TOWSON STATE JOURNAL OF INTERNATIONAL AFFAIRS

TOWSON STATE UNIVERSITY
TOWSON, MARYLAND

Volume XXI Number 1

Fall 1986

Towson State Journal of International Affairs

The editors invite the submission of articles bearing upon problems in international relations. All manuscripts should conform to the *University of Chicago Manual of Style.* A precis of the *Manual* is available as *A Manual for Writers of Term Papers, Theses, and Dissertations.* Editorial communications and manuscripts should be addressed to the *Towson State Journal of International Affairs,* Political Science Department, Towson State University, Baltimore, Maryland 21204.

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Subscriptions and inquiries about advertising may be sent to the Circulation Editor at the Political Science Department, Towson State University, Baltimore, Maryland 21204. The cost of subscriptions is $2.00 per year. The *Journal* is published semi-annually under the auspices of the Department of Political Science and the Committee on International Studies, Towson State University.

Produced by the Office of Design and Publications

Towson State Journal of International Affairs

VOLUME XXI FALL 1986 NUMBER 1

CONTENTS

REVIEW OF BOOKS

The

Towson State Journal of International Affairs

is indexed in

Historical Abstracts and/or America: History and Life

A.B.C. Political Science Index

International Bibliography of Periodical Literature

International Bibliography of Book Reviews

TOWSON STATE JOURNAL OF INTERNATIONAL AFFAIRS

ARTICLES FROM PREVIOUS ISSUES

STATEMENT OF PURPOSE

The study of international affairs as an academic discipline no longer belongs exclusively to the specialists in that field; rather, its scope has been extended to include the work of other related disciplines in recognition of the fact that international problems are not exclusively political in nature. It is the purpose of this journal to speak on matters involving international problems with many academic voices. More important, it is the purpose of this journal to permit undergraduate students to try their wings in describing, analyzing, and possibly suggesting solutions to the problems that have vexed nations in their contacts with each other.

The underlying premise of this journal is that undergraduate students *can* contribute effectively to a reasoned, moderate, academic analysis of international problems and that such contributions will have a more profound effect on the study of international affairs as well as the student contributors to this journal than the passionate, partisan, and emotionally charged outbursts which have in the past permeated American campuses.

Consequently, the *Journal* invites contributors to take an active interest in this publication. It encourages students as well as members of the Towson State faculty, and the students and faculty from other campuses to contribute articles, reviews, and other pertinent materials.

BOTTLENECKS TO CENTRAL AMERICAN INDUSTRIAL DEVELOPMENT

By Hugh Schwartz*
Inter-American Development Bank**

The evolution of Central American industry over the past two decades has been closely tied to the Central American Common Market. This has led some observers to characterize it as an example of inefficiency and high costs under protectionism. In any event, these observers and others have concluded that political strife in the region has undermined the bases for substantial increases in Central American industrialization, and, at the same time, made it increasingly necessary to turn to exports beyond the region to assure the survival of the sector. There is an element of truth in this, but also much that is misleading. The approach here will be to consider a number of factors which present serious problems for Central American industry, and to give particular attention to several which, even though they have not unfolded suddenly, now constitute serious bottlenecks.

The Bottlenecks Concept[1]

Problems are ubiquitous and unending in the development process, and, indeed, some undoubtedly stimulate increased effort and output or alternative approaches in the manner first suggested by Albert O. Hirschman in *The Strategy of Economic Development.*[2] Other problems do not bring forth a strong or rapid corrective response, or, at least they do not do so in certain contexts; they become bottlenecks which inhibit the economic growth of an economy, a sector, or a given group of activities. Some bottlenecks arise from major phenomena of a structural nature. Others develop suddenly and are often temporary, though often recurring — but these can be equally as adverse in impact.

Careful data on bottlenecks are not usually gathered except for those times when an area of economic activity is virtually paralyzed. Much of the discussion of bottlenecks becomes available ex post, and often reflects the difficulties of reconstructing important aspects of the problems of the past and the reasoning which led to the rejection of some of the ways which were proposed to overcome (or avoid) the obstacles.

Bottlenecks to industrial development are those impediments to a smoothly functioning process of industrialization which are costly to overcome, cannot be easily (i.e., inexpensively) circumvented, and do not generate a rapid or strong corrective response. The lack of a rapid or strong corrective response may be due to the nature of the bottleneck itself, or, more likely, to a limited capacity to adapt. This, in turn, may be attributable to the institutional arrangements, to behavioral characteristics, or to the magnitude of the externalities (externalized benefits) which would have to be captured to elicit a suitable adaptation or reaction.

How can the bottlenecks be overcome? While presumably it would be most helpful to understand the basic reasons underlying and the various factors contributing to the evolution of a

*Mr. Schwartz delivered this at the Seventeenth Annual Earle T. Hawkins Symposium of International Affairs, Towson State University.

**The views expressed in this paper are those of the author and do not reflect those of the Inter-American Development Bank.

[1]This section has been adapted from Schwartz, Hugh, *Bottlenecks to Latin American Industrial Development* (Washington: Inter-American Development Bank, December 1983), pp. 6-9.

[2]New Haven: Yale University Press, 1958.

bottleneck, it is likely to be more feasible (and less costly) to evaluate the advantages and disadvantages of alternative options for resolving a bottleneck than to try to ferret out underlying causes. (There are cases, of course, in which one or more of the options may revolve around the elimination of the basic, underlying causes.)

To deal meaningfully with the bottlenecks to industrial development, it is of course necessary to have a solid understanding of the processes of industrialization, the interrelationships, and the extent of the potential impact of impediments to a smoothly functioning process. Account must be taken of the sometimes varying perception of bottlenecks by entrepreneurs, government spokesmen, financiers, and independent analysts and members of the workforce, and of the alternatives which each group proposes for coping with them — differing in part, because of their varying perceptions of the basic data.

The importance of analyzing bottlenecks can be seen in a brief example. Imagine that in a given year, output in one branch of industry increases 9 percent, while in another the growth is only 2 per cent. The inclination of most analysts would be to attempt to explain the success of the former and the (relative) failure of the latter. But, if the former had a growth potential of 15 to 20 percent, which it did not achieve because of a series of minor problems which were handled poorly, while the second industry was plagued by more serious problems, most of which were skillfully circumvented or overcome, then the 2 per cent growth is the success story and the 9 per cent growth represents at least partial failure. In any event, the successes in coping with serious problems in the lower growth industry and the limitations in coping with lesser problems in the higher growth industry represent valuable data which are likely to be overlooked without a systematic and analytical "bottlenecks" approach.

The bottlenecks to industrialization may arise from the limitations of topography and location, from a country's stage of socioeconomic development (or perhaps the stage of development of its industrial sector), from the weakness or inflexibility of the society's institutional mechanisms, from the magnitude of the externalities which would have to be captured to warrant certain operationally quite feasible approaches to problem solving, from the particularly adverse consequences of recent economic events for a given economy or industrial structure, or from a limited capacity to adapt (often evidenced by a slow reaction time to changing technological or market opportunities) — which may reflect the behavioral characteristics of entrepreneurs or any of several of the above considerations. These lead to a dozen or more inevitably overlapping categories, some of which reflect one and many of which reflect several of the above considerations (in particular, the second and third, along with the pervasive, limited capacity to adapt). The presence of more than two or three bottlenecks, seems to have a synergistic impact, moreover. These bottlenecks, which vary in their importance from country to country, and also from one branch of industry to another, even within any given country, are as follows:

1. Difficulties in developing internationally competitive output due to constraints in importing production inputs;
2. Anti-export bias (a bias of public policy incentives against producing for foreign markets);
3. Bottlenecks in the supply of domestic raw materials, i.e., bottlenecks in primary sector production;
4. Economic infrastructure constraints;
5. The relatively higher cost of energy (and the occasional threat that certain forms of energy essential for existing production processes may become temporarily unavailable);
6. Restraints to competition;
7. Marketing difficulties, domestic and international, resulting in inefficient distribution channels, higher costs, and less effective penetration of available markets;

8. Financing difficulties;
9. Human resource deficiencies and limitations, especially managerial limitations;
10. The imperfect suitability of production processes;
11. Low levels of operational efficiency, resulting in higher production costs;
12. Relatively uncharted investment opportunities, and serious difficulties in identifying the projects that warrant more extensive project appraisal;
13. Unclear economic signals and limited means of taking advantage of those signals; and
14. The sometimes accommodating, but all-too-often inhibiting activities of government that affect but are not directed primarily at the industrial sector; and
15. Political strife: sabotage, armed confrontation and economic boycott.[3]

Consideration should be given to various options which might help overcome or circumvent the bottlenecks — in the short, medium and long run, with the likely difficulties in implementing the various options noted, and rough estimates provided of the likely consequences of the various options for industrial output, investment and employment, as well as for such broader factors as external economies and the balance of payments. This analysis is particularly important if we are to avoid repetition of previous shortcoming and to design more effective development policies, accompanied not merely by projects but by programs of projects.

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[3]The bottlenecks might be regrouped under each of nine general categories of factors affecting the process of industrial development, as follows:

1. Major international developments such as
   a. the relatively higher cost of energy, and related, at least in part to that.
   b. the slackened pace of growth and increased tendency towards recession in Latin America's major trading partners, which, in turn has contributed to
   c. increased restraints to international competition;
2. National economic policy and its implementation, reflected especially in:
   a. difficulties in developing internationally competitive output due to constraints in importing production inputs,
   b. anti-export bias (a bias of public policy incentives against producing for foreign markets),
   c. restraints to competition,
   d. relatively uncharted investment opportunities in the context of serious difficulties in identifying the projects that warrant more extensive project appraisal,
   e. changing, conflicting or otherwise unclear public policy signals, and,
   f. the sometimes accommodating, but all-too-often inhibiting activities of government that affect but are not directed solely at the industrial sector but hit it relatively hard (such as price controls, employment regulations, government purchasing policies, and extensive bureaucratic regulations);
3. Economic infrastructure: economic infrastructure constraints;
4. Domestic raw material availability: bottlenecks in primary sector output;
5. Human resources: human resource deficiencies, including especially managerial limitations, but also deficiencies relating to foremen, professionals and skilled workers;
6. Product and process selection:
   a. the weight (and influence) of past decisions on product and process choice, and
   b. the imperfect suitability of production processes;
7. The level of production efficiency: low levels of efficiency, resulting in higher production costs, emanating from particularly small plants, relatively unspecialized product mixes, less than full capacity utilization, inefficient use of given inputs, and/or inadequate entrepreneurial efforts at project identification:
8. Marketing: marketing difficulties, domestic and international (resulting in inefficient distribution channels, higher costs, and less effective penetration of available markets); and,
9. The financing of production and distribution: financing difficulties in addition to those reflecting national economic policy.
10. Political strife: sabotage, armed confrontation and economic boycott.

Key Bottlenecks to Central American Industrial Development

The Constraint of Political Strife

The industrial development of Central America in the last two decades has been focused primarily on the Central American Common Market — which has been highly protected. Thus, the manufacturing growth of each of the countries of the region has been highly dependent on the growth and stability of the others.

Any discussion of obstacles to industrial development in Central America should begin with a factor which has undermined that growth and stability, namely the political strife which has led to sabotage, armed confrontation and economic boycott. One or more of these have been major problems in El Salvador, Nicaragua, and, until recently, Guatemala. In El Salvador the impact of the violence has been particularly notable because of both direct effects leading to the need to undertake elaborate measures to protect factories, provide back-up sources of electricity and manage overland shipments, and because of the indirect effects of the violence which has led to declines in growth rates and in absolute income levels. Moreover, the two factors have led to an increased exodus of managers, professionals and technicians, and to increased capital flight, a portion of which would have been a source of funding, if not always for investment, at least for imports of essential raw materials and intermediate goods. And the continuing exodus of capital and skilled resources has reinforced the inclination of foreigners to keep their own financial commitment low. For the other Central American nations, the consequences of the upheaval in Nicaragua, El Salvador and Guatemala have been mixed, but on balance, strongly negative.

A few industries in Costa Rica and Honduras benefitted by reduced competition, but others experienced even more aggressive marketing efforts from Salvadoran or Guatemalan enterprises desperately trying to survive. At the same time, the regularity of supply problems became a problem for certain raw materials and intermediate goods imported from the other Central American countries (notably Nicaragua). The most important drawback has been the reduced ability to export to the other countries due to the decline in incomes in those countries and the role of the political situation in exacerbating the difficulties that some of the countries have had in paying for imports (reflected, for example, in the growing imbalance in the bilateral trade accounts between the various Central American countries).

The options for really offsetting the political difficulties are extremely limited and the only major means of dealing with the constraint to industrial development is by putting an end to the strife. Even that may not be enough if the termination of violence is followed by an environment characterized by great uncertainty or is otherwise not conducive to undertaking enterprise for profit. Nonetheless, and though it would be of little significance for the short run, there might well be favorable consequences of note for the longer run if the leading political groups would agree that those managers, professionals and other specialists who were employed in industry and who did not participate in extra-legal violent activities (of the right or left), would not be prevented from continuing in private sector employment (or public sector employment, in the case of government owned plants), whatever the shift in the political orientation of the country. Beyond that, it is recommended that studies be commissioned to develop guidelines for industrial production under situations of political strife. While many of the general considerataions doubtless have come to be recognized by producers over the course of time, there are lags in this, and I have detected major differences in the costs of achieving certain results in terms of security or back-up sourcing. Over time such guidelines should be generally useful to all of those actively engaged in production, whatever their political persuasion or that of the regime in power. Neither of these two options to coping with political strife have been attempted yet. Their benefits may be uncertain, but their costs are probably quite low, so that there is a good argument for proceeding with both. The first surely would have been rejected only a few years ago, but conversations in early 1986 with businessmen from El Salvador revealed that there is now some support for such a position.

