with the problems, no matter who they are, all recommend central planning as the first condition of progress."

And Paul Baron, in 1962, the Stanford professor who, as Paul Frank Epps points out, was overlooked by the university that lionized him for his Marxist-Leninist views, said, "The dominant issue of our time is that private property is in irreconcilable contradiction with

the economic and social advancement of people in the underdeveloped countries." Well, that's refreshingly clear. He makes his point, and does not make things confusing, as do some of his milder voiced colleagues.

Boldfacedly he declared in 1962, "Economic surpluses expropriated in lavish amounts by monopolistic concerns and backward countries is not employed for protective purposes. It is neither funneled back into their own enterprise, nor does it serve to develop others."

Crowded Out by Debt. As private property was ruled out of the development process in the 1950s and 1960s for being useless, it was up to the rich countries to provide the non-equity development capital. Thus, from the very beginning, economic development in the 1950s, 1960s, and early 1970s was crowded out by debt.

Now, in the old days the debt came from bonded indebtedness, but following Simon Bolivar's takeover in the late 1820s, the first renunciation of debts occurred. There were four or five major renunciations across the board in Latin America up to the crisis in 1890, which was another dramatic across-the-board renunciation of debt — and in each case, bonded debt. And in 1914, again, across-the-board. In 1931, again it occurred with the exception of Argentina, which had some grain sales and meat sales, and was able to continue on through 1931 through 1933, and I think, Peru was the last to fold in 1933 with debt across-the-board. But that was all bonded debt.

Rich Politicians. In the early 1970s, it all became bank debts. Of course, the Latins, following the concepts of Gunnar Myrdal and others, were happy to grab some of this cash money as they had many times before. And the result of placing vast amounts of resources at the fingertips of the Third World politicians is that many of them are among the richest people in the world.

For most of the 1960s and 1970s, and certainly when I became Ambassador to the Netherlands in the late 1960s and worked with some of the development personnel, from a Netherlands point of view and in U.S. programs in those days, there was an almost supernatural belief that government investments would generate the wealth to pay back the debts incurred, despite the fact that these investments were not guided by any market sense of profitability or productivity.

The matter was compounded when Western banks began to make large loans to the socialist Third World governments. By discounting the likelihood that there was no wealth generated to pay back the loans, the banks removed the last market condition from the process, virtually insuring that the loans in the entire development process would not sour. And such is the case today. If these conditions continue, the vicious circle will never be broken. At this time, a ray of hope is offered by support for the provisions of the report by the Presidential Task Force on free market solutions to these seemingly endless debt problems.

WHY WE HAVE A DEBT CRISIS – AND WHAT TO DO ABOUT IT

by Victor Segal

"Neither a borrower nor a lender be," are the words that Shakespeare put into the mouth of Polonius advising his son about to depart on his travels. I must confess I have always thought this piece of advice to have been rather exaggerated. It is easy to understand a father's concern, but surely to accelerate the momentum of economic and commercial activity, to make the odd investment, to lend a little money, or to borrow a bit here and there seems not unreasonable, up to a point. If Shakespeare were living at this hour, however, he might be smiling, possibly even smirking, because in view of today's global debt crisis, it is clear that Polonius had a point.

The international debt crisis is, of course, a major topic today. It has had widespread impact on the commercial development of the entire world and particular impact on the stability of the banking system, especially on those companies that find themselves burdened with so much debt. The Chairman of our partner company, European InterAmerican Finance Corporation, Martin W. Schubert, addressing this same foundation last January, wondered whether his talk, which dealt with the debt equity conversion concept, should really have been called "Is There Life After Debt?" This is, I think, a valid question.

Irreversible Change. In August 1982, when the government of Mexico telexed its numerous bank creditors all over the world to the effect that it was calling a moratorium on principal debt repayments, the world of international banking changed dramatically and irreversibly.

Certainly Mexico was not the first sovereign borrower in recent times to have had to communicate with its creditors in this fashion. Poland had requested debt rescheduling a couple of years earlier, but in the case of Mexico – oil-rich and with a common border with the United States – it was very much a question of the "unthinkable" actually happening. To be sure, in the preceding months there had been increasing signs of the pressure building upon the Mexican treasury; but international banks were loath to draw the conclusion, now so obvious in retrospect, that Mexico was going to require some accommodation with its creditors.

Suddenly, the soft option of refinancing current maturities with renewed borrowings disappeared as an available course of action to the treasuries of most LDCs. Bankers, in something of a state of shock over Mexico's action, were suddenly unwilling to renew their loans or put up new loans to other LDC governments, none of whom were able to service and repay their debts solely from internally generated resources. So most LDCs in Latin America, East Europe, Africa, and some in the Far East were quickly required to re-examine their ability to meet their debt obligations without being able to rely on new

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borrowings. The result was all too predictable: one by one, the major LDCs were forced to invite their creditors around the table to discuss rescheduling terms.

It is difficult, and perhaps not fruitful, to apportion blame for the circumstances that gave rise to these unfortunate events. Following the oil crisis of 1974, the major international banks were awash with deposits resulting from huge cash inflows into the coffers of the oil-rich countries.

More Caution. Perhaps more caution should have been exercised in deciding whether or not the major banks should really have bid for these deposits and at what rate. More caution also would have tempered the extravagant lending patterns that evolved in the late 1970s, especially toward the LDCs. Banking executives in general were motivated to "sell" their loans to pre-determined target levels, sometimes irrespective of (or without) sensible analysis of the likelihood of potential repayment.

As regards the borrowers, it was always tempting for them to take advantage of the short-term answers that constantly were being offered to the long-term endemic problems. It was too easy to take in another jumbo loan to deal with the current year's debt servicing, and perhaps have a little left over for some new favored project.

Debt-swapping activity had its origins in early 1983 in the aftermath of the new harsh financial reality that finally caught up with these excesses. In 1983, the suggestion that Mexican government loans might be sold at 82 percent or Argentine loans at 78 percent was met with a variety of reactions. At one end of the spectrum were the beleaguered commercial bankers, with significantly more than their fair share of frozen LDC debt, who stated that they were "comfortable" with their Latin American exposure and that it was unthinkable to consider any of it to be worth less than 100 percent.

By contrast, the smaller banks, or those with a less significant proportionate exposure, believed it represented an extremely sensible opportunity. One by one, such banks dipped their toe into this market, and many were successful in eliminating their entire LDC portfolio at prices (and therefore ultimate book losses) that would be the envy of today's seller.

Attractive Possibilities. In the early stages, the buyers included offshore branches of Latin American institutions who, by shrewd management of their liquid resources in early 1982, suddenly found themselves with an array of attractive possibilities. However, the number of buyers was soon swamped by potential sellers; the market would perhaps have been strangled at birth but for the entry on the scene of the most significant player of all, the swapper.

The swapper, the bank that would sell one LDC debt either wholly or in part exchange against a different LDC debt, now saw various opportunities that previously had not existed. Some banks found themselves with uncomfortably high proportions of their total LDC indebtedness in one particular country, and it obviously made sense to readjust the spread of risk. There were, and still are, other banks who believed that most LDCs were in the same boat with comparable chances of either economic failure or (less likely) recovery. They therefore sought, and still seek, to take advantage of any price differential by selling

the debt of country A for a combination of debt of country B and cash, thereby reducing their overall LDC exposure.

The significance of the market in the context of the overall debt problem has always been susceptible to exaggeration. There has always been something instinctively attractive to the journalistic profession about the debt swap market. The number of articles on the subject in the world's financial press, as well as in the number of broadsheets read by international bankers, is constantly proliferating. The very existence of so much comment on the subject has the by-product of creating an illusory sense of the size of the subject matter being described (and of the number of professional intermediary "players").

Over recent years then we have seen a simple and embryonic trading activity develop into a fairly sophisticated market with many key players although, as suggested, perhaps not as many as we might imagine. Through an understanding of the nature of the problems facing international banks with regard to LDC loans, we have seen various innovations gradually take shape. Some of these have hardly progressed beyond the idea stage, but others have been perceived by LDC governments themselves as having some benefit and thus have developed into real systems and opportunities. The debt equity conversion, which has progressed from an idea to a government-backed policy, and in certain countries at least, to a systematic process, is the best example.