The Marketing Bottleneck

Marketing has been an important problem area in the industrial development of Central America in recent years as the need to export beyond Central America has increased. Even marketing within Central America has become more difficult as local markets have shrunk, pressures against regional protectionism have begun to increase, and there has been increasing competition from foreign, particularly Asian manufacturers who were experiencing major increases in productivity, enabling them to compete more effectively in price, even in the context of substantial regional protectionism, and who have had a substantial and probably increasing edge with respect to advertising and public relations. These same factors weigh even more importantly in the markets beyond Central America, which, moreover, constitute new markets for most Central American products. There, Central American inexperience has been much more notable. The precise characteristics of the foreign markets have been imperfectly recognized, and not only have there been no major advertising campaigns, there has been a lack of basic sales representation. Worse still, initially there was little recognition of how great the cost of the lack of attention to marketing might be. The latter can be seen in the only moderate response of Costa Rican industry to major new incentives to export beyond Central America, even in the periods from late 1980 through 1981, and again in 1984-85 when the incentives were strongest.[4] That experience revealed an inability to market effectively what was produced, and a failure to provide a good feedback on unsuccessful marketing experiences concerning the adjustments in Costa Rican products or production processes which would be required in order to be able to sell in those higher per capita income markets.

There are a number of means to alleviate these problems. The first is to think in terms of a long term investment in marketing infrastructure — and to think in terms, not merely of a measure of additional effort, but of an increase that amounts to a critical mass of effort on marketing. This need for "rethinking" refers to governments and trade associations as well as individual manufacturers. The companies that merely availed themselves of a trading company (which, in turn, represented a large and diverse group of producers, and provided the latter with limited publicity in one or two cities in the United States) registered little or no increase in exports. At the other extreme, an enterprise which hired an experienced full time sales representative in the United States to provide it with a better notion of the product which would sell in that market and then dedicated itself to producing and selling that product, contracting consultants to improve the operational efficiency of production facilities, made extraordinary gains in exports to the U.S. market. Those who travelled occasionally to the U.S. or had part time sales representatives and/or used their own personnel to make adjustments to production processes also scored substantial gains, athough not as much as in the latter case. This underscores the importance of a major investment in marketing, not only for itself, but also as a key indicator of other bottlenecks, in particular limitations to industrial development that derive from the dimensions and special economic characteristics of the Central American market and from the limited efficiency of production processes in Central America. The options with respect to marketing itself, involve treating marketing as a serious category for decision making, evaluating alternative private and public sector marketing measures in terms of

[4]This is based on an Inter-American Development Bank report on Costa Rica, which had not yet been released as of May 1986.

their costs and benefits. But marketing expenditures are rarely treated as a 3-5 year investment in the kind of small to medium size enterprises that characterize Central America, and the cost effectiveness of alternative Government programs for promoting exports is also virtually unknown.

The Dimensions and Special Economic Characteristics of the Central American Market

The individual Central American countries constitute small markets. The region itself is a relatively small market in terms of the levels output needed to approach the minimum cost feasible with optimum scale production for many product lines.[5] The limitations of this relatively small local market, effectively even smaller because of the skewed distribution of income and the tendency of the wealthiest to spend a larger portion of their income on imported goods, have been accentuated by the protection of the Central American Common Market which has provided policy incentives for manufacturers to focus on that market (rather than to consider markets beyond the region in an evenhanded manner). Even though the incentives to export to the other countries of Central America have been declining, many producers who invested in plant and equipment are not in a good position to exploit markets outside the region: first because they are less aware of the market preferences of other markets, second, because they themselves are virtually unknown in those markets, and third because their products and their production processes have been so geared to Central America that switchovers would require new investments, and the climate for new investments has not always been favorable in recent years, particularly in Central America. For new undertakings one alternative, of course, is to gear plant and production for exports beyond Central America and there are a number of cases of this — though primarily in the assembly industries. A second way out, in the case of existing industries with small economies of scale or with economies of scale influenced primarily by length of production run, is to redesign products, reduce the number of products manufactured, invest in the auxiliary equipment needed for the redesigned and improved quality output, and improve operational efficiency. This is precisely what has been done in many garment plants in Central America. However, there are product lines for which existing facilities would have to be virtually scrapped and major new investments undertaken in order to manufacture at internationally competitive costs for export — or, indeed, even to compete locally in the less protected environment that the World Bank and others are working so hard to bring to Central America.

A second option, then, very little explored to date, is to identify those groups of products for which the technologies of existing Central American facilities are not badly out-of-date, and for which products, economies of scale are not extremely large. That group should be pruned still further so as to include only those plants in which managerial capacity has proven itself capable of keeping x-efficiency (operational efficiency) levels near international standards, and of making some cost-saving adaptations of production processes. These activities might be divided into three groups: first, those which, with an intermediate level of investment and technical assistance (more, though, than that recently undertaken by garments producers) also could develop several export lines within a few years, and could compete effectively in a larger number of products in the Central American market, even with reduced levels of protection (and/or the continued productivity

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[5]For a discussion of the degree to which economies of scale constitute a problem for Latin American manufacturing — with emphasis on manufacturing exports, see Clifford F. Pratten, "Economies of Scale and Latin American Exports," and Hugh Schwartz, "Overview," in Schwartz (ed.), *Supply Side and Marketing Constraints to the Growth of Latin American Manufactures,* (manuscript, Washington: Inter-American Development Bank, 1985); and William R. Cline, "Economies of Scale and Economic Integration in Latin America," in Eduardo R. Conesa and Jose Nunez del Arco (eds.), *Terms of Trade and the Optimum Tariff in Latin America* (Washington: Institute for Latin American Integration and Inter-American Development Bank, 1984), pp. 233-277.

increases of Asian producers). A second group might require the same effort just to hold onto a reasonable share of the local market. A third group might require particularly large amounts of technical assistance to hold onto the local market, even then covering only somewhat more than variable costs, but might, with the new emphasis on operational efficiency and replacement equipment 3-5 years down the road, be in a position at least to compete profitably in the Central American market.

The thrust of this, then, is that there are hopes for the development of new lines of exports — but also that the focus of industry should be on what can be done to produce for and compete effectively in the local markets as well, and, indeed, to use the still protected Central American market as a proving ground for gaining the experience to be able to compete on costs alone in the local market within say five years, and to export beyond the region to a greater extent than in the past.

Compounding the general problem of a small market is the fact that national as well as business rivalries and the failure of conformance with the previously touted Central American Integration Industries Agreement may have aggravated the overall problem. For a number of product lines, overall Central American demand would be enough to justify a single plant of optimum economies of scale, but the various rivalries have led to two to five such plants, none of which is large enough to achieve or even approach minimum economic costs.

Problems of Efficiency in the Production Processes of the Output Manufactured in Central America

The Marketing and Central American Dimensions bottlenecks are bottlenecks in part because of underlying problems of efficiency in production processes of the output manufactured in Central America. It is not enough to have good marketing if the product is not salable abroad if production processes are so inefficient that costs are high, severely limiting actual sales, or making such sales prossible in the short run and/or only at unacceptably low levels of profits. The dimensions and characteristics of Central America are a drawback because the small and relatively uncompetitive local market leads to a questionable choice of industries and, often a relatively inefficient use of resources within those industries.

First, as already noted, industries have been undertaken in Central America, aimed at the subregional market, for which the level of demand in that market is not sufficient to approach minimum costs of production. Also, even in those products in which Central American demand (or that of the relevant country) is great enough to accommodate a single plant of optimal size, there are often two or three plants of less than optimal size (the second or third often having been established in large measure because the first did not fully satisfy local demand). In these cases and in others in which there is only a single plant in the relevant market, the owner frequently is not sufficiently aware of the extent of economies of scale he is sacrificing by having the smaller plant. (In interviews, I frequently ask producers what impact a doubling or tripling of plant size would have on potential unit costs — whether such an increase would reduce costs of the order of 5-10 per cent, 15-20 per cent or 30-40 per cent. Some know or seem to know the answer, but most readily acknowledge that they do not. They have not bothered to obtain data for scales of capacity so much greater than they have been accustomed to — which may have been understandable in the days before it seemed necessary to export beyond Central America.)

Second, irrespective of the question of scale, many producers have not specialized enough. Their product mix is too great to obtain the economies of scale of long production runs. Computerized operations will tend to reduce set-up times and reduce the economies of scale of longer production runs, but such operations may not be common in Central America for a number of years. The very first step in specializing production, though, would be to eliminate the tendency to do as much as humanly possible in a given plant or company, and to subcontract out to other enterprises those tasks which occupy specialized machines only a few hours a week (selling off those machines). The need to reduce costs in the context of the debt crisis has spurred the use of subcontracting in Brazil, Mexico and Argentina. In Central America, many manufacturing operations were not as vertically integrated as in the latter countries, but there is still considerable scope for increased subcontracting.

Third, there is a problem of inefficiency due to the underutilization of capacity. Some underutilization of capacity is due to the fact that the plant, while large for the market in question, is not large enough to generate the low costs needed to compete internationally. Other underutilization has reflected a lack of public incentives to service export as well as domestic markets. This may be due to protection, overvaluation or other anti-export biases. (It is sometimes, in part, a temporary factor due to a sharp drop in national income.) But there is still a good deal of additional underutilization of capacity which can only be explained in terms of the incomplete maximization of profit opportunities by producers.

Fourth is the question of whether the technology in use is the most appropriate — in the sense of the most efficient. It is not so much that some technology may be too labor saving, which is probably rarely the case in Central America. Rather, there are two other considerations. To begin with, some manufacturers appear to have purchased equipment without a process of search as careful as would have been desirable in economic terms — even though in many cases such limited search could be explained well enough in terms of their own financial calculus. Overlapping that, the technology which manufacturers sought for the protected Central American (or individual country) market would not have been any more optimal from the point of low cost and high quality production at some larger volume than was the scale of operations optimal for the latter.

Fifth, and very important in many activities, I believe, is the middling level of x-efficiency (operational efficiency). This is treated as a very secondary matter by most economists, but better layout and more smoothly organized production, all with the very same equipment has reduced costs 20-25 per cent in a number of plants in Latin America, even while increasing product quality. A good Central American example of this can be seen in a Costa Rican wood products plant that formerly did not export to the United States, but now exports 100 per cent of output to this market.

There are a number of options for alleviating the obstacle of inefficiency. Improved economic policies reducing protection and/or making it temporary, and eliminating anti-export biases will help a great deal. Moreover, until policies are more stable and enable prices to more nearly reflect opportunity costs it can hardly be expected that entrepreneurs will address themselves in a major way to such matters as the search for what might prove to be only a marginally better technology or scale or organizational layout when time spent trying to influence policy is likely to be more remunerative.

Getting the policies right, and getting the prices right, will not be enough to lead to rapid entrepreneurial adjustment, though, especially after two decades of a relatively closed economy. The informational needs are very great and they will require specialized data banks, technology assessment, and, in particular, a high-level industrial extension service. (This means a service which can draw on international caliber experts and is much more serious than those usually proposed of small scale industry, but it need not mean a highly subsidized service.) It may be advisable to make surveys of the size of the x-efficiency gap and the degree to which it is being closed, and of the degree to which the industrial extension services respond to the needs which entrepreneurs perceive. Something will have to be done to make the trade associations as interested in promoting "best practice", improved technology, and increased subcontracting as they have been in the past in tariff levels and subsidized credits. Some of the information on economies of scale is readily available but other components will require studies along the lines of C.F. Pratten's 1971 study, *Economies of Scale in Manufacturing Industry*.[6] Trade associations or Governments will have to be persuaded to

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[6]Cambridge: Cambridge University Press.

fund such analyses — which no one has seemed willing to do up to this time. And finally, an effort is needed to make cost-benefit comparisons of these various approaches to improving industrial efficiency.

Deficiencies in Educational Training—at the managerial professional and technical level. This is probably a more serious constraint on the development of industry in Central America than is recognized, and probably has as much to do with weak educational standards as with the availability of programs and funds to underwrite those programs.

Balance of payments difficulties—in particular difficulties in importing the inputs needed to make output cost competitive (and, in some cases, simply to produce at all). This is a major impediment but so much emphasized that it will not be discussed in this paper.

Difficulties of Financing—and the importance of having good financing arrangements. This, too, will not be much dealt with except to note that the seriousness of the problem is reflected in the fact that it is increasingly common for Latin American enterprises with economically sound projects to experience difficulties of financial survival.

Here there are many alternatives which may help at the margin but one that may have more than merely marginal consequences would be to sell two or three types of bonds, payable in dollars or other hard currency, which would be sold abroad and perhaps in Latin America, for the purpose of providing short, medium and somewhat longer term financing in Latin America. The bonds might be aimed primarily at funding projects involving manufacturing exports or import-substituting projects whose viability really depended upon being able to export within, say, three to five years. These bond sales (and mutual fund alternatives) might be aimed particularly at recent and prospective capital flight and would be a way of getting a portion of that capital flight to contribute to Latin American development while still assuring the remitters (or prospective remitters) the hard currency security that they seek — or rather a high probability of that, with the reduced degree of assurance compensated for over the period by somewhat higher interest rates. (The higher interest rates would be made possible by greater selectivity in project selection.) The possibility of charging higher interest rates might seem to conflict with Latin America's current insistence on lower rates, but rates have dropped substantially in the past few months, and, in the second place, while high interest rates on the virtually unchanged levels of debt outstanding on existing loans which are not enough to really get Latin America's economy moving again are resented and resisted, the prospect of sums which might enable such a resurgence might draw a different response. A danger of the proposal, though, is that while effectively rechanneling a good deal of recent or current capital flight back to Latin America, it might attract some funds which would otherwise have remained in Latin America without such incentives.