Debt Equity Conversion. Stated in its simplest terms, a debt equity conversion is a process by which the debt of a particular LDC that forms part of what was originally a mass of syndicated international commercial bank loans may be redeemed in exchange for local currency of that LDC. A key part of the process concerns the nature of the "investment" to which the local currency is then put. This has been, quite properly, dealt with by the LDCs concerned, and their particular policies in this regard are embodied in the detailed regulations that have been created for such transactions.

Obviously, a debt equity conversion would have no relevance at all without recognition that the debt was impaired and was changing hands in a secondary market at less than nominal value.

The system really is one where advantage may be taken of the discounted price of the debt by the discount being shared among interested parties, such as the issuer of the debt (or its government) and the new investor. It is of course the investor in a particular LDC who provides the key ingredient. Without him there can be no such debt equity conversion.

Chilean Example. To use an example, an international natural resources group may decide to purchase a controlling interest in, say, a Chilean forestry company. If the foreign buyer has to pay a full commercial price, and pay it in a hard currency, he may well take the view that in the current uncertain situation he would prefer to invest in other parts of the world. If, however, instead of putting up hard currency, he buys Chilean government loans at, say 60 percent, pursuant to a scheme where he retains a portion of the benefit of the 40 percent discount, it may just make the difference in his decision making. On completion of the deal, the Chilean-selling shareholder will receive his payment in local currency, the foreign group will have made its investment on acceptable terms, and the Chilean government will have retired a portion of its borrowings.

Debt equity programs are now well established in Mexico and in Chile. In such countries as Brazil, Argentina, and the Philippines, a number of debt equity conversions have taken place, although perhaps not on the same scale as the first two countries mentioned. In addition, such schemes are under active consideration by the governments of most other LDCs, and there has been no shortage of commercial and/or merchant bankers who have made proposals to finance ministers all over the world to help promote wider implementation of these schemes.

Key Question. Any sensible contemplation of debt equity conversions must consider the key long-term question: Is a particular transaction in the best economic interests of the host LDC? If we are to see in the coming months and years a long parade of concluded debt equity conversions where the benefits flow only to the investors and the commercial banks, we are not going to see this type of transaction continue indefinitely. The real pain caused by the LDC debt crisis, certainly in human and political terms, has been felt for the most part in those countries that have become overburdened by their past borrowings. They must now share the economic benefit of debt equity transactions.

The first question that a finance minister might ask himself is whether or not he is giving up an inflow of hard currency by giving approval to a particular conversion. If he is, there must then be serious doubts as to whether such conversion is in that country's long-term interests. The preservation of any over-borrowed country's hard currency balances must be of the utmost importance. The test that should be applied in considering any particular scheme, therefore, is whether or not the foreign investor or the local subsidiary of a multinational would make the investment even without a debt equity conversion. If it would, then clearly the LDC would need to have other valid reasons for the approval of such a scheme.

An economist would, quite rightly, point out that artificially increasing the liquidity of domestic currency in any LDC is an extremely inflationary act. Certainly the danger of creating even more inflation caused by these conversions has to be measured against the economic benefits that would accrue.

Negative Possibilities. As perhaps foreshadowed above, there are negative possibilities in the proliferation of these schemes. The biggest danger is that debt equity conversions might be approved for the wrong reasons, that the considerations mentioned above might not be taken into account as the key factors. For example, there is scope for the authorities to succumb, against their better judgment, to strong commercial and banking suasion. Alternatively, parochial interests within an LDC, especially if voiced with sufficient political clout, might also play a disproportionate part in the decision-making processes of the ministries of finance.

There appear at this stage to be two possible paths that the future development of debt equity conversion might take. First, they may proceed sensibly, in a well ordered manner and in line with the appropriate economic factors touched on above. The market would not then be flooded with a variety of projects many of which might not be appropriate for debt equity conversions. Rather, the smaller number of such projects that do make economic

sense for the LDC and commercial sense for the investors, whoever they are, would then continue to flourish, albeit at a moderate pace.

The other path is one that would lead to an imminent debt equity conversion "boom." We would see a mushrooming of these transactions, many of which would be for the wrong projects and for which approval might have been given for the wrong reasons. Certainly, there is no shortage of commercial banks ready to grasp at any investment opportunity as a method of spreading their risk. If a conversion free-for-all develops, a number of such investments may well be of dubious quality or might not bring sensible economic benefits to the host LDC.

In such a scenario, this frenetic activity might be followed by a period of pause and reassessment, mainly by the LDCs themselves, following which the whole area of debt equity conversions could emerge as a discredited concept. The hope is, of course, that common sense will prevail. This will need to take place not only in the finance ministries of LDCs, but also in the board rooms of the world's major banks.

Taking an overall view, debt equity schemes at best will represent a small part of the solution of the debt problems. Our best hope is that these schemes will continue to form a part, in some cases an important part, of the many answers that will be needed during the remainder of this century to rehabilitate the economies of the so-called Third World. But perhaps the most significant part of the answer will be — time.

HOW TO GET FOREIGN AID POLICY BACK ON TRACK

by Paul J. Haire

I am honored to be here today to talk with you about what the U.S. foreign assistance program should achieve. Having just completed three years as a political appointee at the Agency for International Development, I am also very excited that The Heritage Foundation and its distinguished supporters are expressing such interest in this policy area.

It is a field that I believe to be poorly understood, not only by the public, but by its own practitioners and by the senior inner policy circles of the executive branch and Congress. Although critical to our national interest, this area has been the protected domain of a clannish brotherhood of "development professionals" for far too long.

Heritage's choice of this topic is also timely. There is a struggle developing between two schools of development theory. In the most general description of the differences between the two schools, one side believes in the competence and benevolence of government, and the other side believes in the checks and balances of free markets operating under restrained government oversight. The struggle between these two approaches is one that will affect tens of millions of people and the way in which the U.S. spends, or perhaps whether it continues to spend, the tens of billions of dollars Congress currently appropriates for bilateral and multilateral foreign assistance programs.

Before I proceed too far into the discussion, I would like to issue a disclaimer: There are no good guys and no bad guys in this story. Both sides comprise compassionate, intelligent, and energetic people. Nor is there ethical superiority to either school's approach. I do not like hearing liberals make such claims, and I will not commit the same wrong.

Compassion Not Always Effective. To the extent that the free market school harshly criticizes those who place their faith in government organizations, it is this: Believers in expansive government should recognize that it is not always the case that, if a program is rooted in compassion, it will be effective. Sometimes an initiative is more compassionate if it sets less idealistic goals and is rooted in an effort to be effective.

The balance of the political dynamic that will control which school will eventually win this struggle may be tipped as soon as within the next four to five years. The timing will depend largely on what the Reagan Administration does in this area during the next year. To have a positive impact, the Administration must substantially increase its activities in support of its own announced market approach to development far beyond the level of the past six years. If it does not, then the failure to reform the foreign assistance establishment is likely to remain as one of the Reagan Administration's most significant missed opportunities. But of course, this struggle will outlast the current Administration. It may take up to ten or twenty years.

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Major Forces. I would like to try to give you a brief overview of the three major forces that will shape the nature and the timing of this struggle: relations between donor and recipient nations, the corporate cultures of the large bureaucratic foreign assistance institutions, and the strengths and weaknesses of leadership within the pro-market school.

Since its inception at Bretton Woods 43 years ago, the fundamental purposes for which the United States engages in a foreign assistance program have been clearly understood as: national security, humanitarian compassion, and economic self-interest. While I am certainly only an amateur when it comes to the history of foreign assistance policy, I think I am on safe ground in saying that both the U.S. bilateral and multilateral initiatives share these purposes in common.