Conclusion

A number of factors now constitute serious constraints to Central American industrial development. Some, such as political strife and balance of payments difficulties have been given a great deal of attention, though perhaps with an undue note of fatalism. Other problems, such as those related to financing and indebtedness are discussed more fully, but the solutions posed often stress political rather than economic change. At present, and for at least a while ahead, Central American industrial development will be contingent to a considerable extent upon the region's ability to export, and, in particular, to export beyond the Central American subregion itself. Success in that will greatly alleviate the balance of payment constraint to industrial development, of course. While a great deal of attention has been given to the need to overcome the traditional anti-export bias of overall economic policy by maintaining rates of currency exchange which take account of differential rates of inflation and/or by adopting significant export promotion incentives, other factors also must be emphasized in order to facilitate the generation of exports in the short-to-medium run. "Getting the prices right" is necessary but not sufficient. This paper outlines several bottlenecks which need to be overcome to assure a continuous and increasing flow of manufacturing exports from Central America. The bottlenecks tend to fall under the category of nuts and bolts aspects of marketing, production and investment decision making that tend to be ignored in explicit terms since it is assumed that they will be quickly resolved by the response of entrepreneurs to the revised signals emanating from changed (and improved) macroeconomic policies. Unfortunately, that has not been the case in the small, long protected economies of Central America where the payoff to entrepreneurs often has been greater for efforts to influence government than for those related to such matters as equipment selection, scale of operations, operational procedures, employee training, foreign marketing, etc. Additional, specific measures along the lines of those referred to here are required.

REAGAN AND CONGRESS: CONSENSUS AND CONFLICT IN CENTRAL AMERICAN POLICY

By Richard A. Nuccio*

In the early 1960s, John F. Kennedy offered his now classic characterization of the options for U.S. policy in developing regions undergoing rapid social change:

> We have three choices in descending order of acceptability — a decent democratic regime, another dictatorship, a communist government. We should strive for the first but we can't reject the second until we're sure we can prevent the third.[1]

While John Kennedy may not have been expressing the full range of possible choices of regime for Latin America, he was describing the landscape of political possibilities as it appears from Washington. Striving for decent democratic governments has at times had greater and lesser priority in the United States, but it has almost always been the required goal of high visibility, politically popular, and sustainable policy initiatives toward Latin America.

Writing nearly two decades later, another architect of U.S. foreign policy, Ambassador Jeane Kirkpatrick, faced JFK's dilemma and placed her emphasis on the dichotomy in his original formulation between authoritarian and totalitarian regimes:

> Only intellectual fashion and the tyranny of Right/Left thinking prevent intelligent men of good will from perceiving the *facts* that traditional authoritarian governments are less repressive than revolutionary autocracies, that they are more susceptible of liberalization, and that they are more compatible with U.S. interests.
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> Although most governments in the world are, as they always have been, autocracies of one kind or another, no idea holds greater sway in the mind of educated Americans than the belief that it is possible to democratize governments, anytime, anywhere, under any circumstances. . . . Many of the wisest political scientists of this and previous centuries agree that democratic institutions are especially difficult to establish and maintain. . . .[2]

She did not dismiss democracy as irrelevant but expressed a more than robust skepticism for the ability of the United States to protect its interests *and* achieve decent democracies among its autocratic allies. She also worried that in the naive assumptions about democratic possibilities she saw as characterizing the policies of the Carter administration in Nicaragua, lay the seeds of totalitarian disaster outlined by Kennedy.

The debate over U.S. policy toward Latin America in the 1980s is focused almost exclusively on a region that does not contain many more people than the capital city of Mexico. This debate over Central America is marked by limited public understanding on the one hand and by partisan recrimination among experts on the other. It is easy to understand why. Central America has emerged again as a preoccupation of the United States at that precise moment when the consensus

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[1]Lester D. Langley, *Central America: The Real Stakes* (New York: Crown Publishers, 1985), p.24.

[2]Jeane Kirkpatrick, "Dictatorships and Double Standards," *Commentary*, vol. 68 (November 1979), pp. 34-45.

guiding U.S. foreign policy after the Second World War fractured. The loss of the war in Vietnam caused many to question whether the United States should try to determine events in the Third World. The fall of the Shah in Iran and the long ordeal of the hostages indicated to some that the United States would pay dearly for its unwillingness to stand by its friends. Afghanistan undermined the hope of others that detente with the Soviet Union would lead to its restraint in regional conflicts. For these reasons and others, Central America is the place where a new consensus about how the United States should deal with revolutionary change in Third World countries will be forged (or not forged) in the post-Vietnam, post-Iran, post-Afghanistan era.

Whatever the merits of any approach to the problems of Central America, no policy will be successful if it is not sustainable over the long run. This paper is an argument that emphasizes certain aspects of recent U.S. policy in Central America to make the case that "success" in Central America has come, even in the midst of our foreign policy "crisis of consensus," when strong congressional initiatives have produced compromise by the Executive branch. It focuses on the "success" of policy toward El Salvador and draws lessons for the current failures of policy in Nicaragua that require a change in the objectives the administration hopes to achieve in that country. Finally, it draws on an analogy with the Middle East peace negotiations to outline the parameters of a possible Nicaraguan settlement.

Consensus on El Salvador

In the perceived emergency of the guerrilla offensive in El Salvador in late 1980 and early 1981 and perhaps flush with November victory, the Reagan administration forgot for a time the fundamental lesson of North American politics identified by JFK: "decent democracies" must be the goal of a sustainable U.S. policy toward Latin America. It allowed its ideological distaste for a reformist politician like Napoleon Duarte and its preoccupation with the Soviet specter to reduce its options to the Kirkpatrick dichotomy. But the unprecedented slaughter conducted by the military-civilian junta during 1981, including that of North American churchwomen, galvanized the human rights lobby in the United States sufficiently to exert pressure through the congress on the conduct of policy toward El Salvador. El Salvador's was an overt, not covert, war. Congressional approval for funding of the war effort was crucial to administration policy. And so, over time, the administration made many of the goals of congress its own for El Salvador: support for the reformist Duarte and reform policies including such ideologically unpalatable measures as land reform and the nationalization of the banking sector and foreign trade; attention to massive human rights abuses by the Salvadoran armed forces called for by aid contingency legislation; and the promotion of democracy as the ultimate objective of U.S. policy. In the process it advanced from the Kirkpatrick dichotomy to return to the Kennedy dilemma.

The consequence of this merging of the administration's agenda for El Salvador with that of the congress's was "success." Duarte survived the military-civilian junta with his reformist credentials somewhat intact. He could still not be elected president in 1982, but neither could the administration allow Roberto D'Aubuisson to hold the office. Duarte's election in 1984 was desirable and achievable. By the legislative elections of 1985, after a "dialogue" with the guerrillas had been initiated, Duarte and the Christian Democrats were so powerful that they created a new concern that they aspired to the single-party state model once tried by the military and the PCN.

With Duarte came congressional funding for the war effort, virtually without restrictions. The military situation stabilized for the government and even appeared to have turned in its favor. Human rights abuses decreased and the serial bombardment that was essential to the counter-insurgency strategy produced civilian deaths in guerrilla controlled areas far from cameras and news stories. The military seemed increasingly comfortable and convincing in its new role as defender of the constitutional order.

At this precise moment of its greatest advance in El Salvador, the administration set in motion the policies that may ultimately snatch defeat from these hands of victory. Instead of using its position of strength to sue for peace, the administration raised its objectives in El Salvador. Military defeat of the guerrillas became the goal of U.S. policy, not their elimination as a political threat. That might have been achieved by encouraging Duarte to make a proposal so generous and accommodating to the guerrillas and their civilian allies that it would have undercut all but the most fanatical adherents. However, diplomatic accommodation was undesirable; it would send a message to other guerrilla movements that they could wage war until stalemate and then negotiate at the table what they could not achieve on the battlefield.

For a time in 1985 it looked as if military victory might be at hand. The army's tactics were more effective and prevented the guerrillas from mounting a dry season offensive or even operating regularly in large-scale units. Official estimates of their strength decreased to roughly half of what they had been a year earlier. U.S. military trainers spoke of reducing the guerrillas to bandits and extending government control to 90 percent of the country in three to five years. The dialogue begun with the guerrillas by President Duarte in October 1985 and suspended after the hardline positions of each side became clear during the second meeting at Ayagualo, seemed unimportant. Like El Salvador's own conservatives, the United States believed it could win a whole loaf on the battlefield; why negotiate for half a loaf?

By the beginning of 1986 the optimism that had prevailed just six months earlier seemed misplaced. Changes in guerrilla tactics brought their operations back to the front pages. Attacks on U.S. marines and Salvadoran training bases and the kidnapping of local Christian Democratic mayors and the daughter of President Duarte demonstrated the guerrillas' ability to hold out for the long run and to conduct successfully the "low intensity conflict" that is the new buzzword of military thinkers. The guerrillas extended operations to virtually all parts of El Salvador and, through greater coordination of their factions, became more adept at simultaneous sabotage that can cut off electricity or disrupt transport to major parts of the country.

The Salvadoran economy, never healthy, is now reeling. Five hundred million dollars in U.S. aid annually is no longer even able to keep the economy limping along. Massive austerity measures have had to be taken at a time when Duarte's political strength is noticeably weaker. Destruction of the Brazilian coffee crop may help El Salvador squeak through in the short run by raising prices for the country's primary export product but is unlikely to resolve President Duarte's fundamental political difficulties.

The decline in Duarte's political fortunes can be traced to several causes. Distrusted by the military and the civilian right, Duarte has waged a campaign of accommodation with the interests of the right. He had been quite successful with the military until his negotiations with the FMLN to obtain the release of his daughter undermined his standing with them. The civilian right had never trusted the Christian Democrat who nationalized the banks and the coffee export sector. Less seduced by Duarte's ability to produce U.S. aid, they are ready to desert the President the first time he seriously threatens their interests. As Duarte moved toward accommodation with the right, his traditional source of political support in the Christian Democratic labor unions became more tenuous. Expressing the nub of Duarte's political dilemma, one labor leader commented after the recent austerity measures that, "Now we will not only die because of the war. They're also condemning us to die of hunger." In the political space opened up by Duarte's election, the FMLN intended to move back into the cities to organize political support in the universities, labor unions, and other "popular organizations." Amidst the economic downturn it could expect to find more fertile ground for protest than at any time since the late 1970s.

Pessimists, especially on the left, have not proven to be correct about El Salvador in the recent past. Pointing accurately to potential problems, they have underestimated Duarte's own personal capabilities as well as the pragmatism displayed at key junctures by the Reagan administration. Countervailing trends to the negative developments cited above are also in evidence in 1986. Splits have emerged more publicly than ever before between the FDR and the FMLN over tactics, and some middle-level FDR supporters have returned to El Salvador to test the waters for overt political activity.

However, another pessimistic judgment will be offered here: that the high point of administration policy was reached in El Salvador in 1985 both militarily and politically. Because of the negative developments of 1985 and early 1986, both a military *and* a political solution will be more difficult to achieve in the future. An opportunity to cut a deal with the more moderate elements of the left in El Salvador that would have preserved essential U.S. interests while reducing direct U.S. involvement was passed over in 1985 for the ideologically more desirable goal of total victory. It may be some time before such an opportunity to bargain from strength returns again.

Conflict Over Nicaragua

Nicaraguan policy has never displayed the agility on the part of the administration that was demonstrated in El Salvador. A fundamental reason for this is that the administration has never been confronted with an alternative policy by congress. Because the war against Nicaragua was "covert," congressional funding has, until recently, not been as crucial, as public, or as massive as it was for El Salvador. In the case of Nicaragua the administration has consistently been on the offense and congress on the defense. Supporters of official policy could more accurately and effectively than in El Salvador threaten to charge those in opposition to administration policy with having "lost" Nicaragua. The human rights abuses by the U.S. backed government in El Salvador embarrassed the administration and emboldened the opposition. In Nicaragua, the administration can rely on a "secret" speech by Arce here or a Moscow trip by Ortega there to do their work for them with congress. Human rights violations by the "contras" were never as massive or as embarrassing as those by the "death squads" in El Salvador. And the Sandinistas themselves have moved to decrease progressively political space within Nicaragua.

Still, administration policy in Nicaragua has not ultimately been as "successful" as it was in El Salvador. A congressional consensus for pressure on Nicaragua has been established after intensive lobbying by the administration (and gaffes by the Sandinistas), but it is quite fragile. It is true that there are no longer any friends of the Sandinistas in congress. (Perhaps there is literally one, Ron Dellums.) Thanks to President Ortega's trip to Moscow and earlier spade work by the administration, the congress has approved "humanitarian" assistance to the "contras." Yet it is possible to imagine a "contra" atrocity, a blown CIA operation, or other embarrassment that will threaten the support which exists for "humanitarian" — i.e., overt but politically clean — assistance to the "contras" and prevent military aid from being voted in the future.