In 1944, the free nations of the world met at Bretton Woods to think through how to cope with World War II's aftermath of destruction and demobilization. The conveners of that conference held the belief that prosperous, open democracies do not willfully go to war. They saw the roots of the recent conflagration as ignorance, economic despair, and tyranny. They believed that, if these destructive social forces could be eradicated or at least attenuated, the threat of future global strife could be greatly reduced. Their aim at Bretton Woods was to establish mechanisms and conventions that would ensure international financial stability and secure shared economic prosperity. The International Monetary Fund was founded to provide for international financial stability. The International Bank for Reconstruction and Development, better known as the World Bank, was founded to foster a sharing of economic prosperity among nations.

In setting up these two separate institutions at Bretton Woods, the framers of that agreement saw the two functions as inseparable, as mutually reinforcing; growth and prosperity as necessary to democracy and stability; and democracy and stability as necessary to growth and prosperity. This is still a tenet of the market theory approach to development.

Fundamental Purposes. There is little disagreement, even between liberals and conservatives, that a foreign assistance program can and should be employed to fulfill the three original and fundamental purposes; national security, humanitarian compassion, and economic self-interest. In other words, the flag, mom, and apple pie. No room for disagreement there.

The often vitriolic disagreement that does occur between liberals and conservatives stems, only in part, from what relative priority the two sides assign to each of the three purposes. More important, however, the disagreement stems from differences in the level of faith the two have in what the foreign assistance program is capable of achieving through social engineering.

By social engineering I mean the creation of social institutions that compel behavior within a society that otherwise, because of internal attitudes and values, would not exist in society. The theory is that by compelling involuntary behavior such institutions can take the place of values or foster the creation of values. For example, in place of a corrupt marketplace riddled with price fixing, established monopolies, bribery, and double and triple sets of books, social engineers institute central planning, price controls, credit allocation, and confiscatory tax and licensing systems.

Levels of Complexity. Clearly development depends not only upon institutions, capital, and technology but upon increasing the levels of complexity in social organizations. Factories are more complex than cottage industries, universities more complex than village schools, interbank markets more complex than tribal finances, concepts of constitutional law and judicial precedence more complex than village courts.

The important consideration in development is not to base increasing social complexity in power relationships, particularly not in the government's power over the people, but to root such arrangements in self-perpetuating social values and the relationship of people to people. This is an essential safeguard to democracy and individual civil and economic rights. Such complexity requires people to depend more and more on individuals with whom they have no prior relationship. To structure and support this complexity, there must be a cultural acceptance of an increasingly sophisticated social contract and the ethics, values, and expectations that come with it.

Societies make ethical and moral progress through a dynamic learning process similar to that of the individual human psyche. As they gain experience, they become less impulsive, more cognitive. Individuals can foresee the advantages they would derive if they could get themselves and others to buy into the higher level of social complexity and the requisite higher ethical standards that are necessary to make that degree of social complexity work.

As do humans, however, cultures can hang on to habits long after they recognize intellectually that they are bad habits. Eventually they can unlearn attitudes and behavior, but it takes time. Sometimes it takes sinking into the depths of corruption or tyranny before a cultural catharsis can end old values and forge a consensus around new ones. I believe that we saw this in Argentina following the Falklands debacle, and we all hope that this is happening in the Philippines and South Korea.

Social Engineers. Now, to the extent that both central planning and free market development efforts seek to guide or expedite social change, it can be claimed that all development professionals are to some degree social engineers. It is probably most appropriate to view professionals, programs, and institutions as lying along a continuum ranging from the heavily interventionist "social engineers" to the ever reluctant "free market minimalists."

To those who would minimize or restrain (not eliminate) the direct control of a less developed country's (LDC) government, the harsh reality is that a high degree of social engineering often distorts or stifles the evolution of values, institutions, and mechanisms that would eventually have occurred through open democratic and free market processes. Unfortunately, from the days of Robert McNamara at the World Bank until recently, the social engineers have so thoroughly dominated the teaching and practice of foreign assistance that any penetrating questioning of the doctrine would have led to expulsion from this secure and prosperous fraternity. Any doubts about this security or prosperity would be quickly dispelled by a look at the World Bank salary and personnel structure.