If the essence of the compromise wrought by congressional opposition in the case of El Salvador was the pursuit by the administration of "decent democracy" in El Salvador, the equivalent for Nicaragua would be the acceptance by the administration of a political solution to the Nicaraguan conflict that would not remove the Sandinistas from power as a prior condition. This is because of the other pole of sustainable policy initiatives toward Latin America: the United States can not be overtly engaged in the overthrow of a legally constituted government that does not appear to be an immediate threat to the security of the United States.

Some may argue that the administration is, in fact, not pursuing the overthrow of the Sandinistas. Ignoring for the moment the inhibitions on frankness about overthrowing the legal government of a country with which the United States maintains full diplomatic relations and the "Say Uncle" remark by President Reagan in his news conference of February 21, 1985, it is still possible to demonstrate that current policy toward the Sandinistas is either duplicitous or contraditory in its intentions.

The syllogism of official current policy goes something like this:

> The Sandinistas are Marxist-Leninists.
>
> Marxist-Leninists will only make concessions to democracy if forced to by pressure.
>
> With current levels of U.S. pressure the Sandinistas have become ever more totalitarian.
>
> Therefore, congress needs to approve funding for much higher levels of pressure.

Most students of international affairs will recognize in this characterization of current policy the familiar restatement of a great policy principle: an ineffective policy can be made more effective by increasing the amount of pressure with which it is applied.

A more accurate statement of actual policy toward Nicaragua would probably be as follows:

> The Sandinistas are Marxists-Leninists.
>
> Marxists-Leninists will never willingly surrender power; it must be taken from them.
>
> Current measures are not sufficient to remove the Sandinistas from power, but public support does not yet exist for the direct U.S. role that would be required to remove them.
>
> Therefore, interim measures must be adopted to preoccupy the Sandinistas until public support for their removal becomes manifest.

The dilemma of U.S. policy toward Nicaragua in 1986 is that if this second rendition of administration thinking is accurate, it cannot be publicly supported by a majority in congress. Many U.S. citizens and a significant number of their representatives in congress have difficulty with an attempt by the United States to overthrow a legal government that is not a direct threat to the security of the United States. The result of this dilemma is a series of very elaborate dances around the real issues:

1. Everyone supports Contadora. But the goal of Contadora is to reach a negotiated settlement between the conflicting parties in Central America that would accommodate the Sandinistas. This goal is unacceptable to the administration, but the administration cannot openly reject Contadora so it works within Contadora to oppose any treaty that would leave the Sandinistas in power.

2. The administration opposes the Sandinistas because they are undemocratic. But it pays only the most superficial attention to the issue of democratization within the Nicaraguan opposition.

3. The administration promotes a prominent role for civilian leadership of the *contras* with democratic credentials. Yet, taking a page from the great democrat, Fidel Castro, it discourages pluralism among *contra* groups in the interest of greater military effectiveness. By emphasizing a military approach it sets up the potential for a repeat of the 1979 experience — should the *contras* ever come to power — when the FSLN literally outgunned its civilian allies. By increasing the opposition's reliance on U.S. aid it encourages theistorical pattern in Nicaragua of dissidents looking more to the United States to solve their political disputes than to their own political resources.

Facing the Real Issues

There are various ways to resolve this dilemma of U.S. policy toward Nicaragua. The congress could decide to accept the administration's view of the Sandinistas, override public concern about a direct U.S. military involvement in Central America, and vote much higher levels of United States aid to the *contras* and whatever other assistance is necessary — including U.S. air cover and/or troops to overthrow the Sandinistas. This would "remove" the communist threat in Central America in at least as effective a manner as it was "removed" in Guatemala in 1954. Such an action would also have certain costs.

Some analysts, such as the Rand Corporation's David Ronfeldt, have argued that a reassertion of U.S. hegemony in the Caribbean Basin would be welcomed by many in Latin America. Others, however, assume that much of the rest of Latin America would be horrified by such an action on the part of the United States. The Sandinistas have vowed that, if invaded, they would retaliate, Qadaffi-like, by sending terrorist "hit-teams" throughout Latin America and to the United States itself. In addition, there are the actual costs of the invasion itself which were estimated, before the recent acquisition of a great deal more military equipment by the Sandinistas, to require 61,000 men and result in 2,000 to 5,000 American dead and between 9,000 to 19,000 American wounded.[3]

Another solution would be that suggested by the evolution of U.S. policy toward El Salvador: the presentation by congress of a strong alternative to administration policy. This alternative would place enforceable limits on U.S. tolerance of Sandinista practices, but not actively seek their overthrow unless those limits are violated. Such a congressional alternative would not be taken seriously by the administration unless it were backed by a consistent refusal to grant administration aid requests for the *contras* until the administration signaled its willingness to reject overthrow of the Sandinistas unless they take specific aggressive steps. Such steps might include *massive* levels of support for the export of revolution; installation of Soviet bases; acquisition, with proximate intent to use, of large amounts of *purely* offensive weapons etc.

This alternative, if successful in deterring the administration from pursuit of the overthrow of the Sandinistas, would also have its costs. It would alarm the right in the rest of Central America, though it would be warmly received by the governments of virtually the rest of Latin America (Chile and Paraguay excepted).[4]

It would hearten the Sandinistas and perhaps encourage a spirit of triumphalism that they had tweaked the *yanqui's* nose twice in a decade and lived to tell about it. However, more moderate elements of the Sandinistas would gain ground if they were inclined to battle with more doctrinaire members of the ruling group. The perverse cycle of the ideological right in Washington feeding on the ideological left in Managua and vice versa might thus be broken.

Some parts of the Nicaraguan opposition would feel disillusioned, others, betrayed and abandoned. The contra fighters in particular would become a massive problem for the United States, Honduras, and the surrounding Central American countries if provision were not made for the return of some to Nicaragua and the migration of others to the United States or other third countries. An emphasis on political rather than military opposition would, however, be encouraged and a tradition of elite reliance on Uncle Sam to "fix" Nicaraguan internal disputes broken.

Negotiating Solutions to Intractable Dilemmas

Because Central America is a quagmire, a conundrum, and an apple of discord, a solution to the Central American policy dilemma will have to be similar to that adopted in other intractable policy

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[3]Theodore Moran, "The Cost of Alternative U.S. Policies Toward El Salvador 1984-1989," in Robert S. Leiken, ed., *Central America, Anatomy of Conflict* (New York: Pergamon Press, 1984), p. 156.

[4]Official statements by administration spokespersons that most Latin American governments really want the United States to overthrow the Sandinistas, but that they cannot say so publicly, is no basis on which to build U.S. policy in the region. Many of the same Latin officials cited by the United States as secret adherents to administration policy say exactly the opposite to Western European officials who disagree with U.S. policy. This leads one to the conclusion that Central Americans continue their historic and entirely understandable tendency to act as all small powers must and tell big powers whatever they want to hear.

arenas such as the Middle East. A la Kissinger, a diplomatic accord over Nicaragua will be one that is consciously misperceived by all parties to the dispute. Just as in the Mid-East peace agreement between Israel and Egypt, each side will have to assume that the final agreement is ambiguous enough to be interpreted as favoring them over their opponents. In the case of the United States and Nicaragua the formulation of a negotiated solution would be as follows:

> The Sandinistas would make concessions to the opposition and to the United States that they believed could possibly remove them from power, but probably would not.
>
> The United States and the Nicaraguan opposition would make concessions to the Sandinistas that they believed could possibly leave the Sandinistas in power, but probably would not.

As in the case of the Middle East, such a simultaneously misinterpreted treaty would lead to a great deal of maneuvering on the part of the parties involved to increase their leverage against their adversaries and to potential stalemate. It would have the advantage of emphasizing political over military competition.

This type of agreement in the Middle East was possible because significant actors in the conflict recognized that their maximum objectives were either no longer achievable or too costly to national survival to continue to pursue. All parties to the Nicaraguan conflict now appear to believe that their maximum objectives are within grasp without significant compromise. Until these perceptions (or realities) change, a negotiated outcome is unlikely. However, Congress is an institution uniquely qualified to evaluate the costs of the pursuit of maximum objectives in Nicaragua and to impose a negotiation alternative that could preserve essential U.S. interests at reduced costs.

MAIN FACTORS IN THE CENTRAL AMERICAN CRISIS AND THE ROLE OF ITS COMMON MARKET

By Pedro Abelardo Delgado*

During the last six years Central America has suffered through an economic crisis bringing with it socio-political effects that have given it a dramatic, if not tragic, character. The critical aspects of the crisis have centered in Nicaragua and El Salvador where bouts of violence have not only affected (and continue to affect) the countries themselves, but the rest of the region; and which have brought with them revolutionary undertakings with ideological implications. To a lesser extent, this phenomenon can also be seen in Guatemala where the situation has the potential of reaching a critical level not only for the distribution of income and wealth which seems to be more uneven, but also because of the presence of an indigenous population that has not adjusted completely to the market economy. For the time being one has to recognize that in Guatemala the socio-political crisis has not yet reached the dimensions it has in the two previously mentioned countries given circumstances we cannot analyze here for lack of time but that have to do with a less dense population, more abundant natural resources (it is the only country in Central America that has some although small oil production) and somewhat greater institutional development. This last it inherits from Colonial times when it was privileged to be the seat of the Spanish Colonial Government (the "Capitania General"), a circumstance which has permitted Guatemala from time to time a democratic interlude in the long historic process of fighting its way out of underdevelopment.

The presence of an indigenous population representing more than 40 percent of the total, is at the same time a reason for the delay in the advent of the social crisis — whose factors are there but latent —and an element which can bring the situation to more devastating proportions than in the other countries. The revolutionary activities of the Miskitos in Nicaragua show, on a smaller scale, the potential disruptive impact a significant indigenous population can have in time of turmoil.

With regard to what has happened in recent years, one needs to point out that it is a merging of factors, both structural and "cojuntural", that have brought about not only the deepest crisis in fifty years, but affected practically every sector of the economy. To make matters worse, the various imbalances intertwine with each other in such a way as to make them difficult to control.

Production, consumption, exports and imports, as well as investments have decreased drastically. Inflation has reached levels never seen before in the region, and as a result, real salaries have lowered dramatically and unemployment has reached uncommon growth.

During the 1970s, the annual rate of growth for industry, commerce, and construction allowed for an increase in the real Gross Domestic Product (GDP) of 5.7 percent during the first half of the decade and 4 percent during the second half. It had been even higher in the 1960s, but since then, or in 1979. The result of this was an actual reduction of 0.7 percent in the GDP from the year 1980 to 1984.

Real investment during this period represented 16.8 percent of GDP from 1970-1974, 17.9 percent in 1975-1979 and, 14.1 percent in 1980-1984. The per capita product which rose 14.5 percent from 1970-1974 went up only 6 percent in 1975-79 and went down an alarming 18.1 percent between 1980 and 1984. According to SIECA (General Secretariat for Central American

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Integration) this meant that the GDP per capita for the region corresponding to 1983 was lower than the one registered for 1973 ten years earlier, and that to bring by 1990 a level of income similar to the one in 1980, the regional economy would need to experience growth of 5.2 percent in annual cumulative rates in real terms for the remaining years.

With regard to inflation, one needs only to point out that (with a base of 1978 = 100) in 1984 consumer prices in urban areas doubled in El Salvador, went up 80 percent and 50 percent in Guatemala and in Honduras respectively, and increased five fold for Costa Rica and Nicaragua, even higher in the last instance (550 percent).

With regard to the levels of poverty in Central America, in a study by ECLA in 1981, the percentage of the population in a state of poverty, that is to say that could not satisfy their basic necessities (including those under extreme poverty), fluctuated,[as can be seen in Table #1], between 25 percent in Costa Rica to 70 percent in Guatemala.

The Central American crisis followed the same pattern as the rest of Latin America. It varies, however, in its socio-political characteristics, which are shared by only a few South American countries, particularly in its violent aspects that, in at least three of Central American countries, have the features of a civil war. What is really alarming is that the problem has degenerated into an East-West confrontation and as such is subject to the circumstances created by international conflicts.

Central America, like some of the Latin American countries, suffers from a high concentration of production in a "dual" agricultural sector. On one side it has a mere subsistence agriculture that is combined on the other side with a medium technology agriculture, mainly to export. Central America has a high level of consumption that is not in agreement with the levels of income; this, in turn, determines an overdeveloped commercial sector and a gross fixed capital formation that falls below the needs of a productive structure. Central America has a regressive system of taxes that results in a low tax burden which limits the government's role in the process of development.

Within this framework, some structural factors remaining from Colonial times have accumulated tensions through the years, such as the distribution of wealth and income, or are part of our inborn weaknesses, such as the size of the market or the openness of the economy, which constitute in themselves a dependency factor in turn so determinant of our underdevelopment.

Others are "cojuntural" like the cyclical fall of the "terms of trade" and the disturbances the international economy is going through. The former originates from within and the latter has an external origin, but it has multiple subfactors that have contributed to the crisis, such as: the high interest rates, the onerous terms of external financing, and above all the reduction and ultimate stoppage of financial flows to the region.

As everyone knows the Central American Common Market came about from the need to have a bigger market than those of the individual countries, to serve as a basis for the industrialization drive that was already underway at the national level under a policy of import substitutions. This was a trend that Latin America was following even before the fifties.

It was assumed that this stage would lead to another one in which the part of production not being consumed locally would be exported in competitive condition which would be developed during that first stage. Even though the process of import substitution permitted growth in the region that lasted almost two decades (1961-1979), the regional market was too small to absorb the relatively large amounts of raw materials which should be produced to achieve economies of scale, therefore, at prices competitive with those still being imported tax-free. This was even more valid for the intermediate and capital goods that new investment required. The substitution of raw material encountered opposition from the Central American industrialists who thought that their cost would be increased by the use of local raw materials, reducing their chances of competing in the market.