At long last, however, as a result of two decades of social engineering that have ended in widespread stagnation among the countries receiving foreign assistance and as a result of an

increasingly skeptical and budget conscious electorate in the donor countries, the limits of the social engineering approach are finally being critically discussed. Furthermore, those in charge of "selling" the foreign assistance program are having to explore for new sales pitches, and the rhetoric of free market minimalists has frequently been enlisted. In the hope that it will attract the swing votes for their budgets in bilateral and multilateral programs, small "throwaway" amounts of money are being given over to "experimentation" with programs that emphasize individual rights and initiative.

Essential Experiments. These programs are based on the approach that, if governments restrain themselves to the role of ensuring open and competitive markets, equal opportunity under the law, and the civil and economic rights of individuals, then individual initiative and creativity will lead to growth and prosperity. Even though they are currently grossly underfunded and unintegrated into the major operations, programs, and projects of the various foreign assistance institutions, these "experiments" are essential to any hope that the foreign assistance program can achieve long-term constructive results.

This is not to say that this approach is the one-shot cure. There is no single arrow with which to slay the cruel oppression of poverty and oligarchy. Programs are needed to fight savage childhood diseases and protein-starved diets that leave large segments of LDC populations mentally and physically impaired. On the other hand, such things as agricultural price controls that destroy farmers' incentives or systems of government-provided credit that displace the evolution of private systems must be avoided. And yet free market programs are receiving only minimal institutional support from within the foreign assistance establishments in either donor or recipient countries. In virtually every foreign assistance institution, if there is any support at all, it is confined to a narrow group of managers and professionals. Moreover, I cannot think of a single institution, U.S. or multilateral, where senior management has provided the level of resources, personnel, and authority that will be necessary if significant change is to occur.

If the most important thing for the foreign assistance program to achieve is the reorientation of the foreign assistance establishment away from the dominance of social engineering, what are the problems? To answer that, I would like to focus more specifically on donor-recipient relations, internal management of donor foreign assistance institutions, and leadership from within the ranks of free market minimalists.

Philippine Golden Rule. Within donor-recipient relations, one of the most serious impediments is the refusal by both to confront local value systems that do not hold collusion and graft to be unethical. My favorite example of a deeply imbedded value system of this type is the ethic in the Philippines reflected in their Tagalog saying "*Utang Na Lob*." I am not singling out the Philippines because it is relatively worse than other countries I have dealt with. Rather, it is because I have always been charmed by the subtlety of "*Utang Na Lob*" and because the Philippines is a clear case of a culture attempting a radical transformation.

The closest translation of "*Utang Na Lob*" in the English language is the old colloquialism "you scratch my back and I'll scratch yours." But that translation does not capture the complete meaning that phrase has for a Filipino. To them "*Utang Na Lob*" also contains the golden rule — "Do unto others as you would have them do unto you." "*Utang Na Lob*" is

viewed by many Filipinos as essential to their social dynamic. There is a social obligation to scratch a colleague's back whenever it is possible.

In an effort to side-step this diplomatically delicate matter of values, both donors and recipients often avoid free market solutions. They do so because, for a free market to be a free market in more than name, a government must be willing to seek criminal and civil sanctions against those who perpetuate collusion and graft.

Furthermore, it is not only a reluctance to confront social values that works against the adoption of free market approaches. I am stating the obvious when I remind you that very powerful personal interests have been built up around the central planning approach; interests that depend on government control for personal economic benefit.

It was always a bit strange to talk with a minister or member of staff about reforms when I was with AID. The thought always haunted me that the person I was talking to might be gaining 80 to 90 percent of his or her personal income from the existence of a function, such as licensing, which I wanted to see abolished.

Paid for Peace. Another problem within donor-recipient relations that works in opposition to the adoption of free market solutions is the U.S. State Department's use of foreign assistance funds to buy cooperation from a country's government. One of the best examples of this, on a monumental scale, is the $8 hundred million that the U.S. gives each year to Egypt. In theory, this assistance is given to Egypt to secure cooperation in a reduction of tensions with the state of Israel. But the result of U.S. assistance is that, in Egypt, the U.S. finances the continuation of one of the largest, most stifling bureaucracies in the world. It is a mechanism of government control that could not perpetuate itself financially if the U.S. taxpayer were not footing the bill.