Therefore, the size of the market was, and continues to be, one of the main factors in the crisis, since it could not offer on its own a proper base for industrialization oriented to export production outside the region. This brings about a narrowing of horizons where the integration scheme tends to run out of possibilities.

The openness of the economy was conditioned by the possibility of exporting a few primary products (coffee, banana, cotton, and sugar) whose prices are subject to fluctuations. These exports determine the import capacity of the countries and the general level of their economic activity. As is known, these suffer another structural flaw which is the slow increase in the growth of their consumption and, therefore, their demand.

Furthermore, even the interchange of products within the C.A.C.M. has been affected by the fate of the primary export products. When the prices and the demand for said products are high, trade within Central America grows, and when they decrease, growth diminishes even though generally at a lower rate, which has made the Common Market a factor that helps at the time of economic depression.

The very fact is that Central America has not been able to escape its condition of an agro-export economy, since even at its highest, the interchange within the Common Market amounted only to 30 percent of total exports, while primary products continued to rank as high as 60 percent of the total.

As far as the distribution of wealth and income is concerned, it is definitely a factor that affects the size of the market. Though its concentration in few hands could facilitate the formation of savings and, therefore, investment, the poor distribution is, and will surely be, an obstacle to the expansion of the internal market and the development of a higher demand for the goods produced within the Common Market.

The worst thing about such a situation is that, together with the lack of opportunities to participate in politics, it has generated violence and rebel movements that not only affect daily life, the cost of production, production itself, and investment, but they discourage foreign investors and even bilateral and multilateral lenders.

What makes it even worse is that it has brought about the intervention of outside forces and interests, which have turned the region into a battlefield of East-West confrontation, taking the solution of the conflict out of the hands of the Central Americans.

The fall in the "terms of trade" starting in 1978 was the principal contributor to the balance of payment problems which are afflicting the region. The subsequent financial imbalances have been exacerbated by the internal conflicts and their disastrous effects in terms of reducing the production and increasing unemployment. For example, the cotton production has been reduced drastically as well as the production of meat and meat products; the price of sugar had a record fall, and even coffee and bananas were greatly affected. As a result, the value of exports in 1983 was almost one billion U.S. dollars less than in 1980.

With respect to the financial imbalance itself one must say that some of the contributing factors were the monetary and fiscal policies that were adopted by Central American governments in 1979 and 1980 in an effort to maintain the level of investment and consumption in each country. This was done by increasing public spending, or maintaining overvalued rates of exchange that facilitated imports, or by asking for loans at taxing conditions, or by financing investment programs and sometimes consumption needs, with inorganic currency issues of the Central Banks. In some countries the expenditures for defense occupy a high percentage of the national budget. Even the interchange within the Common Market was financed in this manner, resulting in debts among the Central Banks themselves of over 700 million dollars. All this brought about, in turn, balance of payment problems and a shortage of foreign exchange, and started an inflationary process that has decreased the real value of the income of the Central Americans.

The decrease of trade within the Common Market is caused not only by the phenomena mentioned above, but also by the Common Market's difficulty in meeting its payments within the Central American Clearing House. While the countries had enough foreign exchange to pay their balances after the compensation took place within the Clearing House, the interchange grew in Central America. This was the case until 1978, up to which time the prices of the primary export products stayed at a reasonable level. When the foreign exchange coming from trade with the rest of the world disappeared, it was necessary to finance such balances through the Central Banks, which accumulated debts that have become so big that they are impossible to pay back. This has reduced the rate of trade to less than 70 percent of what it was in 1980: from 1,129 million dollars in that year to a little over 700 million dollars in 1984. The decrease in the use of installed industrial capacity meant, of course, of labor and higher rates of unemployment. The lack of trust that this generated with the investors brought not only a halt to investment, but capital flights aided by the overvalued rates of exchange.

But nothing contributed as much to the economic crisis as the paralysis of the financial flow that had sustained, and worsened, the state of things. The sudden halt of the external financing was one of, if not the key contributing factor to the collapse of the Central American economy. Even short-term credit that used to be handled by the commercial international bank system was suspended to the point of asking for deposits of 100 percent of its value in dollars (which virtually meant prepayment!) before opening a letter of credit. Even now when the economic situation and climate have improved, deposits of up to 50 percent are required for opening such short-term credits. This obviously raises the financial needs of commerce as well as those of production and, therefore, the operating costs.

The recession that affected the industrialized countries at the beginning of the 80s had, in turn, an important effect on the export markets of Central American countries, not only because of the decrease in demand for their products that the recession generated, but because of the tightening of protectionist policies that could be observed in the developed world. This meant, as well, a reduction in production and more unemployment.

High interest rates and shorter term loans produced a situation in which the burden of servicing external loans, which had already reached relatively high levels, became unbearable. With a total debt that by 1984 had reached 4,050 million U.S. dollars for Costa Rica and 2,250 million U.S. dollars for Honduras, the servicing of the debt came to be close to 40 percent of exports earnings for that year for the former, and around 25 percent for the latter. The situation is even worse now for both of them.

Nicaragua needs to be mentioned separately not only for the relative size of the debt (3,900 dollars in 1984) but because a good portion of it is owed to countries of the Eastern Bloc.

Among the internal causes of the economic crisis one can add the type of industrialization that was adopted by the Central American governments. Import substitution of raw material became problematic, because the Central American industrialists had gotten used to making their products using imported materials of consistent quality which came into the country tax free. They themselves operated in a protected environment with privileges and subsidies that accustomed them to easy gains and did not provide incentives for increased productivity, which were required for entering the larger international market. Under these conditions, they were not prepared to compete with goods produced with local raw materials.

As a result, the raw materials and intermediate products came to comprise a high percentage of imports, and it was difficult to reduce them when the lack of foreign exchange called for such measures. This added as well to the problems of balance of payment. When no more foreign exchange was available to import such raw materials, industrial production declined and, therefore, trade within the Common Market, creating yet another factor that propelled the region toward the crisis.

Finally our dependence on the developed world which, as said in the beginning, is the major factor in our underdevelopment, is in itself engendered by a series of subfactors that range from our being a predominantly agro-export economy (and as such dependent on the cyclical fluctuations that primary products are subject to as well as the slow growth in demand) to the type of industrialization that came about as a result of the effort to integrate Central America, which depends on high use of imported inputs, and to, finally, the unbearable burden of our debts.

We can now ask ourselves, What are the prospects for the coming years? What can be done to come out of this crisis? It is obvious that any efforts in that direction require at least a reduction of tensions on the political and military fronts, and a formula to achieve it does not seem to have been found. The efforts generated under the auspices of the Contadora Group have managed to slow down the conflict, maintaining hopes for dialogue, but do not seem to have enough backing of the superpowers involved in the conflict. Without their active participation and commitment, any deal made is just talk. We want to hope that justice and reason will prevail sooner or later, providing a chance to find a solution.

In the meantime, Central America is trying to find ways to overcome some of the contributing internal "cojuntural" factors. There is a process of adjustment in almost all the countries' economies. Costa Rica started to devaluate its currency in 1980; Nicaragua, El Salvador and Guatemala have gone through similar processes more recently. This has been done in a majority of the cases alongside other measures that look to stabilize the economy and get it moving. Other external contributing factors have also started to change, for example, the higher prices for coffee, the lowering of oil prices and interest rates, the renegotiation of the debt for some countries, and for others a limited access to credit.

It would seem Central America is coming out of its collapse, at least if one goes by the figures of a 1.5 percent growth in GDP in 1984, when both exports and imports grew by about 6 percent.

A lot of effort is being invested in solving the problems of payment within the Common Market and each of the countries is making an effort to orient its economy toward exports outside the region as a way of getting foreign exchange.

But expansion and diversification of exports and access to markets depends on the capacity to compete both price and quality wise, as well as on the lowering of restrictions in trade still present, even with the opening created by the Caribbean Basin Initiative (CBI) and the arrangements for one way free trade with Mexico, Colombia, Venezuela and Argentina, sponsored by the Inter-American Development Bank.

At the same time most of the governmental programs include policies for saving foreign exchange. Let's hope those programs are actually implemented.

Nevertheless, the structural factors still exist and will continue to do so, and there is very little one can do to change them.

In both Nicaragua and El Salvador, some steps are being taken toward an agrarian reform that could improve the distribution of income. But the ongoing war and other circumstances limit drastically the results with regard to improvement in the living conditions of the beneficiaries.

Though it is true that without a sincere effort of the countries themselves and of Central America as a whole, there will not be an improvement in the economy of the region, it is also necessary that Central America again counts on economic and financial international cooperation, including foreign investment. The flow of net external financing has to increase so as to normalize imports and thereby contribute to the reactivation of the productive sectors. There is also a need for funds to finance both public and private plans of investment and to rebuild some of the economies damaged by the war.

Only new international economic orders can open the possibilities to overcome such factors as the "terms of trade" which are at the core of the problem. In the meantime, we will continue to fight for economic progress, no matter how limiting the frame of development.

ON THE FEDERAL REPUBLIC OF GERMANY'S EXPORT COMPONENT IN ECONOMIC GROWTH: AN ECONOMIC ANALYSIS

By Oliver C. Dziggel*

Popular reportage has frequently accused the Federal Republic of Germany (FRG) of a policy of "exporting unemployment." Since this theory has gained common currency in discussions of the FRG's contemporary economic history, it may be of value to examine the foundation for the assertion, and to determine to what extent it can be said to be true. Moreover, in light of the impending danger of global economic stagnation in the face of several "bull" market years, what steps, if any, can be expected to be taken by German policy-makers to insulate their economy from these destabilizing forces and uphold the high status of the German economy in the international market.

In simple terms, the phrase "exporting unemployment" implies that the FRG was able to accomplish its *Wirtschaftswunder* by implementing an economic policy of export-led growth, which in turn ensured full employment domestically to the detriment of workers in the importing states.

Empirical data tends to verify the consistent economic well-being of the FRG, from 1950-1980, which is the period under review in this essay. (Refer to the Annex for relevant tables relating to real GNP growth, industrial production growth by sectors, total labor force and foreign labor force as a percentage of the total, foreign trade and balance of trade and balance of payments statistics.) The question to be addressed is whether this dynamic economic performance is the reflection of factors unique to the German situation, and to what extent this "politics of prosperity" can be exported to Germany's global trade partners. In this context, the record shows that the FRG under Schmidt was reluctant to serve as the "locomotive" of economic recovery for the Western industrialized world. It remains to be seen whether the new Conservative Kohl coalition is any more willing or perhaps any more able.[1]

Except in a broad theoretical realm, this essay will not directly address the impact which German foreign economic policy had upon Germany's trading partners. Instead, the investigation will focus on her domestic components: how the economic primacy of exports developed and to what degree has the German economy become export-dependent; the special instruments, conditions and resources German policy-makers have at their disposal to implement a policy of export-led growth and the functions that are necessary to maintain this dynamic equilibrium; the significant trade-offs which had to be made in the pursuit of this line of policy implementation and the hurdles which have been crossed to achieve this goal; and finally, the contribution of the relevant sectors of society to the fulfillment of policy objectives — specifically, the role of industry and labor in the policy of shared management known as *Mitbestimmung* (co-determination) and their contribution to the overall government economic decision-making.

In a recent analysis of German post-war development, one scholar cogently expressed the observation of many Germany-watchers that, in the FRG, "economics became a prime preoccupation of a people who suffered want and were alienated from politics."[2] Before embarking

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[1] "Leading From Strength," *Time* magazine, Vol. 113 #24, (11 June 1979), pp. 26-40.

[2] "The Dynamics of Growth," R. Kreile, in Katzenstein, *Between Power & Plenty,* p. 196.

on an analysis of the policy aspects of export-led growth, then, it is vital to begin with a firm foundation of economic theory relating to the development of German economic policy to discern why those particular policies proved so successful in the German case.

Briefly stated, economic analysis can be undertaken in two broad modes: static, that is to say, in the short term; and dynamic, looking at the long run effects. Static analysis encompasses a survey of the direct production effects (ie: what impact trade would have on what is produced and vice versa) and the instantaneous welfare effects (ie: what social benefits befall upon a country resulting from the production and trade of certain goods). For the purpose of this paper, however, a greater emphasis will be placed on the dynamic effects, in that the critical notion is the success of German export policies over time — hence, an examination of the trends in exports and their impact on the economic growth rate.

In this context, two statistical facts are particularly relevant. The first is that "an analysis of export developments over the period 1953-1965 shows that export growth rates developed a trend which was almost uninterruptedly declining from 1954 to 1960, but became more or less stabilized in the 60s at an average of 8.8 percent. This is more than the growth rate of private consumption but less than that of government expenditures."[3] This is not to say that the absolute value of exports was declining, merely that the rate of increase had been slowing and leveling off.

With the assumption of no change in the competitiveness of the export sector as a whole (ie: no new trade barriers, and no change in the productivity of capital) this can be interpreted as a saturation of export markets by the FRG, and, if accompanied also by a similar leveling off of imports (or of complementary productive factors) a state of trade equilibrium can be said to have been reached. Moreover, a common assumption of industrial development is that a trend towards declining increases in real GNP growth (towards a point of stabilization) is a reflection of a maturing industrial economy. If the above analysis is correct, then, the FRG's economy already showed signs of maturation in the mid-to late 60s.

The second point of statistical significance to this argument is that the export sector was in fact the largest contributing factor to the overall economic growth rate. "By far the highest average growth rate among the components of final demand has been experienced by exports. German exports totaled DM 25.4 billion in 1953, rising till 1965 to DM 91.4 billion. Average annual growth rates were 12.4 percent, if based on annual data, and 12.0 percent according to the trend values."[4] These trends have continued into the 1970s, and indeed, the adjusted export growth rate for 1980 (the last year to be examined here), was a healthy 11.4 percent over the previous year.[5]

While it can be said that initial German export growth rates can be attributed to Germany's re-entry into the world economy from a rock-bottom at the close of the war, it is clear that by the mid-50s, the novelty had worn off and the pump was well primed and operating steadily. From there on there were at least three main influences maintaining German export growth.

First of all, "the lion's share of her exports go to other highly industrialized countries with relatively high receptivity for imports."[6] From a welfare-economic point of view, this type of arrangement is optimal for the most efficient allocation of scarce resources, owing to competition and eventual factor price equalization. In this context, in a liberal trade environment, exports serve to utilize each country's abundant factors of production and competition among capitalists promotes the most efficient sectors. From a more business-economic perspective, it is argued that

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[3]Wolfgang Michalski, *Export Trade and Economic Growth,* Hamburg: Verlag Weltarchiv (1972), p. 52.

[4]*Ibid.,* pp. 51-2.

[5]Refer to table in Annex.

[6]*Op. cit.,* Michalski, p. 52.

once domestic demand is fully satiated, exports represent the expansion and exploitation of similar markets abroad.[7] This first phase was not the case for German exporters, however, as will be discussed later.

Second, "comparative costs were on the low side and exports consisted mainly of investment goods. In the international division of labor context, Germany specialized in those branches of manufacture for whose demand is growing at above average rates."[8] In other words, Germany operated to its comparative advantage; certain industries had a particular technological or productive advantage over those in other countries. Moreover, these industries were the so-called "growth industries" — those in which demand for the productive output is rising and expected to continue to rise.

Third, "in the period of 1953-1965, many obstacles to the flow of international trade were dismantled. Mostly industrial manufacturers were benefiting from this process."[9] After the war, American hegemonic interests enforced a liberal trade world-order well into the 60's (when America became more preoccupied with the Conflict in Indonesia). The FRG's "take-off" in industrial exports can be directly linked to the Korean Crisis, which had a ballooning effect on the global demand for steel and related capital goods. It has been reported that the FRG's steel production doubled in two years to meet this enormous demand.[10]

Other relevant industries that can be said to be export-dependent include: (1978 figures)

— the investment goods industries (= 55 percent of total)	47.4 percent
—machine building	56.0 percent
—automobile	52.0 percent
—iron and steel production	67.0 percent
—chemical	48.5 percent

Moreover, specific industries dominate specific categories in terms of export-dependence: Daimler-Benz exports make up 39 percent of the automobile share, while three of the largest steel producers, Hoechst, Mannessmann and Thyssen, constitute 32 percent, 50 percent and 34 percent of the iron and steel share, respectively.[11]

This concentration of production has numerous economic advantages, particularly for the capital-intensive industries. Concentration provides facilities for intensified research and development, thus accelerating technological innovation as well as necessary renovations of plant and equipment. The economies of scale which result from this concentration means an optimal plant size can be constructed to meet the global demand for the exports, and the increased size of productive capacity also means a more substantial quantity of loanable funds (internal) to channel into additional plants and equipment (and more modern and up-to-date production facilities translates into more productive use of labor and a lower average cost).[12] Thus, although Marshall Aid provided a vital initial stimulus to growth in the early post-war period, since then, the German industrial sector has been able to finance its own growth through internal means.[13]

Before concluding the analytical economic introduction, the issues of productive factor prices

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[7] *Ibid.*, p. 53.

[8] *Ibid.*, p. 54. See also article comparing the FRG with the industrial decline in Detroit, *Wall Street Journal,* Dec. 3, 1982.

[9] *Ibid.*, p. 54.

[10] Alfred Grosser, *Germany in Our Time,* NY; Praeger (1970), p. 167.

[11] *Op. cit.,* Kreile, P. 201.

[12] *Op. cit.,* Michalski, pp. 131-2.

[13] *Op. cit.,* Kreile, p. 202; also, Michalski, *Op. cit.,* pp. 81-2, 129-30.

and factor mobility have to be addressed, owing to their particular significance to the export competitiveness of German industry and the economic growth rate.

One of the fundamental concepts of international trade theory is that free trade maximizes world welfare. Among the essential welfare gains listed by Lipsey are: 1) specialization of production (the comparative advantage argument), 2) economies of scale (for certain types of production, the size of the operating plant may enhance the competitiveness of the industry), 3) changes in the terms of trade (relating to the bargaining value of the goods produced), 4) forced changes in efficiency (meaning that foreign competition increases domestic efficiency), and 5) a change in the growth rate (implying that as trade relations develop, the economic growth is bound to adjust upward.[14]

Samuelson's contribution to the welfare effects of liberal trade analysis was the theory of factor price equalization. Simply stated, it argued that under liberal trade arrangement, factor prices (meaning the components of production — labor costs, capital inputs, land) would equalize over time. This conclusion was based on the assumption that efficiently produced imports would hold down the costs to consumers in the importing country, while the export of efficiently produced goods would similarly hold down the labor costs domestically.[15]

Mundell extrapolated this concept further to include the movement of labor as well as capital in the equalization process. His argument is particularly important in the German case, since the booming German economy faced a lengthy period of labor shortages that only slowly was filled by the inflow of foreign labor. The key point he presented was that commodity movements and factor movements are economic substitutes.[16]

Furthermore, Kindleberger determined that the impact of the expected resultant growth rate increase is markedly different between the exporting and importing country; Germany reaped the benefits both of an exportation of manufactures and the importation of productive cheap labor.[17]

As will be detailed later, German exports are highly weighted towards what is commonly known as "glamour" commodities: high-tech and high-quality manufactured and capital-intensive goods. Significantly, Germany's major trading partners are predominantly other highly-advanced industrial states with well-developed consumer markets and elastic demand for imports. On the domestic side, overall German consumer demand grew steadily as a result of export revenues, and was channeled into durable consumer goods and savings. Moreover, the importation of foreign labor not only had an "upward-ratcheding" effect on the labor force (ie: freeing a higher proportion of the German native population for advanced education and therefore an implied preference for higher-skilled jobs upon graduation), but it also saved the state "human capital," (ie: translated into a savings of monies that would normally have been spent on education, medical expenses and employment insurance). In overview, then, it is quite clear that the FRG did benefit quite substantially from the practical application of fundamental liberal trade theories.[18] The question now to be addressed is how Germany came to benefit so spectacularly from these policies, to the extent that many of its trading partners (who weren't quite so successful in the long term) came to feel alienated if not stifled by its dynamic economic performance.

The evolution of Germany's post-war economic policies was strongly influenced by its distant economic history as well as the contemporary political constraints imposed upon it as a result of having lost the war. The oft-cited abhorrence for runaway inflation manifested itself in policies aimed specifically in stabilizing the price index. In fact, Germany policy-makers possessed such a

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[14]Quoted in Bhaghwati, *International Trade Theory,* p. 265.

[15]Paul Samuelson, "Factor Price Equalisation Again," *The Econ J,* June 1949.

[16]Robert Mundell, "International Trade & Factor Mobility," *Amer Econ R,* specifically, see p. 321.

[17]Quoted in Askari, p. 342.

[18]Although, in all fairness, the FRG preceded the publication of this theory.

strong aversion to any trace of inflation that even so-called "creeping" or structural inflation was seen as a potentially lethal symptom. One German economic study suggested four primary reasons for state objections to inflation: 1) it reduces the propensity to save, 2) it persuades people to hoard irrationally, 3) it produces an incentive to make the wrong decisions about investment, and 4) it may lead to runaway inflation.[19]

Yet, this same study concluded that of the six basic policy objectives desired by the Bonn regime, only three were ultimately successful: 1) economic growth has been constant in national economic terms and inflation has been suitably controlled, 2) the strength of the currency was maintained and international confidence in the DM was bolstered, and 3) unemployment was kept quite low and job security was assured in several prominent "national champion" industries. However, the concentration on exports as the keystone of the economy proved a failure in meeting all of the objectives simultaneously in these respects: stability of prices, spatial distribution of economic growth and external equilibrium.[20] The report concluded by noting: "During 1953-1965, the high rate of export growth (was) a target *alternately* achievable as against price stability and external equilibrium, whilst full employment and economic growth seem to be more or less rough reflections of export growth."[21]

In examining the FRG's contemporary economic policies and political structure, the old Burmese anecdote comes to mind: "one fears most the python that bit last" — which is to say that Germany's post-war development was an acute reaction to the economic and political ills that paved the way for the authoritarianism embodied in the rise of the Hitler regime. The symbiotic interaction between economic and political interests dates back to the genesis of the German state as a sovereign entity. The creation of the *Zollverein,* or customs union, was an answer to the political needs of Germany's conflictually-oriented regional overlords, and resulted in the eventual unification of the German-speaking nation from 26 separate principalities into a single state in the 19th Century.[22]

By the turn of the century, the German political system was fully consolidated, but economic issues still managed to tear at the fabric of stability, both inside the system as well as outward toward Germany's neighboring states. As Calleo remarked on the emerging primacy of economic interests under Bismarck: "In effect, the German model was inspired not by the peaceful liberalism of Cobden, but by the armed mercantilism of Clausewitz. Like the old Prussian state, the German economy was scientifically organized for combat. Trade was war by other means."[23]

Unfortunately for the German people, the commercial ambitions of the ruling elite proliferated the economic battle onto the military sphere, an entanglement which led directly not only to the massive destruction of the First World War, but which later re-emerged as the leading cause of the Second World War.[24]

Fortunately, from the Western point of view, the lessons gleaned from the harsh treatment of Germany after the First World War and its consequences averted an encore performance of this tragic policy-cycle. In the interwar period, Germany was economically hamstrung by the Western states. Germany was not only saddled with outrageously high reparations demands, but also

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[19]*Op. cit.,* Michalski, p. 133.

[20]*Ibid.,* p. 170; See also Burtenshaw, *Germany: Economic Geography,* London: Macmillan (1974), pp. 226-7.

[21]*Op. cit.,* Michalski, p. 173.

[22]See James Sheehan, *German Liberalism in the 19th Century,* Chicago: Uni of Chicago Press (1978) p. 52; and more generally, Jacob Viner, *The Customs Union Issue,* London: Stevens (1950), and JE Meade, *Case Studies in European Econ Integration,* Oxford: Oxford Uni Press.

[23]*Op. cit.,* Calleo, p. 58.

[24]James and Suzanne Pool, *Who Financed Hitler,* NY: Dial Press

economically incapacitated by its victors, thereby preventing its sincere efforts to fulfill its obligations. Thus, the rape of Germany's industrial capacity, coupled with the prohibitively high import tariffs and trade barriers erected by the Western industrial states led to the collapse of the economic system, which then led inevitably to high inflation, high unemployment and the eventual collapse of the democratic system of government. Clearly, the long-term interests of the West were not best served by the ostracization of the German state.

It is in sharp contrast, then, that the Western states, under the dominant leadership of the US, constructed a decidedly liberal economic world-order after the defeat of Nazi Germany in 1945. There is ample evidence to suggest that the spark that ignited German post-war revitalization and the implementation of an export-led growth policy is solely the doing of the US, in three important components (all relating to its own vital national interests, and de facto hegemony over all of Western Europe together with a strong ideological commitment to free trade and the "containment" of the Communist threat to the free world).

The first component was the infusion of much-needed capital into war-torn Europe. Although clearly all the recipients of Marshall aid benefited to some degree, it can be said that Germany and the Balkan states benefited the most — in addition, of course, to the substantial benefits which befell upon the donor. For Germany, the ready availability of massive amounts of funds meant start-up capital for the rebuilding of the industrial sector in the Ruhr. In spite of the great "brain drain" which had occurred during and after the war, Germany still had a miraculous reservoir of technical, scientific, and management talent to tap for the restructuring process. Furthermore, the loss of much of Germany's prime agricultural territories to the Soviet bloc states mandated a concentration on industrial prowess to counterbalance the perceived deficiency in former resources.

As will be illustrated later, it also meant that the ancient cleavage between the interests of industry and the interests of agriculture, which had so often led to power struggles and political rivalry, instability and bloodshed in the past, was substantially deactivated at long last.[25] The most important aspect of the split is that there existed after the war a decidedly one-sided pressure group exerting its influence on German policy-makers: that of industry and big business. Moreover, the manner in which the Marshall Aid was distributed in the FRG also had a significant impact on the subsequent evolution of the German political system and the development of a growth policy based on the primacy of export-led growth. The fact that the Ministry of Economics, which was established to disperse these funds and chronologically preceded even the creation of the Foreign Office, a disproportionately high degree of political clout arose (which didn't just disappear once the full complement of the government evolved). In point of fact, it can be argued, as Kreile does, that its dominant position became unassailable once the Wirtschafswunder was an internationally-recognized reality.