Furthermore, is it necessary or constructive to pay someone not to attack a neighbor? First of all, it is a lot less expensive for Egypt to be at peace than to maintain a war footing. In other words, it is in Egypt's own financial interest to be at peace, and they do not need to be compensated for it. Indeed, U.S. financing reduces the natural tensions between Egyptian domestic and military spending.

Second, because the U.S. is "paying" the Egyptians not to go to war with Israel, it is in Egypt's interests to maintain a sufficient degree of tension to ensure continuance of the largess. Lastly, it is not in the interest of any other Middle Eastern party currently hostile to Israel to initiate a peaceful dialogue of their own volition because they would be unilaterally conceding their best hope of obtaining a deal similar to Egypt's.

Dumping Dollars Game. Another debilitating aspect of donor-recipient relations is the U.S. effort to secure short-term stability through pouring dollars into a country's economy. I call this the dumping dollars game. The process begins when a strategically or politically important, friendly nation finds itself bankrupt, either with a central government budget deficit or with national imports and payments for debt in excess of their dollar exports. Faced with such a situation, our ally argues that the changes necessary to bring government or national finances into balance would have a destabilizing influence on the party in power or the country as a whole.

To avoid such a calamity, the U.S. dumps dollars into the local economy through projects that are developmental in name only. More often than not, the effect is the exact opposite of development. As in El Salvador, where the Minister of the Interior has declared that coffee does not belong to the farmer who grows it, but to the country as a whole (by which he means the government), U.S. funds sustain a flawed system that will eventually find its ally in a deep, perhaps untenable, economic hole.

Game of Chicken. Furthermore, the recipients and their high-powered, highly paid Washington consultants have learned how to play a game of chicken with the bilateral and multilateral donor agencies. They are well aware of the pressure on AID to spend its allocated funds by the end of the fiscal year or lose the money back to the Treasury. They are also aware of the multilateral institutions' bureaucratic self-interest in running up the amount of loans outstanding. So, many of the LDC governments have learned to drag their feet until donor agencies give up on their demands for significant reforms.

Interlocking with these pressures on donor-recipient relations are the operational rigidities within the organizational structures of the U.S. bilateral foreign assistance establishment and the four multilateral development banks. In simpler terms, the social engineering school of development has nearly total control over these institutions and has developed systems to defend it. To begin with, it must be recognized that policies do not enact themselves. People are required to carry them out. Whoever controls the people controls the policy.

Punish or Reward. What I have to say next should come as no surprise. It is the staff — not management — which controls the destiny of personnel in both the bilateral and multilateral institutions. The outcome, quite naturally, is that staff — not management — controls policy.

The system by which staff at AID insulates itself from such "exigencies" as the general public's exercise of free will through general elections is referred to as the Foreign Service System. It is Foreign Service Officers — not management — that control the hiring of new personnel, the assignment of overseas postings, promotions, classifications, pay bonuses, and the allocation of resources, both financial and personnel, that will be available to each and every department, post, and person. In other words, the Foreign Service Officer brotherhood — not management — can punish or reward.

This system is further reinforced by the self-selecting process inherent in who applies for jobs in foreign assistance. The vast majority of those who apply are people who seek close, personal, cross-cultural experiences. Many of them come out of the Peace Corps. They are usually highly compassionate people, often with a great distaste for competitiveness. Most value getting along in an amiable way with those around them more than they value the bottom-line outcome of effectiveness.

In some of their more frustrated moments, the social engineers refer to advocates of the free market approach as "robber barons" or "neocolonialists." In what was probably one of my most revealing experiences at AID, at the annual meeting of those individuals assigned the responsibility for AID's private enterprise initiatives in the countries of Africa, the basic

concept of private enterprise was attacked. I was told: "AID is in business to help the needy not the greedy."

It is apparent from such comments that the common perception among the majority of foreign assistance bureaucrats is that the bureaucracies are benevolent and government intervention provides only a minimum threat of abuse. It is also clear that these individuals are either unaware of or distrustful of the checks and balances that are inherent in a system under which a government restrains itself to the role of ensuring markets against unfair trade practices. Many Foreign Service Officers equate advocacy of free enterprise with an advocacy of Marcos-style cronyism and other forms of exploitation.

Not only does the foreign service union control the quality of life enjoyed while in government employ, but it may also control the quality of life upon retirement. Former Foreign Service Officers do not die (the retirement rules allow them to retire as early as 50 years old). They do not die, they go into academia or consulting.

"Amen Chorus." And what happens to former Foreign Service Officers in these professions? They form the other two points of an iron triangle. By controlling the technical selection panels that award contracts, research jobs, honoraria, and travel funds totaling in the billions of dollars, the Foreign Service can assure itself access to a large and vocal "amen chorus" every time it needs one. On the other hand, the Foreign Service can do serious damage to a person's reputation and livelihood through the use of adverse reports circulated without substantiation through the far-flung, high-speed rumor network that exists among them and crosses over into ministries throughout the less-developed world.

The Foreign Service Officers' brotherhood, as does its counterparts in the foreign assistance establishment, has a large vested interest in the dominance of the social engineering approach. Free markets do not need powerful bureaucrats. If development assistance programs shift their focus away from institution building, their power and prestige with their overseas constituents will wane. Worst of all, many Foreign Service Officers will find that their skills are no longer needed. Hence the social engineering vs. free market minimalist debate crosses subtly over into concerns of pride and job security.

While I have not commented directly on the personnel systems within the multilateral institutions, I can assure you that, although there is not a foreign service officer union at the multilaterals, the same dynamics are in force. Indeed, it is much worse, in large part because of the inability of the President to hire, fire, or transfer anyone without, for all practical purposes, the consent of the permanent staff.

Need to Spend. My last consideration in the area of the management of the foreign assistance establishment is the organizational emphasis on pushing money out the door, the dumping dollars game. During my time at AID, I was once lectured to by the individual in charge of our mission to India on how it was his responsibility to spend $70 million a year on projects and that he could not find a way of obligating that much money in projects involving the private sector. Leaving aside for a moment my disbelief that the private sector of India could not absorb that amount of money in a week, much less a year, I was struck by the man's sincere expectation that he was going to be judged by our Ambassador

in India, the Congress, and AID and State back home, not on whether he achieved a positive impact through the expenditure, a matter which could be interminably obfuscated, but simply on the matter of whether or not the funds were spent.

It is also critical to recognize that one of the major stumbling blocks to the ascendancy of the free market school of development stems from its failure to sufficiently develop the ability to lead. There is a wealth of excellent theoreticians and advocates. But sharing the free market agenda does not sufficiently prepare them to go into the bureaucracy, to survive, and to turn this juggernaut around.

What we do not have are the skills and experience at management. They do.

We do not have people who know the ways to make the personnel and contracting systems work for us. They do.

We do not have the people with the knowledge and background to design and manage complex international projects. They do.

They have the luxury of large institutions with large budgets funded by the American taxpayer. We do not.

What we do have is The Heritage Foundation.

I cannot stress enough the critical role that Heritage plays in preparing and sustaining the new leadership that will be essential if we are to succeed in recapturing the policy and project implementation process.

One of the most upsetting aspects of my decision to leave AID was that I realized that there was no one coming along to take my place. Much of my work will be aborted or dismantled.

Yesterday Ambassador Middendorf referred to my colleagues and myself as giants. While I was flattered, I think a better image is that scrappy little fellow David slinging rocks at Goliath. Unlike the story of David, though, the Goliath of social engineering is not going to drop with a single rock. It is and will continue to be an exhausting series of skirmishes. We must find successive generations of bright and willing young men and women to take up the fight and to enter the inhospitable world of the foreign assistance bureaucracy. They must be found, motivated, and trained, not only in conservative principles but in management, in how the federal personnel system and contracting systems can be used for the free market system instead of against it.

It is a tough situation but not a hopeless one. It will take time. It will take dedication. It is an opportunity we must not let slip by.