The second component of US involvement was the desire to establish Germany as the keystone in the American containment policy. Aside from its geopolitical importance, Germany also was clearly the state least likely or able to balk at the imposition of US policies. In fact, by virtue of the Allied Occupational Forces and the provisional government (OMGUS), Germany was strictly in the passenger seat of the initial restructuring initiatives. In the first place, all essential imports of food and petroleum into Trizonia were required to be paid in US dollars. This policy was to the great disadvantage of France and Britain, who also faced as severe a capital (and especially dollar) shortage as Germany. Furthermore, the dollar stipulation also served to hamper trade between Germany and all other states except the US. In retaliation, some European countries established

[25]Only recently have there been studies emerging by East German scholars on the implications of this agricultural base within the GDR geographical borders.

import quotas on German goods to protest the dollar policy and salvage their valuable dollar reserves.[26]

On 1 January 1947, the Joint Export-Import Agency (US/UK JEIA) was established to specifically boost exports from Germany into the US. Once again, there were clear underlying reasons why the US promoted such an agency: 1) to satisfy the post-war consumer demand for manufactures in the US, and 2) to reduce the burden on the US taxpayer in the rebuilding of the German economy. "From the onset, it was the aim of the American government to sell at the highest possible export prices in order to reduce the burden on the American taxpayer."[27]

To assist in the establishment of fair market prices for German exports, US private sector consultants and trade representatives from large retail firms (such as RH Macy) were called in to promote trade. This was also part of the effort to "civilianize" the Economic Division of the Export Import Section of OMGUS, which at one point had a staff of 50 trade officials, including 20 German commercial specialists.[28]

To underscore the "containment" aspect of the policy, the following OMGUS memorandum (Cable dated 3 May 1946) serves succinctly: "On the subject of the Import-Export Program: The US and France and the UK would cease the dismantling of German industrial plants in their sectors if the Soviet Union would not comply with the Potsdam agreements which stipulated the treatment of Germany as a single economic unit. Until the question is resolved, any further action on our part would create an additional financial liability for the US to support its zone in Germany."[29] General Draper, the US commander in Germany, listed the following sources of difficulty in speeding up the desired export policy wanted by the Administration: "Primary difficulties in developing German exports: Lack of a foreign exchange rate; need for transactional mail; need for Germans to travel abroad; and need for German export agency which would have authority to hold foreign funds." These hurdles were crossed in short order with the cooperation of the JEIA, the newly-created *Aussenhandelskontore* (regional foreign trade bureaus) and the amalgamation of the Bank Deutschen Laender (BDL, which in 1957 became the federal central bank, Bundesbank.)[30]

The essential export infrastructures were barely in place when the Korean Conflict erupted and the US began an active mobilization of war forces which single-handedly changed the global outlook for steel production. In a two-year period, the productive capacity and output of German steelmakers doubled.[31] Due to the severe shortage of labor in the extracting industries (an issue integral to the Schumann Plan's labor mobility schemes in the European Coal and Steel Community), massive amounts of raw materials had first to be shipped to Europe from the US for the smelting and purifying process. The third component of Germany's export-led growth policy, then, was the virtual overnight revitalization of the heavy industry sector to meet the increase in demand for steel and machinery needed for the Korean campaign.[32]

The distraction of US attention away from Europe and the emergence of the Cold War as the central policy concern of the American administration in the 1950s contributed to the transfer of the reins of German policy-making to domestic German leadership. The staunchly pro-US and devoutly moderate presence of Adenauer at the helm of the German leadership instilled further

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[26]John Backer, *Priming the German Economy,* Durham: Duke (1971), p. 117.

[27]*Ibid.,* p. 113.

[28]*Ibid.,* p. 106.

[29]*Ibid.,* pp. 110-11.

[30]*Ibid.,* p. 111.

[31]*Op. cit.,* Grosser, p. 167.

[32]Wolfram Hanrieder, *West German Foreign Policy,* Stanford: Stanford Uni Press, p. 61.

confidence among the Allies, especially in his instrumental role in and commitment to the European integration movement.

Adenauer was aided in the development and implementation of an export-led growth policy by virtue of strong and independent personalities in key Ministerial positions. Article 65 of the FRG's *Grundgesetz* (Basic Law) provides that a Minister "shall conduct the affairs of his department autonomously and on his own responsibility." Nonetheless, the record shows a very strong consensus among Ministers in their commitment to export-led growth.[33]

Dr. Vocke, the President of the BDL/Bundesbank was called in the press "a banker's banker," possessing the quintessential characteristics needed to run the central bank according to the Grundgesetz mandate of "protecting the currency." He was strongly opposed to loose, uncontrolled government spending in the Keynesian sense of stimulating the economy, and worked for tight credit restrictions to combat the ever present inflationary spectre. In addition, the Central Bank, under his control, raised the minimum cash reserves to be held by commercial banks by 50 percent and boosted the discount rate from 4 percent to 6 percent. As a consequence, the price spiral evident in most Western states is barely noticeable in the FRG.[34]

The success of the export policy acted as a double-edged sword: According to Kreile, "export surpluses were seen as a consequence of import restrictions and lagging domestic demand and were largely accepted as the main source of inflation." This conclusion is presumably based on the general upward pressure on prices by rising direst demand as a result of high export volumes and surpluses.[35] On the other hand, the massive inflow of capital increased incomes from surpluses of current transactions, and improved the German liquidity to almost unmanageable proportions.[36] Schaeffer, as the Finance Minister, began the trend towards balance of payments surpluses in his desire to establish a "Juliusturm," or nest egg for contingency purposes. It was also part of a redistribution of income scheme to help those who had lost all in the war.[37] By the 1970s, Germany had piled up greater gold and dollar reserves than any other country in the world — a formidable instrument of leverage in international trade negotiation.)

But by far, the greatest amount of economic strategising emanated from Erhard, the Minister of Economics. His most meaningful contribution was the conceptual implementation of a *Soziale Marktwirtschaft, a hybrid brand of free market economics with a social conscience. Market forces are encouraged to operate fully, but according to the basic "rules of the game" set down by the state to meet its vital interests. This policy of state economic steerage came to be known as Ordnungspolitik* (ordering of priorities) which later evolved into *Strukturpolitik* (the re-shaping of socio-economic fabric).

Professor Wallich described the system most cogently: "it was a harsh system but in keeping with the situation. The war ended in crushing defeat and there was no illusion that peace would be enjoyable. 'Fair shares' (as advocated by the British Socialists) might have overburdened the strong and all might have sunk together. By being able to save their own skins first (through incentives), the strong were put in a position where they could pull the rest after them. The rapid advance of the economy took the place of the redistribution (of wealth), In this sense, the Soziale Marktwritschaft . . . produced socially positive results."[38] Erhard himself wrote that the principal concept to be stressed

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[33] *Op. cit.*, Grosser, p. 116.

[34] *Ibid.*, pp. 166-9.

[35] *Op. cit.*, Kreile, p. 202.

[36] *Op. cit.*, Michalski, p. 133.

[37] *Op. cit.*, Grosser, p. 173.

[38] Quoted in Grosser, *Op. cit.*, p. 171.

was that "if the state does intervene, the important thing is how and why it does so — intervention in itself is neither good nor bad."[39]

Examples of government intervention are numerous and include measures preventing the formation of monopolies, and the taking of anti-cyclical measures to maintain stability. "These stabilizing measures must be as automatic as possible to avoid arbitrary intervention. Major inequalities of income should be moderated by means of progressive income tax, but must be mild enough not to interfere with incentive."[40]

The policy which best served these desired ends was a consistent and deliberate undervaluation of the DM, a policy which was supported by the US and was equally beneficial to both the German export sector (because it enhances their competitiveness in foreign markets by artificially lowering the prices of their goods) as well as the domestic producers (because it artificially made foreign products more expensive).

Furthermore, exports had "a most welcome anti-cyclical influence during the period under review because of a strong phase-shift between the FRG's trade cycles and those of some of its most important trade partners, which had the effect that exports were able to expand massively just when domestic demand was dropping." In addition, exports "have provided some kind of pump priming for the next upward swing."[41] So, not only did exports contribute significantly to economic growth, but steady economic growth fueled an expanding export sector.

The success of the export-led growth policy would not have been possible without a definitive *Konzierte Aktion* (concerted action), not only on the part of the various Ministries, as well as between the relevant Ministries and key industries, but also between labor and management. Simply stated, it was the "practice of calling together, under the chairmanship of the Minister of Economics, the representatives of the employers; associations, trade unions, and the Bundesbank for consulting and jointly deciding periodically on the acceptable rates of productivity gains and profit and wage increases."[42]

German planning avoided the rigidity of France's Commissariat du Plan which worked in formal 5-year plans (but which was nonetheless instrumental in the French re-tooling of France's vital industries and the building-up of new ones). Instead, it concentrated on medium-term financial planning and the drafting of legislation enhancing the overall economic goals (such as the 1967 Stabilisation Law). Other specific measures ensuring continued export growth consisted of: 1) export credits, 2) credit insurance, 3) tax subsidies, 4) foreign exchange retention (for leverage), and 5) bilateral trade agreements. (And on a higher plane, import liberalization and conservative monetary-fiscal policies.)[43]

Export credits concessions were made on three plateaus: 1) credit facilities for individual exporters, 2) balance of payments credits via EPU and swing margins of bilateral agreements (these were financed by the Bundesbank in their totality), and 3) the central bank discounted short term export drafts freely at rates equal to discount rates prevailing in the importer's country. (For exporters, this meant a relatively cheap loan plus the advantage of not having to engage his credit line at his bank. It contains a distinct subsidy element, of course.)[44]

Export credits insurance is privately organized by the Hermes Kreditversicherungs AG but

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[39]Quoted in Grosser, *Ibid.*, p. 178.

[40]Henry Wallich, *Mainsprings of German Revival,* New Haven: Yale Uni Press, p. 115.

[41]*Op. cit.*, Michalski, p. 57.

[42]*Ibid.*, p. 186.

[43]*Op. cit.*, Wallich, p. 244.

[44]*Ibid.*, p. 245.

backed by the federal government to a limited extent. The government sets specific limits to which it will back credits, and usually these limits are not overstepped.[45]

General tax incentives are used for two specific purposes, each affecting exports only indirectly. First, to reduce marginal tax load (ie: the top bracket tax) on the tax payer — to stimulate effort, in that high marginal tax rates tend to kill off incentives. And second, to stimulate savings and investment. Investment is economically said to be at the expense of savings, of foregone consumption.[46]

Tax incentives specifically aimed at exporters include:

1) remission of the turnover tax (VAT) of 4 percent (1955) which would be payable if the product were sold at home

2) refund of 2.5 percent of the turnover tax presumed to have been paid on the materials entering into the product. This is largely believed to be less than the actual value involved.

3) deduction from taxable incomes of an amount equal to 3 percent of export sales

4) remission of tax on negotiable financial instruments (Wechselseuer)

5) remission of tax on insurance policies.

It has been calculated that the aggregate of benefits accruing to the exporter under provisions 1, 2 & 3 allows a manufacturing exporter to price his merchandise 11.5 percent below domestic prices. In so far as GATT allows, other countries do the same — such as Britain's "purchase tax" and France's "taxe sur le chiffre d'affairs" ("turnover tax").[47]

It is important to note that even with the reduced capacity of the Bundesbank to manipulate the exchange value of the DM on the international money markets, exports continue to expand healthily. During the period between September 1969 and March 1978, the DM appreciated 81 percent against the dollar, 25 percent against the yen, 65 percent against the franc, and 145 percent against the pound sterling. Still, exports were not significantly hurt, owing largely to continued low German inflation rates and the fact that capital goods are generally said to be price insensitive.[48]

But if the continued strength of the DM can be said to be the principal source of export competitiveness and hence German economic well-being, then it must also be pointed out, as Kreile argues, that the weak link in the economic chain which may imperil the future stability of the German economic system, is the question of continued labor cooperation in what appears to be a prolonged period of economic recession. To date, the "politics of prosperity" have proven sufficient to ensure some measure of continued optimism.

Hermann Winkhaus of Mannesmann displayed remarkable foresight, when he was quoted by a reporter for the *Wall Street Journal* in 1952 as saying: "As long as things go good, there won't be any trouble. If we could have four years of unbroken prosperity, I can educate these labor directors to see the light on how business should be conducted, but if we have bad times, they will take their orders from the DGB." (workers union).[49] According to Kreile's argument, labor's passivity can be explained by two prominent factors: 1) both labor and industry reaped the benefits of thirty years of the "dividends of growth," and 2) at the branch level (ie: the producers associations, peak associations, labor unions) the interests of labor and capital converge.[50] As the economic pie begins to shrink, however, and as the name of the game changes from "positive sum game" to "zero sum

[45] *Ibid.*, p. 247.

[46] *Ibid.*, p. 128.

[47] *Op. cit.*, Calleo, p. 192.

[48] *Op. cit.*, Kreile, p. 202.

[49] *Op. cit.*, Grosser, p. 184.

[50] *Op. cit.*, Kreile, p. 203.

game," the potential for conflict tends to increase. Economically speaking, the rate of return on capital depends on the supply of labor. The more elastic the supply of labor, the greater the return to capital and the greater the volume of further re-investible funds. This raises the capital-to-labor ratio and hence the labor productivity.

Traditionally, the FRG was able to bridge its labor gap through the importation of foreign labor. In 1955, the first agreement was signed on a bilateral basis — in this case with Italy — to recruit foreign labor. Other agreements include: Spain (1960) (only these two were signed prior to the building of the Berlin Wall — a significant blockade of potentially highly productive labor resources), Greece (1961), Turkey (1964), Tunisia (1965), Morocco (1966), Portugal (1967), Yugoslavia (1968); agreements with Japan (1962), South Korea (1963), and Chile (1967) pertained only to miners.[51] By 1969, there were over 1.5 million Italians, Greeks and Turks employed in the FRG, where the working population at that time was over 26 million. In that year, there were less than 200,000 unemployed and over 700,000 jobs vacant.[52] In the FRG, Italians, Greeks, Spaniards, Portuguese, Turks and Yugoslavs together constitute 80 percent of the foreign workers employed.[53] Foreign workers, mostly *Gastarbeiter* (literally "guest-workers," implying that their term of stay is anticipated to be short) now number at more than 10 percent of the total labor force.[54] Significantly, 57 percent of foreign workers stay in the FRG less than three years at a time, with the return migration flow ranging from 9 to 45 percent and an average of 27 percent in the years 1957-73.[55] On the average, family incomes for immigrants is lower than for indigenous families. In France, for example, it was about 12 percent lower than the average for all families in 1970.[56]

In Germany, "the rapid increase of foreign workers merely compensated for the reduction of yearly hours of the native component of the German labor force. This decline was due to lower birth rates, coupled with delayed entry into the labor force because of more extensive education, shortening of work hours and more extensive vacations."[57] After the 1975 recession, however, which saw a new trend towards a declining immigration wave, and as a result of many companies laying off foreign workers (non-European Community), the labor force grew considerably scarcer and began to exert an upward pressure on wages to compensate. Normally, under free-market mechanisms, this cost would be passed directly on to consumers, but due to government constraints and anti-inflationary policies, an upward revaluation of the DM had to be undertaken.[58] Generally speaking, immigration can affect the balance of payments in four ways: 1) inflation rate (depending on the exchange rate regime), 2) direct effect of increased demand and production, 3) remittances, and 4) net balance of payments effects of immigration-induced investment.[59] This balance of payments imbalance could prove to become a long-term problem, as the economy is now too large for the outflow of foreign services, transfer payments to the families of Gastarbeiter, outflows of capital investment, and tourism. If exports start to falter significantly, the overall payments schedule could show negative. Further signs of difficulties on the horizon include enormous bank exposure

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[51] *Op. cit.*, Burtenshaw, p. 26.

[52] *Op. cit.*, Grosser, p. 175.

[53] *Op. cit.*, Blitz, p. 484.

[54] *Op. cit.*, Blitz, p. 479.

[55] *Ibid.*, p. 485.

[56] *Ibid.*, p. 485.

[57] *Ibid.*, p. 483.

[58] *Op. cit.*, Calleo, pp. 191-2.

[59] *Op. cit.*, Macmillan, p. 267.

to East bloc loan defaults, and an increasingly large federal budget deficit (instigated by US prodding) which now approaches 3 percent of the GNP.[60]

In response to the threatening storm clouds gathering on the horizon, the FRG "began restricting the issue of entry permits for foreigners in 1973 and by July 1976 the total number of foreigners had fallen to 3.76 million, among whom Turks, Yugoslavs and Italians were the most prominent. In theory, all could be sent home in acute economic (German unemployment). In practice, however, the task is not as easily accomplished — since many workers also brought their families and are regarded as part of the permanent population, and do the chores that Germans rather despise."[61]

In addition, despite a massive state effort to restructure certain particularly vulnerable industries, "the jobless figure has remained remarkably low," despite low-cost competition from the Mediterranean members of the EC. "West Germany's textile industry is now oriented to high fashion, steel toward high-grade specialty alloy, shipbuilding away from supertankers to small specialised vessels."[62]

The restructuring process will not be an easy task, but a vital one requiring the Konzierte Aktion of all the relevant sectors to preserve the German economy. The long periods of prosperity fueled by export-led growth has meant that important and long-needed structural changes have been put off. The need is now to establish a "parity" among a more diverse blend of the sectors of the economy, for it appears likely that the counter-cyclical ability of the export sector to maintain economic stability is near its end. "The very success of the export sector has undermined some of the foundations upon which it was built — economic strength has increasingly become a source of vulnerability," according to Kriele. The answer to the dilemma is political in nature. The primacy of the export sector as the champion of three decades of spectacular growth will have to be augmented to accommodate the changed circumstances of the era of stagflation. The basic balance will have to be attended to, and the state will have to take a more active or interventionist role in the shaping of the economic policies of the future. The promotion of long-term capital exports is already establishing a trend. The present trends towards increased protectionism and "trade wars" will have to be halted to avert imminent danger. The opening-up of major new markets will have to be carefully considered in terms of the long-term geopolitical consequences (not an easy take for the FRG, where millions of jobs already lie at stake on the successful completion of the Siberian gas pipeline, not to mention the solvency of the bulk of the Western world's financial institutions imperiled by defaultation of the biggest borrowers — the East bloc and the Third World).

The first steps have been taken in the re-tooling process. It now remains to be seen whether the coming decades will bring the same magnitude of prosperity enjoyed during the last several decades.

[60]*Op. cit.*, Calleo, pp. 193-4.

[61]Michael Balfour, *West Germany*, NY: St. Martin's, pp. 261-2.

[62]*Op. cit., Time*, 11 June 1979, p. 30.

REVIEW OF BOOKS

The Political Economy of International Monetary Interdependence. Koichi Hamada. (Cambridge, Massachusetts, MIT Press, 1985, 187 pages).

Watch the products and cars go by: silverware from Taiwan, fine fabrics from Korea, autos from just about everywhere. Can anyone doubt the ubiquity of interdependence between national economies?

Hamada discusses two large and important questions that bear directly on this demonstrated interdependence among trading nations. First, how does the choice of an international monetary regime (e.g. gold standard, fixed or floating exchange rates, or a blend) affect interdependence and the resulting distribution of economic welfare among nations; and, second, what kind of international monetary regime is both desirable and feasible? Faced with questions such as these, one longs for a change of name from "economics" back to "Political economy."

The first three chapters discuss the range of incentives available to nations which might motivate them to adopt a particular monetary regime. The remaining six chapters consider in some (and occasionally mathematical) detail how exchange rate regimes affect policy interdependence. An eight-page bibliography is provided of works both in Japanese (the book titles are transliterated into the Roman alphabet and then translated into English) and English. The translation is excellent throughout.

As trade between nations grows, the problem of settling international transactions becomes ever more complex. The international monetary system used to settle these transactions has both political and economic effects on such matters as levels of production, economic growth, inflation, and the distribution of income between rich and poor both internally and in the world economy. Lacking a world government, the international monetary system must be based on consensus — which presents other problems. Ideal systems proposed by economists tend to lack political feasibility, yet the sheer strength of the major trading nations — the United States, Germany, France, Japan, and members of the European Economic Community — requires that all nations consider the possible reactions of these powerful nations to changes in policy.

Political behavior thus takes its place as one determinant of economic behavior (and the reverse is also undeniably true). For example, a nation beset with recession and rising unemployment may deliberately increase its own rate of monetary growth above the international average. The result is a higher level of production and consumption domestically at the cost of inducing higher inflation rates for its trading partners. Worst of all, those nations who value their own assets in terms of the monetary unit of the inflation-inducing maverick will find the purchasing power of those assets reduced as prices rise. If the transmission of such undesirable economic effects are to be prevented or dampened, some difficulty may be experienced in obtaining a policy consensus as each nation first seeks to pursue its own self interest.

Significant benefits can be derived from the integration of a group of nations into a single currency area. Monetary unions of this kind are by no means new. One of the most successful was the Scandinavian Monetary Union established in 1873 by Sweden and Denmark, and joined in 1875 by Norway. Banks of the three nations accepted one another's notes at par and exchanged deposits. Regrettably, this highly successful experience in monetary integration was ended by the dislocations of World War I.

Think of the sheer convenience of not being required to exchange currencies as the tourist or business traveler passes national boundaries. Think of the losses that would not be sustained from fluctuations in exchange rates. Think of the savings resulting from not keeping foreign exchange reserves in several different currencies. And one might even consider the increased prestige which could result from cooperation in so enlightened an arrangement.

Unfortunately, such membership also carries some political and economic costs. The loss of monetary independence makes internal adjustments difficult when trying to curb domestic inflation or unemployment. Adjustments in open economies (i.e. economies with large import and export flows) may be fairly small; but Hamada feels that closed economies (i.e. nations whose foreign trade is a relatively small proportion of the gross national product) might find it necessary to make large adjustments internally in response to international economic changes from which they can no longer insulate themselves. Worst of all, a member nation, pressed by domestic problems, may take actions which will leave all nations worse off. One can envision a Minister of Economics attempting to control a domestic recession by increasing the money supply while walking the knife edge that would not transmit this "controlled" inflation to other nations.

A blend of politics and economics is almost inescapable in such an interdependent world. Hamada analyzes the implications of such a world by applying the methodology of economics to political science. For example, consider the economico-political Rational Theory of Participation. This theory contends that a decision unit decides whether or not to participate in some collective action by balancing expected benefits and costs. Participation is ensured if this calculation indicates that benefits will exceed costs. Unfortunately, some economic decision units embrace entire nations and thus the decision-making process is dyed with bright political hues. These units also frequently lack uniformity of composition and opinions concerning joining in the collective action may differ broadly. Trying to balance the opinions of widely divergent interest groups may make a decision impossible no matter how desirable the proposed collective action may be.

Monetary integration is a good example of an application of the economic Theory of Clubs. This theory argues that optimal action will be taken when the advantages of membership can be restricted only to members. If the benefits of joining a monetary union can be restricted to its members, the politicians in charge may have an easier time getting the needed policies adopted. This, of course, assumes that the politicians involved are aware of both political and economic benefits. Such an awareness is occasionally difficult to ensure or achieve.

Hamada does not attempt to describe the policies or structure of the ideal monetary regime. Rather, he lists the matters to be considered in choosing an international monetary policy and what is most likely to emerge.

Under a "clean," or completely flexible, system of floating exchange rates in which the forces of supply and demand in the money markets determine the price of a national currency, price levels are determined by the rate of monetary expansion. Under a "dirty," or system in which exchange rates are permitted to fluctuate within limits set by each nation for its own monetary unit, system intervention by central banks to maintain the integrity of the limits can transmit economic fluctuations to other nations. Return to either the gold standard or a system of fixed exchange rates is now unlikely given the experience most nations have had under these monetary regimes.

Hamada is thus led inexorably to the integrated monetary union in which all member nations use a single currency unit as the most advantageous regime. Lacking political integration, however, such an ideal is probably impossible given the current climate of national independence in policy-making. The best we can expect for the foreseeable future is a continuation of the system of managed floating exchange rates until either a massive education program persuades the political authorities of the economic and political advantages of a monetary union, or some unthinkable international disaster forces this conclusion on national leaders. The considerable amount of analytical work in this area reported by Hamada does give some hope that the sheer weight of logic and reason will encourage movement toward the consensus needed. For the moment, the realities of interdependence will continue to build, perhaps to the extent that the education of world leaders will preclude the disaster.

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Game Plan: A Geostrategic Framework For the Conduct of the U.S.-Soviet Contest. Zbigniew Brzezinski. (Boston, Atlantic Monthly Press, 1983, 288 pages).

Among the many recent publications on U.S.-Soviet relations, Brzezinski's book deserves special attention, particularly at a time when these relations have reached an unusual, controversial, and highly conflictive momentum. This book presents a comprehensive perspective on America's most crucial security problems since World-War II — coping with the Soviet Union — and a corresponding discussion of U.S. strategy for a long-term competition with the Soviet Union.

The author, upon reviewing the historical background of the contest between the two "empires", suggests that this competition has taken place along three major fronts: 1) Europe, 2) Far East, and 3) Southwest Asia. He also indicates the high probability of extending this competition to Central America. On each of these three, and possibly four, major fronts, according to Brzezinski, there is a pair of states (Poland and Germany; South Korea and the Philippines; Iran and Pakistan) where a change in their alignment could deeply influence the current balance, not only in the respective region, but also on a global scale. The author provides further an overview of the forces arrayed on either side evaluating the contest in each region, particulary from the vantage point of the Soviet Union. In this competition, Brzezinski portrays the Soviet Union's behavior as a consequence of its socio-cultural and political roots: "Soviet intentions derive from the historical desire to achieve a preeminent global standing".

On the other hand, he limits the role of Communist ideology in Soviet expansionism. Consequently, he postulates as a *conditio sine qua non* the study of the Russian Empire first when analyzing the current Soviet system in some or all of its dimensions.

Contrary to that position, Brzezinski advocates that the U.S.A. should review and use its ideology as a successful weapon against Soviet expansionism in order to win the struggle for global hegemony. He anticipates that in this contest the U.S.A. will succeed if its ideological forces will be skillfully deployed. Furthermore, Brzezinski's optimism leads him to the conclusion that a nuclear war or even a limited conventional war won't be caused by this ongoing competition. Strong diplomacy and effective ideological influencing of other nations by the U.S.A. are the only ways to stop the Soviets as well as prevent "The Day After".

Undoubtedly , Brzezinski's *Game Plan* represents a fine example of a genuine and comprehensive scholarship. However, the author's subjective perspective proposal for resolving the continuing conflict between the two super-powers limits this interesting work to another "green table consideration" only. Brzezinski fails to provide a realistic analysis of both super powers, particularly of the military environment which has been created by both parties as well as their respective allies. His military analysis is far from the reality which eventually might influence actions on both sides if other means in the competition would fail, thus leading to an undesired global scale confrontation.

Despite its limitations, Brzezinski's work constitutes a great asset among the books on the complexity of U.S.-Soviet relations. Therefore, it should be studied by scholars and politicians aspiring to understand and eventually resolve the growing tensions between the U.S.A. and the Soviet Union.

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